No. 18-16053
(Before the Honorable Carlos F. Lucero,
Consuelo M. Callahan and Bridget S. Bade
Opinion filed April 28, 2020)

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JUDITH BADGLEY,
Plaintiff – Appellant,
v.

COMMISSIONER OF INTERNAL REVENUE,
Defendant – Appellee.

Appeal from the United States District Court
for the Northern District of California
No. 4:17-cv-00877-HSG

PETITION FOR REHEARING *EN BANC* OF PETITIONER-APPELLANT JUDITH BADGLEY

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
Counsel for Plaintiff-Appellant

TABLE OF CONTENTS

Page

Page

Appendices

TABLE OF AUTHORITIES

Page(s)

FEDERAL CASES

TAX COURT CASES

Page(s)

FEDERAL STATUTES

REGULATIONS

PERIODICALS

Page(s)

OTHER AUTHORITIES

INTRODUCTION AND RULE 35(b) STATEMENT

Appellant Badgley's appeal concerns an exceptionally important question of first impression on the interpretation of § 2036(a)(1) of the Internal Revenue Code.[1] Section 2036(a)(1), which is sometimes referred to as a "strings section," addresses whether property that a taxpayer transfers during her life may be pulled back into the transferor's gross estate for estate tax purposes (i.e., pulled back into the estate by one of the "strings" § 2036(a)(1) identifies) after her death. Specifically, § 2036(a)(1) provides that a decedent's gross estate will include the value of property that the decedent has transferred (except a bona fide sale for adequate and full consideration) if the decedent retained for life, or a period not ending before the decedent's death, the "possession or enjoyment" of, or the "right to the income" from, the transferred property.

A panel of this Court affirmed a decision of the District Court on an important issue concerning § 2036(a)(1): the applicability of § 2036(a)(1) and its three strings to a qualified annuity interest (as defined in § 2702) from a grantor retained annuity trust, or GRAT.

---

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1986 (26 U.S.C.) (the "Code"), as amended and in effect with respect to the time in question.

Even though § 2702 authorizing GRATs was enacted in 1990, and GRATs have been a widely-used estate planning tool for decades, there is no judicial precedent addressing the application of § 2036(a)(1) to GRATs. Thus, the decision in this case will settle an open question with potentially far reaching consequences.

The panel's decision affirming the District Court is based upon a superficially appealing legal theory which, upon analysis, is untenable. The decision also creates an internal and inter-circuit conflict, and upends established positions of the IRS as well as settled understandings among taxpayers and tax professionals on what constitutes retention of a "right to income" from or "enjoyment" of transferred property.

The most important legal issue in this case to which the parties and the District Court directed almost their entire attention, is whether a retained right to receive an annuity from a GRAT, where the payments can be fully satisfied from GRAT principal, constitutes a retained "right to income" from the GRAT under § 2036(a)(1). Remarkably, the panel elected not to address this central issue. The panel instead affirmed the District Court on the basis of a legal theory to which it and the parties gave only cursory attention: that a retained

annuity constitutes retained "enjoyment" of the GRAT corpus within the meaning of § 2036(a)(1). Op. 17, fn.6. Adoption of this theory allowed the panel to affirm the District Court without having to face the issue to which the parties devoted the bulk of their briefing and oral argument; namely, whether a retained annuity constitutes a retained "right to income" from the transferred property.

Instead, the panel adopted a rule that a retained annuity constitutes retained "enjoyment." The inference from prior decisional authority and the comments of Treasury and the Internal Revenue Service ("IRS") on their own regulation is that they do not themselves support such a sweeping rule, which effectively nullifies the retained "right to income" string under section 2036(a)(1). Importantly, there is nothing in the panel's decision that limits the application of its rule to GRATs. Private annuity and installment sale transactions (i.e., sales of property in exchange for a series of future payments) previously believed to be safe from estate inclusion under § 2036(a)(1) are placed in jeopardy by the panel's decision.

The panel gave no explanation for avoiding the central issue in this case. However, it can reasonably be inferred that, faced with the fact that the word "income" is unambiguous, the panel settled upon its

"retained-annuity-constitutes-retained-enjoyment" theory as a way to affirm the District Court without having to confront the decision of the Supreme Court in *Wisconsin Cent. Ltd. v. United States*, 138 S. Ct. 2067 (2018), which holds that a court is bound by the plain meaning of an unambiguous word in a statute and may not give it a different meaning in order to satisfy what the court believes to be the purpose of the statute. In other words, unwilling to reverse the District Court because it believed the District Court had arrived at the right result but for the wrong reason, the panel adopted a novel, superficially appealing, but ultimately untenable legal theory.

Further, the panel elected not to address Badgley's argument that Treasury Regulation § 20.2036-1(c)(2)(i) (the "Regulation"), as yet untested in the courts, is contrary to the plain language of § 2036(a)(1) and is invalid as applied to a GRAT where the annuity payments can be fully satisfied out of principal without touching income. Op. 19, fn.7. Finally, the panel refused to consider Badgley's argument that the formula the Regulation prescribes for determining the portion of the corpus of a fixed-term GRAT includable in a grantor's gross estate is arbitrary, holding Badgley waived this issue for failing to cite supporting legal authority. Op. 19.

This was manifest error. There is no such legal authority; the Regulation and the formula speak for themselves, and the formula's flaw is self-evident.

A decision which avoids the most important issue in a case of first impression concerning a section of the Code that impacts a significant amount of tax planning, which case involves an untested regulation, should not be allowed to stand. The Court should rehear the case *en banc*.

STATEMENT

A. Factual Background

Patricia Yoder ("Yoder") created a GRAT in 1998 with a 15-year term that would expire in January 2013. She transferred to the GRAT a 50 percent general partner interest in Y&Y Co., a family partnership. At the time of funding, Y&Y Co. held three rental real estate properties in southern California. The gift value of the Y&Y Co. partnership interest when transferred to the GRAT in 1998 was $2,418,075. The trust agreement called for Yoder to receive an annual annuity of 12.5 percent of such value, or $302,259 per year, payable in quarterly installments of $75,565.

As a result of the profitable performance of the rental real estate

in the Y&Y Co. partnership, distributions of partnership income to the GRAT each year far exceeded the fixed annuity paid out to Yoder. The value of the this GRAT grew over the years. The GRAT assets at Yoder's death consisted of the Y&Y Co. partnership interest (valued at $6,409,000); $1,384,558 held in a bank account; and $3,193,471 held in an investment account.[2] Yoder died in November 2012 with only one quarterly payment remaining on her annuity interest. At Yoder's death the rate under § 7520 had declined to a historically low 1%.[3] The formula prescribed in the Regulation produced a value greatly in excess of the value of the GRAT assets at Yoder's death, but under the ceiling limitation in the Regulation, the includable value was limited to the total value of the GRAT assets.

