No. 18-16053

**IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

JUDITH BADGLEY,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

**ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA**

BRIEF FOR THE APPELLEE

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General

TERESA E. MCLAUGHLIN (202) 514-4342
NATHANIEL S. POLLOCK (202) 514-8139
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:

ALEX G. TSE
United States Attorney

TABLE OF CONTENTS

Page

Table of contents i

Table of authorities iv

Glossary ix

Statement of jurisdiction 1

Statement of the issues 2

Applicable statute and regulation 4

Statement of the case 4

A. Overview of the case and proceedings below 4

B. The relevant facts 6

1. Decedent's interest in Y&Y Company and the creation of the GRAT 6

2. Operations during the term of the GRAT 8

3. Decedent's death, the estate tax return and the claim for refund 10

4. The proceedings in the District Court 11

Summary of argument 14

Argument 18

Page

I The District Court correctly held that the value of decedent's grantor retained annuity trust is includible in the gross estate under I.R.C. § 2036 as a retained interest by which decedent enjoyed the right to income from the transferred property for a term of years that did not in fact end before her death 18

Standard of review 18

A. Introduction 18

1. The inclusion of retained interests in the gross estate 18

2. GRATs and the Treasury Regulation addressing the proper extent of inclusion of a GRAT in the gross estate 22

B. Under Section 2036(a)(1) and Treas. Reg. § 20.2036-1(c)(2), the property held in decedent's grantor retained annuity trust was includible in her gross estate 27

1. I.R.C. § 2036(a)(1) does not specifically address retained annuity interests, but its application to such interests is clear 30

2. The regulation reasonably interprets Section 2036(a)(1) 37

a. Treas. Reg. § 20.2036-1(c)(2)(i) reasonably interprets Section 2036(a)(1) because it is in harmony with *Ray* 38

b. When it issued Treas. Reg. § 20.2036-1(c)(2)(i), the Treasury Department carefully considered and rejected the argument the estate makes here 39

Page

c. The cases discussed in the preamble, as well as others, reject the narrow reading of Section 2036 advanced by the estate 41

d. The cases relied upon by the estate do not support its position 47

e. The legislative and regulatory history supports the validity of Treas. Reg. § 20.2036-1(c)(2)(i) 56

3. The regulation's formula for determining the amount of property to be included in the gross estate when an annuity is retained is reasonable 60

II Independent of decedent's retained annuity interest in the property she transferred to the trust, she "possessed or enjoyed" the property for purposes of I.R.C. § 2036(a)(1) by continuing to control it and by obtaining tax benefits that flowed from it 61

Conclusion 68

Statement of related cases 69

Addendum 70

Certificate of compliance 73

Certificate of service 74

TABLE OF AUTHORITIES

Cases: **Page(s)**

Becklenberg's Estate v. Commissioner,
273 F.2d 297 (7th Cir. 1959) 50, 55

Estate of Bergan v. Commissioner,
1 T.C. 543 (1943) 52

Board of Trustees of Glazing Health & Welfare Tr. v. Chambers,
903 F.3d 829 (9th Cir. 2018) 62

K.M. ex rel. Bright v. Tustin Unified Sch. Dist.,
725 F.3d 1088 (9th Cir. 2013) 62

Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.,
467 U.S. 837 (1984) 13, 16, 29, 32, 37, 60

Commissioner v. Church's Estate,
335 U.S. 632 (1949) 19-20, 42-45, 47-48, 56-57, 63

Estate of D'Ambrosio v. Commissioner,
101 F.3d 309 (3d Cir. 1996) 21

Davis v. Michigan Dept. of Treasury,
489 U.S. 803 (1989) 31
Fidelity-Philadelphia Trust Co. v. Smith,
356 U.S. 274 (1958) 50-53, 55

Food and Drug Admin. v. Brown & Williamson Tobacco Corp.,
529 U.S. 120 (2000) 31

Estate of Frothingham v. Commissioner,
60 T.C. 211 (1973) 21

Estate of Gregory v. Commissioner,
39 T.C. 1012 (1963) 21

Cases (cont'd): **Page(s)**

Helvering v. Hallock,
309 U.S. 106 (1940) 19-20, 44-45, 47

Horner v. United States,
485 F.2d 596 (Ct. Cl. 1973) 54

Estate of Magnin v. Commissioner,
184 F.3d 1074 (9th Cir. 1999)..21

Mayo Found. for Med. Educ. & Research v. United States,
562 U.S. 44 (2011) 29, 38

McNichol's Estate v. Commissioner,
265 F.2d 667 (3d Cir. 1959) 45-46

Oregon Rest. & Lodging Ass'n v. Perez,
816 F.3d 1080 (9th Cir. 2016)...................................29-30, 38

Pardee's Estate v. Commissioner,
49 T.C. 140 (1967) 46

Ray v. United States,
762 F.2d 1361 (9th Cir. 1985)....................33-38, 42, 55-56, 64

Spiegel's Estate v. Commissioner,
335 U.S. 701 (1949) 44-45, 47

Estate of Strangi v. Commissioner,
85 T.C.M. (CCH) 1331, 2003 WL 21166046 (2003) 49

Estate of Trombetta v. Commissioner,
106 T.C.M. (CCH) 416 (2013) 34, 63-65, 67

Tubbs v. United States,
348 F. Supp. 1404 (N.D. Tex. 1972), *aff'd*,
472 F.2d 166 (5th Cir. 1973)..63-64

Cases (cont'd): **Page(s)**

United States v. Byrum,
408 U.S. 125 (1972) 47-50

United States v. Estate of Grace,
395 U.S. 316 (1969) 20

United States v. O'Malley,
383 U.S. 627 (1966) 54

Wisconsin Cent. Ltd. v. United States,
138 S. Ct. 2067 (2018) 47

Statutes:

Internal Revenue Code of 1986 (26 U.S.C.):

§§ 671-677 66
§ 677 33
§ 2001 .... 14, 18
§ 2033 18
§ 2035 19
§§ 2035-2038 21
§ 2036 .... 2-3, 4-5, 11-13, 16-17, 19, 20, 21-22, 24-28, 30-34, 37-42, 44-49, 51, 53-55, 57, 59, 62-64, 67
§ 2512(b) 21
§ 2702 .... 8, 12, 22, 23
§ 6511(a) 2
§ 6532(a)(1) 2
§ 7422(a) 2
§ 7520 .... 8, 12, 23, 59
§ 7805(a) 38

28 U.S.C:
§ 1291 2
§ 1346(a)(1) 2
§ 2107(b) 2

Statutes (cont'd): **Page(s)**

Revenue Act of 1978, Pub. L. No. 95-600, § 702(i),
92 Stat. 2763, 2931 50

Regulations:

Treasury Regulations (26 C.F.R.):

§ 20.2031-7 .... 12, 25
§ 20.2036-1(a) 12, 32
§ 20.2036-1(c)(2) 27, 59
§ 20.2036-1(c)(2)(i) 3-5, 12-13, 15-16, 24-27, 38-39, 41, 56, 62, 64
§ 20.2036-1(c)(2)(iv) 28

Regulations 37 (revised, 1919), Article 24
(Revenue Act of 1918) 57, 58

Regulations 37 (revised, January, 1921), Article 24
(Revenue Act of 1918) 58

Regulations 63 (1922 Edition), Article 20
(Revenue Act of 1921) 58

Regulations 68 (1924 Edition), Article 18
(Revenue Act of 1924) 58

Regulations 70 (1929 Edition), Article 18
(Revenue Act of 1926) 58

Miscellaneous:

74 Cong. Rec. 6902 (March 3, 1931)
(Statement of Senator Smoot) 57

74 Cong. Rec. 6902 (Statement of Congressman Hawley) 57

Miscellaneous (cont'd): Page(s)