Appellant Badgley ("Badgley"), in her capacity as statutory executor of the estate, filed a federal estate tax return including in the gross estate the total value of the GRAT's assets. The estate paid $11,187,475 in taxes, and then filed a claim for refund for $3,810,004 on the ground that Yoder's retained annuity was not covered by

---

[2] The panel states "The only property in the GRAT was the partnership interest, ..." Op. 17), which is categorically untrue.

[3] Section 7520 sets interest rates for various purposes described in the Code, which rates are based upon market yields from marketable obligations such as Treasury Bills.

§ 2036(a)(1). The IRS took no action on the refund claim within six months and Badgley filed a refund action in the District Court.

B. Statutory and Regulatory Background

In the case of a GRAT, § 2036(a)(1) will cause the assets of the GRAT to be included in the grantor's gross estate if and only if it can be shown that the grantor's retained annuity interest constituted either (1) the possession or enjoyment of the trust property or properties, or (2) the right to income from the trust property or properties. In other words, if the grantor retained any of these three "strings," the transferred asset(s) will be pulled back into the taxable estate by the string the grantor retained.

C. The Regulation

Prior to the promulgation of the Regulation, neither the Code nor any prior regulation addressed how the "right to income" language in § 2036(a)(1) would be interpreted if the interest retained were something other than an express right to the income from the transferred property, such as a right to receive an annuity. In 2008,[4] years after GRATs came into wider use following the enactment of

[4] The Regulation was issued a decade after Yoder created and funded her GRAT at issue here.

§ 2702 in 1990,[5] Treasury promulgated the Regulation to provide guidance to taxpayers and their advisors as to the treatment of retained annuities for estate tax purposes. The Regulation provides, based upon the doctrine of substance over form, that a retained right to an annuity from a GRAT constitutes a retained right to income from the property transferred to the GRAT within the meaning of § 2036(a)(1). One commentator participating in the notice-and-comment process recommended that an annuity interest where trust principal alone was sufficient to fully satisfy the annuity payment should not be treated as a retained right to income. Treasury rejected this recommendation as bad policy because it would condition estate tax treatment on the nature and performance of investments selected by the trustee. Treasury believed that the application of § 2036(a)(1) 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 on the actual performance of the trust assets.[6]

Regarding GRATs, the singular focus of the Preamble is on the "right to income" language of § 2036(a)(1). That singular focus on

---

[5] Omnibus Budget Reconciliation Act of 1990 (P.L. 1011-508).

[6] Treasury Decision 9414, 73 FR 40173-40179, July 14, 2008 ("Preamble").

the "right to income" string implicitly negates the applicability of the "possession or enjoyment" language. It is particularly noteworthy that Treasury did not reject the commentator's recommendation on the ground that because a retained right to an annuity constitutes retained "enjoyment" of the property, the income/principal mix of the payment is irrelevant. If Treasury believed that a retained annuity constituted retained "enjoyment," then Treasury would not have needed to discuss the policy concern, because the grantor's "enjoyment" of the granted property would not be affected by the choice or performance of the trust assets. It must be presumed that Treasury did not engage in an idle act by addressing the policy concern. Thus, the Preamble must be interpreted as implicitly ruling out the panel's "retained-annuity-constitutes-retained-enjoyment" legal theory.

D. The District Court's Decision

Badgley argued to the District Court that no portion of the GRAT value was includable in Yoder's gross estate under § 2036(a)(1), because the statute does not apply to an annuity which can be fully satisfied from principal; and to the extent the Regulation provides otherwise, it is overly broad and an invalid interpretation of the statute. In other words, to the extent the regulation provides

otherwise, it is an impermissible attempt by Treasury to legislate by regulation.

There being no material factual disputes, Badgley and Appellee filed cross motions for summary judgment. Badgley argued that as a matter of form an annuity is not the same as income, and as a matter of substance, absent an ordering rule (i.e., a rule that income must be used first to satisfy the annuity, then principal), an annuity right is not the same as a right to income where the annuity payment can be fully satisfied from principal.

The District Court agreed with the parties that there was no judicial precedent addressing the application of § 2036(a)(1) to GRATs, and looked to dicta from aging Supreme Court decisions for interpretation of the statute. None of these cases involved a settlor of a trust retaining an annuity interest. Nevertheless, the District Court concluded that the Supreme Court had developed a substance-over-form approach for determining when retained economic rights will cause the estate to include trust assets, which approach should govern the annuity interest in a GRAT.

The District Court addressed the "enjoyment" language of § 2036(a)(1) only in passing because of the fact that Yoder, in her

fiduciary capacity as the Trustee of the GRAT, remained in possession of the Y&Y Co. partnership interest until a few days prior to her death. However, relying on its substance-over-form approach, the District Court did not feel constrained by the literal terms of either test under the statute.

E. The Panel's Decision

The panel affirmed the District Court, but not on the "right to income" language on which the District Court primarily focused. Instead it affirmed on the ground that a retained annuity constitutes retained "enjoyment" within the meaning of § 2036(a)(1).

Further, the panel refused to address the interpretation and validity of the Regulation, i.e., (1) whether or not the Regulation bases estate includability of GRAT corpus on the term "enjoyment" as opposed to the "right to income" language of § 2036(a)(1), and (2) if based on the "right to income" language, whether the Regulation is valid as applied to a retained annuity which can be fully satisfied from principal. Op. 19, fn.7. It can reasonably be inferred from the panel's refusal to address the "right to income" language that the panel agreed that the word "income" is unambiguous and not synonymous with an annuity.

REASONS FOR GRANTING THE PETITION

I. THE PANEL'S DECISION ON THE EXCEPTIONALLY IMPORTANT ISSUE BEFORE IT THREATENS TO UPSET SETTLED PRINCIPLES OF ESTATE TAX LAW

It has been a settled feature of estate tax law regarding private annuity and installment sale transactions that, based upon the principle set forth by the Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), only the right to income language in § 2036(a)(1) (i.e., the "right to income" string) must be avoided in order to escape estate inclusion.[7]

In *Fidelity-Philadelphia*, the Supreme Court sought to create a principle that could be used in distinguish between a sale (or exchange), on the one hand, and a transfer where the transferor retains a right to receive fixed payments that in substance is equivalent to the

[7] *Commissioner v. Clise*, 122 F.2d 998 (9th Cir. 1941) cited by the panel, pre-dated *Fidelity-Philadelphia* and dealt with joint and survivor annuity contracts (the estate tax treatment of which is today governed by § 2039) where the decedent's death is the generating event, i.e. survival of the decedent is necessary for the second annuitants to possess and enjoy the property. The Court held that the economic benefit of the annuity contracts which the decedent reserved to herself during her lifetime constituted enjoyment of the transferred property. The Court's analogy to a trust where the grantor reserved an annuity for life is not only dicta, but has no relevance to a GRAT with a fixed term where the expiration of the term, not the death of the decedent, is the generating event.

retention of the right to receive income, on the other. The Court indicated that, if three conditions are satisfied, and even if the bona fide sale exception could not be satisfied, the transaction should be viewed as a sale and the decedent should not be treated as having retained a right to income under § 2036(a)(1) leading to inclusion of the transferred property in the decedent's gross estate:

(1) The obligation to make payments to the decedent is not chargeable to the transferred property.