Blattmachr, Slade and Zeydel, 836-2nd T.M., *Partial Interests — GRATs, GRUTs, QPRTs (Section 2702)* 12, 23, 59

Fed. R. App. P. 4(a)(1)(B)(i)... 2

Rev. Rul. 82-105, 1982-1 C.B. 133 59

T.D. 9414, *Grantor Retained Interests Trusts—Application of Sections 2036 and 2039*, 73 FR 40173-01 (July 14, 2008).. 25-26, 39, 42, 44

GLOSSARY

Acronym	Definition
GRAT	grantor retained annuity trust
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18-16053

JUDITH BADGLEY,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEE

STATEMENT OF JURISDICTION

This suit for refund of federal estate tax was brought by Judith Badgley as the executor of the estate of her deceased mother, Patricia Yoder (decedent). On January 29, 2014, the estate filed decedent's estate tax return and paid the reported tax due of $11,187,475. (ER 6, 689.)[1] On May 16, 2016, the estate filed a timely claim for refund and

[1] "ER" references are to the estate's excerpts of record.

request for abatement, seeking a refund of $3,810,004 in estate tax allegedly overpaid. (ER 6, 768.) *See* 26 U.S.C. § 6511(a).[2] On January 23, 2017, after more than six months had elapsed without action being taken on the claim, the estate timely filed this suit for refund. (ER 6, 1380.) *See* I.R.C. § 6532(a)(1). The District Court had subject matter jurisdiction under I.R.C. § 7422(a) and 28 U.S.C. § 1346(a)(1).

On May 17, 2018, the District Court issued an order granting the Government's motion for summary judgment and denying the estate's motion for summary judgment. (ER 2-18.) Judgment was entered accordingly that same day. (ER 1.) The judgment is a final, appealable order that disposed of all claims of all parties. The estate filed a timely notice of appeal on June 7, 2018 (ER 19-20, 1385). 28 U.S.C. § 2107(b) & Fed. R. App. P. 4(a)(1)(B)(i). This Court has jurisdiction under 28 U.S.C. § 1291.

Statement of the issues

Under Section 2036(a)(1) of the Internal Revenue Code, property transferred during a decedent's lifetime is nonetheless included in his

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

gross estate when he "has retained," during his life, any period not ascertainable without reference to his death, or any period that does not in fact end before his death, "the possession or enjoyment of, or the right to the income from, the property." The Treasury Department has determined, by regulation, that a retained annuity "constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036." Treas. Reg. § 20.2036-1(c)(2)(i). Here, decedent transferred her 50 percent interest in a family real estate business to a trust known as a grantor retained annuity trust (GRAT) and retained an annuity therein, but she died before the term of the annuity expired. In addition, decedent controlled this family business both before and after she transferred her interest in the business to the trust, and she continued to take depreciation deductions from the business on her personal income tax returns. The issues presented in this appeal are as follows:

1. Whether the District Court correctly held that decedent's interest in the GRAT is includible in her gross estate because at the time of her death she "retained . . . the possession or enjoyment of, or

the right to the income from," the transferred property under I.R.C. § 2036(a)(1) and the Treasury Regulation.

2. Whether, in any event, decedent "possess[ed] or enjoy[ed]" the transferred property for purposes of I.R.C. § 2036(a)(1) by continuing to control it and by obtaining tax benefits that flowed from it.

APPLICABLE STATUTE AND REGULATION

The portions of the statute, I.R.C. § 2036(a)(1), and regulation, Treas. Reg. § 20.2036-1(c)(2)(i) (26 C.F.R.), relevant to the disposition of this appeal are set out in the Addendum, *infra*.