(2) The obligation is the transferee's personal obligation.

(3) The amounts payable to the decedent is not dependent on the actual amount of income generated by the transferred property.

Taxpayers and tax professionals thereafter concluded that section 2036(a)(1) inclusion could be avoided by satisfying the three conditions announced in *Fidelity-Philadelphia*.[8] While the Supreme

---

[8] *See e.g.* Whitty, *Heresy or Prophecy*: *The Case for Limiting Estate Tax Inclusion of GRATS to the Annuity Payment Right*, 41 Real Property, Probate and Trust Journal 381 (2006); Gans and Blattmachr, *Private Annuities and Installment Sales*: *Trombetta and Section 2036*, Journal of Taxation 227 (May 2014); Gans and Blattmachr, *Treatment of GRATS under the Section 2036 Proposed Regulations-Questions Remain*, Journal of Taxation 143 (September 2007); Blattmachr, Gans and Zeydel, *Final Regulations on Estate Tax Inclusion for GRATS and Similar Arrangements Leave Open Issues*, 109 Journal of Taxation 217, (October, 2008); Whitty, *GRAT Expectations: Questioning, Challenging, and Litigating the Service Position on*

Court in *Fidelity-Philadelphia* formulated this principle in the context of discussing an annuity transaction, the IRS has indicated that it applies to installment sales as well even if the decedent died before the note was fully discharged and even if the bona fide sale exception could not be satisfied.[9]

Neither Treasury nor the IRS have ever advanced the panel's "retained-annuity-constitutes-retained-enjoyment" theory. Based upon IRS Revenue Rulings dealing with annuities in contexts other than GRATs,[10] as well as on *Fidelity-Philadelphia*, the only concern of taxpayers and tax professionals was the interpretation of the "right to income" language in § 2036(a)(1) as applied to GRATs. Neither those Revenue Rulings nor *Fidelity-Philadelphia* gave the slightest hint that the term "enjoyment" might apply to retained annuities.

Treasury and the IRS have never made clear why, when faced with the question of the tax treatment of a retained annuity under

---

Estate Tax Inclusion of Grantor Retained Annuity Trusts, 36 ACTEC Journal, No. 1, 87 (Summer 2010).

[9] Rev. Rul. 77-193, 1977-1 C.B. 273.

[10] *See e.g.* Rev. Rul. 82-105, 1982–1 C.B. 133, where the IRS, asked to rule on the nature of a retained annuity under a charitable retained annuity trust, or CRAT, a close cousin of a GRAT, held that the annuity constituted a retained right to income from a portion of the transferred property, never mentioning retained enjoyment.

§ 2036(a)(1), they have always considered the issue to be whether the retained annuity constituted a retained right to income, and never whether it constituted retained "enjoyment." However, it can be inferred that it was because they considered the "enjoyment" theory to be untenable due to the fact that, unless the annuity was treated as income, it would be impossible to identify the "enjoyed" property or portion thereof properly includable in the annuitant's estate. *See* III *infra* pp. 19-21.

Nothing in the panel's decision limits the "enjoyment" theory to GRATs. Taxpayers and tax professionals never considered that, even if the *Fidelity-Philadelphia* criteria were satisfied, there might nevertheless be a risk that a retained annuity or installment note would be treated as retained enjoyment of the transferred property. Such a position would also be contrary to the general understanding derived from existing case law.[11] Note that this general understanding is reinforced by the Regulation which, in the case of a retained annuity, prescribes a formula to determine the amount of the GRAT corpus

[11] Cf. *LaFargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982) [transfer to a GRAT was a sale in exchange for an annuity; the annuity payments were consideration for the transferred property and thus not income taxable to the grantor under § 677].

necessary "to produce sufficient *income* to satisfy the retained annuity....". [emphasis added]

The panel, however, bypassed the "right to income" language of § 2036(a)(1) in favor of the term "enjoyment." The panel's novel interpretation of the statute ignores (i) the formula prescribed in the Regulation, (ii) the conclusion of the IRS in Revenue Ruling 82-105 that an annuity constitutes income, and (iii) the disjunctive syntax of Regulation itself.

The consequences of the panel's novel theory are potentially far-reaching. If the decision is allowed to stand, taxpayers and tax professionals who previously relied upon the *Fidelity-Philadelphia* criteria now must determine how to avoid "enjoyment" as well as "right to income." Moreover, the impact of the panel's decision will become even greater in the future if proposed legislation is enacted which will set the minimum term of a GRAT at ten years.[12]

II. THE PANEL'S DECISION IS IRRECONCILABLE WITH EXISTING CASE LAW AND PREVENTS UNIFORM APPLICATION OF THE ESTATE TAX LAW

The panel's decision flies in the face of the statement in *United States v. Byrum*, 408 U.S. 125 (1972) that "the terms 'possession' and

[12] *See* H.R. 4849 and H.R. 5297.

'enjoyment' used in § 2036(a)(1) were used to deal with situations in which the owner of property divested himself of title but retained an income interest or, in the case of real property, the lifetime use of the property." *Id.* at 147. The decision also contradicts the statement in *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2d Cir 1993) that "possession" and "enjoyment" have been interpreted to mean "the lifetime use of the property." *Id.* at 593.

Moreover, in *Estate of Becklenberg v. Commissioner*, 273 F.2d 297 (7th Cir. 2007) a case much like this case, the Seventh Circuit Court of Appeal reversed a holding of the Tax Court that the retention of a right to an annuity which, at the discretion of the trustee, could be paid from either corpus or income was a retention of a right to income[13] holding that a retained annuity that could be paid from principal did not constitute a retained right to income. The IRS never argued that even if it did not constitute a right to income, the retained annuity constituted retained enjoyment of the contributed property, which, according to the panel, would have been a winning argument. It must be assumed that the IRS did not overlook the argument, but

[13] *Estate of Becklenberg v. Commissioner*, 31 T.C. 402 (1958), at 410).

failed to make it because it knew that its reach would be too extensive and that it was untenable. Similarly in *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985) this Court concluded that the transaction at issue was not a true annuity arrangement because of the "tie" between the amount of the payments and the trust income. If the panel is correct that a retained annuity constitutes retained "enjoyment," that would have been a much simpler and straightforward ground upon which this Court could have held in favor of the IRS. The failure of the IRS to advance the "enjoyment" theory shows again that the IRS knows better. Thus, the panel's decision has created an intra-circuit conflict and has put the Ninth Circuit in conflict with the Seventh Circuit.

The reliance by the District Court and the panel 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 § 2036(a)(1) required the right to income to be legally binding, and the Court held that it did not. The only relevance of *Estate* of *McNichol* in this case is its observation 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. Before the *Estate of McNichol* enjoyment principle can apply, it must first be determined that the taxpayer has a right to the income from the transferred property.

Case law makes clear that there can be no "enjoyment" of the property in the absence of actual possession, present use, or a right to the income therefrom. Thus, Yoder cannot be held to have retained the enjoyment of the Y&Y Co. partnership interest unless she retained a right to the income from it, which she did not.

En banc review is warranted in order to ensure the uniform and properly limited application of § 2036(a)(1).

III. THE FORMULA PRESCRIBED IN THE REGULATION IS COMPLETELY UNSUITABLE IF ESTATE INCLUDABILITY IS BASED ON "ENJOYMENT," AND LEADS TO DISPARATE TREATMENT OF SIMILARLY SITUATED TAXPAYERS IF BASED ON "RIGHT TO INCOME"

Under § 2036(a)(1), if "enjoyment" of property is retained, the date-of-death value of the "enjoyed" property is includable in the transferor's estate. This presents no problem if there is only one property and "enjoyment" is based on a right to income, as was the case in *Estate of McNichol v. Commissioner*, *supra*. However, in the case of a GRAT such as Yoder's GRAT, which at the grantor's death

owns multiple properties, if estate includability is to be based on retained "enjoyment" and not on a right to income it is impossible to determine which of the "enjoyed" properties or portions thereof is includable in the grantor's estate. The formula prescribed in the Regulation is completely unsuitable for doing so because that formula is based on an income equivalence test and produces a value equal to or greater than the full value of the GRAT properties. As stated, *supra*, in this case the formula produced a value for exceeding the total value of the GRAT properties at Yoder's death.

The Regulation treats reserved annuities from GRATS as rights to income and mandates that every such annuity interest must be valued for estate inclusion purposes as if it were an annuity in perpetuity even if, as in Yoder's case, the GRAT has a fixed term. Under the formula, the amount includable in the grantor's estate is that amount of corpus necessary to generate an income equal to the amount of the annuity payment, by dividing the amount of the annuity by the § 7520 rate in effect for the month of death, whether the payment is from income or corpus, or both.

In this case Yoder died just before the termination of the GRAT term with one quarterly payment remaining unpaid. It certainly does

not take $10,987,029 of principal to satisfy a remaining annuity payment of $75,565 unless the principal of the trust can never be deemed to be invaded for the annuity payments.

It is self-evident that in the case of a fixed-term GRAT where includability in the decedent's estate is based upon a retained right to income, a formula designed to determine the amount necessary to support payment of the annuity in perpetuity, without regard to the term of the GRAT, is arbitrary. Moreover, where estate includability is based on retained "enjoyment" as opposed to a retained right to income, such a formula is completely unsuitable.[14] Nevertheless the District Court held the formula prescribed in the Regulation to be reasonable, and the panel refused to review such holding.

[14] For an extended discussion of the arbitrary nature of the formula, and examples of its disparate treatment of similarly situated taxpayers, *see* Whitty, *GRAT Expectations: Questioning, Challenging, and Litigating the Service Position on Estate Tax Inclusion of Grantor Retained Annuity Trusts*, *supra*, pp. 117-122.

CONCLUSION

The District Court got it wrong, and the panel compounded the error by affirming on the ground of a superficially appealing but untenable legal theory. In the absence of actual possession or present use of property, there can be no "enjoyment" of such property within the meaning of section 2036(a)(1) without a right to the income from the property.

The Court should grant rehearing *en banc* and reverse the decision of the District Court.

Dated: May 22, 2020

Respectfully submitted,

/s/ PAUL FREDERIC MARX

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

CERTIFICATE OF COMPLIANCE

1. Pursuant to Fed. R. App. P. 32(a) and Ninth Cir. R. 32-1, the undersigned hereby certifies that the attached brief is proportionally spaced, has a typeface of 14 points or more, and contains 4,013 words, exclusive of the exempted portions of the brief, as provided in Fed. R. App. P. 32(a)(7)(B).

2. The brief has been prepared in proportionally-spaced typeface using Microsoft Office Word 2013 in 14-point Times New Roman font. As permitted by Fed. R. App. P. 32(a)(7)(C), the undersigned has relied upon the word-count feature of this word-processing system in preparing this certificate.

May 22, 2020

/s/ *Paul Frederic Marx*
Paul Frederic Marx
Counsel for Petitioner-Appellee

APPENDIX A

Panel's Opinion

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JUDITH BADGLEY, *Plaintiff-Appellant*, v. UNITED STATES OF AMERICA, *Defendant-Appellee.*	No. 18-16053 D.C. No. 4:17-cv-00877-HSG OPINION

Appeal from the United States District Court
for the Northern District of California
Haywood S. Gilliam, Jr., District Judge, Presiding

Argued and Submitted December 2, 2019
San Francisco, California

Filed April 28, 2020

Before: Carlos F. Lucero,[*] Consuelo M. Callahan,
and Bridget S. Bade, Circuit Judges.

Opinion by Judge Lucero

[*] The Honorable Carlos F. Lucero, United States Circuit Judge for the U.S. Court of Appeals for the Tenth Circuit, sitting by designation.

SUMMARY**

Tax

The panel affirmed the district court's summary judgment in favor of the Internal Revenue Service, in an action challenging the inclusion of a grantor-retained annuity trust in a decedent's gross estate for purposes of the estate tax.

At issue in this appeal was whether, under 26 U.S.C. § 2036(a)(1), a grantor's interest in a grantor-retained annuity trust (GRAT) is a sufficient "string" that requires the property interest to be included in the gross estate.

After Donald Yoder's death, his wife, decedent Patricia Yoder, succeeded to his fifty-percent partnership interest in a family-run company. Decedent created a GRAT to transfer that partnership interest to her daughters, while decedent retained a right to an annuity paid from the GRAT for 15 years. Decedent died before the end of the 15-year annuity period. The estate tax return reported a total gross estate that included the GRAT's assets. The statutory executor of the estate, daughter Judith Badgley, filed a tax refund action in district court, asserting an overpayment resulting from the inclusion of the entire date-of-death value of the GRAT in the gross estate, and arguing that only the net present value of the unpaid annuity payments should have been included. The district court held that, because the decedent's retained annuity interest was both a retained right to income from and continued enjoyment of the property, the

** This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

entire date-of-death value of the GRAT should be included in the gross estate.

The panel first rejected appellant's argument that, because 26 U.S.C. § 2036(a)(1) does not expressly mention annuities, the full value of decedent's GRAT cannot be included in the gross estate. The panel explained that in § 2036(a)(1), Congress set forth three "strings" tying a grantor to property, and instructed that we look to the result—possession, enjoyment, or a right to income therefrom—rather than the form those strings take.

The panel next addressed whether the annuity flowing from a GRAT falls within the class intended to be treated as substitutes for wills by § 2036(a)(1). The panel held that it does; to avoid the force of § 2036(a), a grantor must completely divest herself of possession, enjoyment, and income from the property, and the beneficiaries' interest must take effect prior to the grantor's death. The panel concluded that when a grantor derives substantial present economic benefit from property, she retains the enjoyment of that property for purposes of § 2036(a)(1). Here, because decedent's annuity was a "substantial present economic benefit," it stemmed from a property interest placed in the GRAT, it reserved to decedent the enjoyment of that interest during her lifetime, and was not transferred to the beneficiaries before decedent's death, the annuity was required to be included in the GRAT's date-of-death value in the estate.

Finally, the panel addressed appellant's challenges to 26 C.F.R. § 20.2036-1(c)(2), which includes the formula the IRS uses to calculate the portion of the property includable under § 2036(a). The panel concluded that, even if this challenge were not waived by the cursory manner in which it was raised on appeal, it would not apply in this case.

COUNSEL

Paul Frederic Marx (argued), Rutan & Tucker LLP, Costa Mesa, California, for Plaintiff-Appellant.

Nathaniel S. Pollock (argued) and Teresa E. McLaughlin, Attorneys; Richard E. Zuckerman, Principal Deputy Assistant General; Tax Division, United States Department of Justice, Washington, D.C.; for Defendant-Appellee.

OPINION

LUCERO, Circuit Judge:

Thanks to Benjamin Franklin, death and taxes are inextricably linked in most Americans' minds as the only two things in this world that are certain. Thanks to the estate tax, certainty is not the only tie. For the duration of its existence, taxpayers have attempted to avoid the estate tax by utilizing a variety of legal mechanisms to transfer property during their lifetimes while holding onto the fruits of that property. In response to taxpayers' impulse to retain a legal interest in the property despite the transfer, Congress enacted what is now 26 U.S.C. § 2036(a).

At the most colloquial level, § 2036(a) stands for the proposition that if the taxpayer does not let property go, neither will the taxman. It delineates three criteria—possession, enjoyment, and a right to income—for determining when the connection between a grantor and property is sufficient to require the property's inclusion in the grantor's estate for purposes of the federal estate tax. § 2036(a)(1). Unless a taxpayer "absolutely, unequivocally, irrevocably, and without possible reservations, parts with" her possession of, enjoyment of, or a right to income from the property—leaving no "string" tying her to the property—property transferred inter vivos is included in a decedent's gross estate. *Comm'r v. Church's Estate*, 335 U.S. 632, 645 (1949); *see also Estate of McNichol v. Comm'r*, 265 F.2d 667, 670–73 (3d Cir. 1959).

Judith Badgley challenges the application of § 2036(a) by the Internal Revenue Service ("IRS") to her mother's grantor-retained annuity trust ("GRAT"). The district court granted summary judgment in favor of the IRS. To resolve this appeal, we must determine whether under § 2036(a)(1),

a grantor's interest in a GRAT is a sufficient "string" that requires the property interest to be included in a gross estate. Exercising jurisdiction under 28 U.S.C. § 1291, we affirm, holding that because the grantor retains enjoyment of a GRAT, it is properly included in the gross estate.

I

A GRAT allows a grantor to transfer property to a beneficiary while retaining the right to an annuity from the transferred property. John F. Bergner, 44 U. Miami L. Ctr. on Est. Plan. ¶ 401.1 (2019). The grantor creates an irrevocable grantor trust for a fixed term of years, transfers assets into it, and designates trustees and beneficiaries. She receives an annuity for a specified term of years. *Id.* At the end of the term, the GRAT dissolves and the property is transferred to the beneficiaries. Howard Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis with Forms*, ¶ 12.06(1) (5th ed. 2013 & Supp. 2020).

At the time of transfer into a GRAT, property is subject to a gift tax on the present value of the GRAT's remainder interest, valued according to the methodology in 26 U.S.C. § 7520. *Id.* A reduction in the transferred property's gift value for tax purposes is permitted if the recipient is a family member and the transferor or a family member retains a "qualified interest" in the property, which includes "any interest which consists of the right to receive fixed amounts payable not less frequently than annually." 26 U.S.C. § 2702. For a GRAT, this means that the value of the transferred property subject to the gift tax is lessened by the amount of the retained annuity. Depending on the structure of the GRAT, it is possible to eliminate the applicable gift tax entirely by modifying the trust term and annuity amount to zero out any remainder. Zaritsky, *supra*, ¶ 12.06(3)(c)(i). This permits assets to be transferred to beneficiaries at the

termination of a GRAT's term without the imposition of a gift tax. *Id.* Moreover, if the term of a GRAT ends before the grantor dies, the property is not included in the grantor's gross estate for purposes of the estate tax. *See* § 2036(a).

In this case, Patricia Yoder ("Decedent") was married to Donald Yoder, a fifty-percent partner in Y&Y Company, a family-run general partnership and property development company in southern California. After Mr. Yoder's death in 1990, Decedent succeeded to his fifty-percent partnership interest. In February 1998, Decedent created a GRAT to transfer the partnership interest in Y&Y, valued at $2,418,075, to her daughters, Judith Badgley and Pamela Yoder. The interest was the only property placed in the GRAT. Decedent retained a right to an annuity of $302,259 paid from the GRAT for fifteen years, equivalent to 12.5 percent of the date-of-gift value of the partnership interest. In April 1999, Decedent filed a gift tax return reporting the gift to her daughters of the GRAT's remainder interest and paid a gift tax of $180,606.

Decedent was both the grantor and trustee of the GRAT, with her daughters serving as special trustees. The GRAT instrument provided that the special trustees could make additional distributions to Decedent if requested. At the end of the fifteen-year annuity term or upon her death, whichever occurred earlier, the GRAT's corpus would pass to her daughters. Decedent explained to them that if she did not outlive the fifteen-year annuity term, the partnership interest "would probably go back into her estate" for tax purposes.

From 2002 to 2012, Y&Y reported income ranging from $994,642 to $1,325,478.[1] Half of Y&Y's income was distributed to the GRAT. Y&Y made cash distributions to the GRAT ranging from $435,400 to $730,000. Although neither party identified the source of the annuity payments in a given year, these cash distributions were sufficient to pay the annuity without decreasing the value of the partnership interest or requiring the sale of any of Y&Y's holdings.

Decedent died on November 2, 2012, shortly before the fifteen-year annuity period expired. The estate tax return reported a total gross estate of $36,829,057. This included the GRAT's assets, which consisted of the Y&Y partnership interest (valued at $6,409,000); $1,384,558 held in a bank account; and $3,193,471 held in an investment account. The estate paid $11,187,475 in taxes.

In 2016, Badgley, in her capacity as statutory executor of Decedent's estate, sought a refund of an overpayment of Decedent's estate tax in the amount of $3,810,004. She asserted that the overpayment resulted from the inclusion of the entire date-of-death value of the GRAT in Decedent's gross estate and argued that only the net present value of the unpaid annuity payments should have been included.

The IRS did not act on Badgley's refund claim within six months, and Badgley filed a refund action in district court, as authorized by 26 U.S.C. § 6532(a)(1). Both parties filed motions for summary judgment. The district court denied Badgley's motion and granted the government's cross-motion. It held that Decedent's retained annuity interest was

[1] The parties have not produced evidence of Y&Y's income before 2002.

both a retained right to income from and continued enjoyment of the property. Both "strings" tied the GRAT to Decedent, requiring inclusion of the entire date-of-death value of the GRAT in her gross estate.[2] The court also concluded that 26 C.F.R. § 20.2036-1(c)(2), the Treasury regulation construing § 2036(a)(1) to apply to GRATs, was valid. Badgley timely appealed.

II

We review a district court's order granting or denying summary judgment de novo, examining all evidence in the light most favorable to the non-moving party. *Oswalt v. Resolute Indus., Inc.*, 642 F.3d 856, 859 (9th Cir. 2011). The court "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 & Cas. Co.*, 873 F.2d 1338, 1339–40 (9th Cir. 1989).

Section 2036(a) provides:

> 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

[2] 26 C.F.R. § 20.2036-1(c)(2) caps this amount at the total value of the GRAT's corpus on the date of death rather than the value otherwise calculated under the formula provided in the section.

> 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 . . . .

Id. "The general purpose of the statute [i]s to include in a decedent's gross estate transfers that are essentially testamentary—*i.e.*, transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime." *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969).[3] To this end, a decedent's gross estate includes the value of property transferred while the decedent was alive if the decedent retained possession of, enjoyment of, or the right to income from the property. These three factors—possession, enjoyment, and income—are referred to as "strings" tying the transferor to the property despite the transfer. *See, e.g.*, *United States v. Brown*, 134 F.2d 372, 373 (9th Cir. 1943).

A

At the outset, we address Badgley's argument that because § 2036(a) does not include the term "annuity," it unambiguously does not apply to annuities. In § 2036(a)(1), Congress set forth the three "strings" tying a grantor to property, but did not specify which property interests qualify. One could imagine a version of the statute that

[3] *Estate of Grace* addressed a prior version of § 2036(a), § 811(c) of the Internal Revenue Code of 1939. Section 2036(a) has been amended since its original passage in 1916, but Badgley does not argue that these amendments are substantive.

includes property in the grantor's gross estate if the decedent "retained an annuity drawn from the property" or "lived on the property for more than half a year." But Congress did not include such specifications. Instead, it instructed us to look to the result—possession, enjoyment, or a right to income therefrom—rather than the form those strings take. *See Estate of McNichol*, 265 F.2d at 673 ("[T]he criterion for determining whether property transferred inter vivos is subject to a death tax is the effect of the transfer . . . .").

The fact that § 2036(a)(1) does not include the term "annuity" does not exclude annuities from its ambit. This is consistent with the decisions of the Supreme Court and our sibling circuits, which have concluded that interests such as reversionary interests, the power of appointment, and rent—also not expressly listed in § 2036(a)—nevertheless fall into one of the three categories. *See, e.g.*, *Estate of Spiegel v. Comm'r*, 335 U.S. 701, 705 (1949) (potential reversionary interest in property is possession or enjoyment); *Fid.-Phila. Tr. Co. v. Rothensies*, 324 U.S. 108, 111 (1945) (beneficiaries' estates "took effect in enjoyment" only at transferor's death because she held power of appointment); *Estate of McNichol*, 265 F.2d at 671 (rent from property is enjoyment).

As far back as the 1940s, the Supreme Court rejected the proposition that taxpayers could "escape the force of this section by hiding behind the legal niceties contained in devices and forms created by conveyances." *Church's Estate*, 335 U.S. at 646 (quotation omitted); *see also Fid.-Phila.*, 324 U.S. at 111 ("The application of this tax does not depend upon elusive and subtle casuistries." (quotation omitted)). We reject Badgley's argument that because § 2036(a)(1) does not expressly mention annuities, the full

value of Decedent's GRAT cannot be included in the gross estate.

B

We turn to the main issue: whether the annuity flowing from a GRAT "fall[s] . . . within the class intended to be treated as substitutes for wills" by § 2036(a)(1). *Church's Estate*, 335 U.S. at 646. We need only look to Supreme Court precedent construing the statute to conclude that it does. To avoid the force of § 2036(a), a grantor must "absolutely, unequivocally, and without possible reservations, part[] with all of his title and all of his possession and all of his enjoyment of the transferred property . . . [and the transfer] must be unaffected by whether the grantor lives or dies." *Id.* at 645–46. Thus, § 2036(a)(1) focuses on both the grantor, who must completely divest herself of possession, enjoyment, and income, and the beneficiaries, whose interest must "take effect" prior to the grantor's death. *See id.* at 637.

From the passage of the first federal estate tax in 1916 until the Supreme Court decided *May v. Heiner*, 281 U.S. 238 (1930), the Treasury Department treated trust transfers that distributed the corpus at the grantor's death but reserved a life income to the grantor as falling within the sweep of § 2036(a)'s precursors. *See Church's Estate*, 335 U.S. at 639. In *May*, however, the Court "upset[] the century-old historic meaning and the long standing Treasury interpretation of the 'possession and enjoyment' clause" by holding that "because legal title had passed from the settlor irrevocably when the trust was executed," the retention of income did not constitute an interest in the transferred property. *Id.* at 639–41. Congress quickly corrected the Court, amending the statute to clarify that retention of any possession, enjoyment, or income from the transferred

property rendered the property includable. *See id.* at 639–40 (discussing congressional action following *May*, 281 U.S. at 243); H.R.J. Res. 529, 71st Cong. (1931) (enacted).

The Court deviated from *May*'s holding when it addressed a similar question in *Helvering v. Hallock*, 309 U.S. 106 (1940). *Hallock* held that transfers of property with retained reversionary interests made the transfers contingent upon the decedent's death and thus were "too much akin to testamentary dispositions not to be subjected to the same" estate tax. *Id.* at 112.

In *Church's Estate*, the Court explicitly overruled *May*, holding that retention of the right to income for life from transferred stocks constituted possession or enjoyment of the stocks. 335 U.S. at 637, 641, 644–45. Looking to the historical meaning of "possession or enjoyment," the Court noted its "return[] to the interpretation of the 'possession or enjoyment' section under which an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property."[4] *Id.* at 637–39, 645.

Further, "[i]t is well settled that the terms 'enjoy' and 'enjoyment,' as used in various estate tax statutes, are not

[4] Following *Church's Estate*, Congress passed the Technical Changes Act, which proscribed *retroactive* application of *Church's Estate* to any transfers made prior to March 4, 1931 by a decedent who died prior to January 1, 1950, thereby exempting transfers made in reliance on *May*. *See Comm'r v. Estate of Canfield*, 306 F.2d 1, 4–6 (2d Cir. 1962). In 1953, it extended the exemption to all transfers completed before March 4, 1931, regardless of the decedent's date of death. *See id.* at 5.

terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates." *United States v. Byrum*, 408 U.S. 125, 145 (1972) (quotations omitted); *see also Comm'r v. Estate of Holmes*, 326 U.S. 480, 486 (1945) (same). In *Estate of McNichol*, the Third Circuit held that rent from income-producing real estate constituted enjoyment. 265 F.2d at 671. McNichol had transferred real estate to his children, with an oral agreement to retain the rent from the property. *Id.* at 669. Concluding that "[h]e who receives the rent in fact enjoys the property," the court held that "[t]he conclusion is irresistible that the petitioners' decedent 'enjoyed' the properties until he died" because "one of the most valuable incidents of income-producing real estate is the rent which it yields." *Id.* at 671, 673; *see also Estate of Stewart v. Comm'r*, 617 F.3d 148, 154–55 (2d Cir. 2010) (holding that when determining who retains "substantial present economic benefit," "[a]ll we have to do is follow the money"); *cf. Greene v. United States*, 237 F.2d 848, 853 (7th Cir. 1956) (holding beneficiaries who received income from securities and then paid it to decedent did not have beneficial possession or enjoyment because they "were neither able to retain nor to enjoy the income from the securities").

In *Commissioner v. Clise*, 122 F.2d 998 (9th Cir. 1941), involving annuity contracts outside of the trust context, we concluded that when a grantor retained the "economic benefit" of annuity payments, she retained enjoyment of the property. *Id.* at 999, 1003–04. Because the annuities went to Clise for her lifetime and to a designated second annuitant upon her death, "[t]he practical effect of the annuity contracts was to reserve to [her] the enjoyment of the property transferred and to postpone the fruition of the economic benefits thereof to the second annuitants until her death." *Id.* at 1004; *see also Forster v. Sauber*, 249 F.2d

379, 380 (7th Cir. 1957) (holding retained annuity includable in gross estate because "grantor has retained the economic enjoyment of the contracts for life"); *Mearkle's Estate v. Comm'r*, 129 F.2d 386, 388 (3d Cir. 1942) (holding annuity contracts includable because their practical effect was "to reserve to the annuitant the enjoyment of the property transferred and to postpone the fruition of the economic benefits to the second annuitant until after the death of the first").

We conclude that when a grantor derives substantial present economic benefit from property, she retains the enjoyment of the property for purposes of § 2036(a)(1).[5] As in *Clise*, Decedent's annuity was a "substantial present economic benefit," requiring inclusion of the GRAT's date-of-death value in her estate. She received $302,259 per year for fifteen years through the annuity. Moreover, because the partnership was the only property placed in the GRAT, the annuity stemmed from that property interest. As "something of value enjoyed by her," *Bayliss v. United States*, 326 F.2d 458, 461 (4th Cir. 1964), the annuity reserved to Decedent the enjoyment of the partnership interest during her lifetime. And because Decedent died before the termination of the GRAT, the property was not transferred to its beneficiaries before her death—and remained tied to her by the string she created.

[5] We reject Badgley's argument that "economic benefit" means "income." Certainly, income is one type of economic benefit, *see, e.g.*, *Church's Estate*, 335 U.S. at 644–45, but it is not the sole form that economic benefit may take.

C

Badgley argues that the Supreme Court has disavowed the "substance-over-form" approach described above in favor of a plain-language method of statutory interpretation. She cites *Byrum* as a more recent Supreme Court decision addressing § 2036(a). But *Byrum* itself states that enjoyment connotes substantial present economic benefit. 408 U.S. at 145.

We agree with Badgley that statutory interpretation begins with the plain meaning of the statute at the time of its drafting. *See Wis. Cent. Ltd. v. United States*, 138 S. Ct. 2067, 2070 (2018). Yet "[w]hile every statute's meaning is fixed at the time of enactment, new applications may arise in light of changes in the world," and courts must determine whether new applications fit within the statute's meaning. *Id.* at 2074 (alterations omitted). That precisely is what we do here: we begin with the text of § 2036(a)(1) and determine whether, within the statute's meaning, a grantor's retained interest in a GRAT constitutes enjoyment.

The Court's "substance over form" approach is entirely consistent with this method of statutory interpretation. Section 2036(a)(1) provides that property is included in a gross estate if the decedent retained possession or enjoyment of the property or the right to income from it. In applying the statute, we focus on the substance of the retained interest. Labels are not dispositive. *See Church's Estate*, 335 U.S. at 644 ("However we label the device if it is but a means by which the gift is rendered incomplete until the donor's death the possession or enjoyment provision applies." (quotation and alteration omitted)). "[T]echnical concepts pertaining to the law of conveyancing cannot be used as a shield against the impact of death taxes when in fact possession or

enjoyment of the property by the transferor . . . ceases only with his death." *Estate of McNichol*, 265 F.2d at 673.

D

Badgley makes much of the distinction between a trust's income and its principal. She argues that because the GRAT's principal exceeded the annuity for several years of the fifteen-year term, the annuity could have been drawn from prior year distributions from the partnership and the interest earned on those distributions. We decline her invitation to speculate about the precise part of the trust from which Decedent's annuity could have been drawn.

Further, such an inquiry is irrelevant. Badgley argues that Decedent's decision not to use the word "income" in the GRAT document should permit her to avoid estate tax responsibilities. But as noted above, when determining whether a decedent has retained a string under § 2036(a), our charge is to look at the substance of the arrangement, rather than at formalities. *See, e.g.*, *Church's Estate*, 335 U.S. at 644. The only property in the GRAT was the partnership interest, and the annuity was drawn from the GRAT. Thus, any money received by Decedent as part of the annuity came from the partnership interest, and, as discussed above, conveyed substantial economic benefit to Decedent. The GRAT corpus was within § 2036(a)(1)'s reach.[6]

[6] Because we conclude that in any event, Decedent's annuity constituted enjoyment under § 2036(a)(1), we do not address the parties' arguments whether Decedent retained a right to income from the property. We also do not reach the government's argument that the GRAT was part of the gross estate because Decedent continued to exercise managerial duties for and retain tax benefits from the partnership after creating the GRAT.

E

Inclusion of the GRAT's corpus in Decedent's gross estate should come as no surprise to GRAT grantors. A GRAT's risks are well-known, with the foremost being that the grantor may die before the GRAT's termination. *See* Kerry O'Rourke Perri, *Understanding Grantor Retained Annuity Trusts*, *Practical Law Trusts & Estates* (2020); Bergner, *supra*, ¶ 401.4.A.2 ("There is no solution to the problem of dying earlier than expected."). In setting up a GRAT, a grantor makes the decision that the potential benefits outweigh this risk. If the grantor does not die before the termination of a GRAT, the property passes to the beneficiaries free of the estate tax and with a gift tax that is diminished or even eliminated by the value of the retained annuity. Zaritsky, *supra*, ¶ 12.06. This benefit exceeds that of either immediate transfer of the properties (which would result in the application of the gift tax to the entire value of the property) or a transfer at death (which would result in the application of the estate tax to the entire property). GRATs, like other tax-avoidance devices, cannot "escape the force of this section by hiding behind legal niceties contained in devices and forms created by conveyancers." *Church's Estate*, 335 U.S. at 646 (quotation omitted).

III

Badgley also challenges 26 C.F.R. § 20.2036-1(c)(2), which includes the formula the IRS uses to calculate the portion of the property includable under § 2036(a). The regulation interprets § 2036(a) to provide that GRATs are

includable in a grantor's gross estate because they are sufficiently tied to the grantor.[7]

Badgley's argument regarding the formula is limited to two sentences and two footnotes, without a single citation to legal authority. As we have previously held, arguments presented in such a cursory manner are waived. Federal Rule of Appellate Procedure 28(a)(8)(A) requires an appellant's opening brief to contain the "appellant's contentions and the reasons for them, with citations to the authorities and parts of the record on which the appellant relies." *Id.* "Arguments made in passing and not supported by citations to the record or to case authority are generally deemed waived." *United States v. Graf*, 610 F.3d 1148, 1166 (9th Cir. 2010).

Even were Badgley's challenge to the formula not waived, it would not apply to this case. She asserts that the formula is flawed because it assumes that the annuity payment will come entirely from the GRAT's income, rather than contemplating the amortization of principal. But she does not argue that Decedent's annuity contemplated the amortization of principal, or even that the formula is flawed with regards to Decedent's annuity. She also does not contest the government's assertion that her argument about the formula does not apply to Decedent's annuity. Rather, she merely contends the formula might be arbitrary if applied to a short-term GRAT that contemplates the amortization of principal as the primary source for the annuity payment, which is not the case here. Without

[7] Badgley argues this is an invalid interpretation of the statute. Because we conclude that GRATs are includable under § 2036(a)(1), we do not address this argument.

sufficient or compelling argument, we decline to address the validity of § 20.2036-1(c)(2).

IV

AFFIRMED.

APPENDIX B

District Court's Opinion

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

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.

A. Factual Background

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

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

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

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

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

At least as early as 2002, the income generated by the Y&Y Co. partnership was sufficient to fund Patricia's quarterly annual annuity payments. *See* Dkt. No. 46-9 ("Def. Ex. 7"); Def. Mot. at 6; Def. Reply at 3.[4] Between 2002 and 2012, Y&Y Co. reported income of $999,192 (2002), $1,119,383 (2003), $1,120,283 (2004), $1,197,510 (2005), $1,319,704 (2006), $1,306,287 (2007),

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

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

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

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

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

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

B. Procedural History

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

II. LEGAL STANDARD

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

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

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

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

at 323.

III. DISCUSSION

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

A. Section 2036 Applies to Patricia's GRAT and the GRAT Property Was Properly Included in Patricia's Gross Estate

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

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

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

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.

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

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

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

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

110.

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

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

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

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

> 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

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

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

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

annuity; and (5) Patricia died before the GRAT's expiration. *See* Badgley Dep., 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. Exs. 8-12; Pl. Exs. M-Q, R-T; Def. Mot. at 7; Pl. Mot. at 14. Plaintiff does not dispute, and there is no evidence to show, that any of the three properties constituting the original trust corpus were ever sold to fund Patricia's annuity. *See* Def. Opp. at 7.[7] As a result, Patricia's annuity necessarily drew either from the GRAT's accumulated income (i.e. the principal) *or* the current income that flowed into the GRAT each year from the rents received through Y&Y Co. Def. Mot. at 13; Def. Reply at 5. Plaintiff sets forth no legal basis for distinguishing these two funding sources within the meaning of section 2036 or its predecessors. *See* Pl. Opp. at 8-9.

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

[7] Even if Patricia *had* sold one of these properties to fund the annuity, that would likely also constitute some "use and enjoyment" of the property sufficient for section 2036. *See* Def. Reply at 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.

clause, instead of circumscribing the 'possession or enjoyment' clause in its application to retained income, broadened its sweep." *Id.*

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

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

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

In line with these pragmatic concerns, the Court agrees with Defendant that differentiating between annuities based on their funding source would facilitate circumvention of the tax code. For instance, an individual could substitute the word "income" for annuity in a trust document, give property to the trust, and structure the trust so that the annuity payment is less than the amount of income generated. *See* Def. Reply at 5. Consequently, the property in the trust (that is, the original corpus) would never need to be sold, and could pass to eventual beneficiaries free of taxation. In addition, an individual could "select[] an investment such as a mutual fund from which annuity payments could be made from capital distributions, as opposed to current income," 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.

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

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

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

from her interest in Y&Y Co. That is sufficient to bring the GRAT within the meaning of section 2036.[9]

B. The Regulation is a Reasonable Interpretation of Section 2036

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

> This paragraph (c)(2) applies to a grantor's retained use of an asset held in trust or a retained annuity. . . including without limitation . . . 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.[10]

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

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

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

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

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

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

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

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

73 Fed. Reg. 40173-01 at 47015. And it was the finding of a bona fide sale upon which the Ninth Circuit relied in *LaFargue*. *See* 689 F.2d at 846-47 ("Under these circumstances, absent some indication that the annuity payment agreed upon is a mere disguise for transferring the income of 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

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

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

IV. CONCLUSION

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

IT IS SO ORDERED.

Dated: 5/17/2018

Haywood S. Gilliam, Jr.

HAYWOOD S. GILLIAM, JR.
United States District Judge

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 May 22, 2020.

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.

May 22, 2020

/s/ *Paul Frederic Marx*
Paul Frederic Marx
Counsel for Petitioner-Appellee