STATEMENT OF THE CASE

A. Overview of the case and proceedings below

During her lifetime, decedent transferred property to a trust in return for an annuity for a term of 15 years or her prior death, with the remainder passing to her daughters. (ER 3-4.) This trust, known as a grantor retained annuity trust (GRAT), resulted in a taxable gift of the remainder interest to her daughters. (ER 6.) If decedent had died after the end of the annuity's 15-year term, the assets remaining in the trust would have passed to her daughters free of estate tax. Decedent died, however, before the 15-year annuity period expired.

This case concerns the extent to which the value of the GRAT is includible in decedent's gross estate. The Government's position is that decedent's retained right to an annuity that did not end until her death constituted "the possession or enjoyment of, or the right to income from, the property" within the meaning of I.R.C. § 2036(a)(1). That being so, the amount necessary to fund the annuity is includible in the gross estate, up to the date-of-death value of the GRAT's assets ($10,987,029). *See* Treas. Reg. § 20.2036-1(c)(2)(i) (26 C.F.R.). In this refund suit, however, the estate takes the position that the assets of the trust are includible in the gross estate only to the extent of the net present value of the remaining unpaid annuity amount at decedent's death ($101,903.86). (Br. 3.) The estate contends that Treas. Reg. § 20.2036-1(c)(2)(i), which supports the Government's position, is invalid. The District Court (Judge Hayward S. Gilliam, Jr.) rejected the estate's argument. It upheld the Treasury Regulation, held that the value of decedent's retained annuity interest is includible in the gross estate and denied the estate's refund claim. The estate now appeals.

B. The relevant facts

1. Decedent's interest in Y&Y Company and the creation of the GRAT

Patricia Yoder (decedent) was married to Donald Yoder, and Donald was the owner (or part owner) of three real-estate-related businesses. Donald had a real estate partnership with his father called Yoder and Yoder. (ER 3.) He later formed a real estate partnership with his brother called Y&Y Company. (*Id.*) Finally, he owned a company called Yoder Development, which managed properties owned by Y&Y Company. (*Id.*).

In 1982, Donald and decedent created the D&P Yoder Revocable Trust. (ER 3.) This trust held Donald's interests in the two real estate partnerships—Yoder and Yoder and Y&Y Company. (*Id.*) When Donald died in 1990, his interest in these two partnerships passed to decedent, and she continued to hold those assets in the D&P Yoder Revocable Trust. (ER 3, 201.)

By the time of Donald's death, Y&Y Company had acquired three multi-tenant parcels of rental real estate in Southern California. (ER 3.) Yoder Development manages the properties owned by the Y&Y

Company. (ER 3.) Y&Y Company pays Yoder Development a management fee and leasing commissions for its services. (ER 201-02.)

After Donald died, decedent became involved in the affairs of Y&Y Company. (ER 3.) This meant providing input on decisions about the properties and managing Y&Y Company's relationship with Yoder Development. (ER 202.) Sometime after Donald's death, decedent approved an increase in the management fees Y&Y Company paid to Yoder Development. (ER 5-6, 204.)

On February 1, 1998, decedent created the Patricia Yoder Grantor Retained Annuity Trust. (ER 3, 607-14.) She transferred to this GRAT her one-half interest in Y&Y Company, which was valued at $2,418,075 on that day. (ER 632.) She retained an annuity for 15 years or her prior death, payable quarterly, equal to 12.5 percent of the asset's date-of-gift value, or $302,259 per year. (ER 3-4.) The transfer was not a bona fide sale, and no consideration was given in exchange for the transfer. (ER 3.) In addition to this annuity, the GRAT permitted additional distributions if decedent "for any reason need[ed] additional amounts . . . over and above the annuity amount," but these

distributions were to be made "in the sole discretion" of her daughters. (ER 623-24, 628.)

Under the terms of the GRAT, upon the completion of the 15-year term, or upon decedent's death (if sooner), the Y&Y Company interest was to pass to decedent's daughters, plaintiff Judith Badgley and Pamela Yoder. (ER 4.) The purpose of the GRAT was to transfer decedent's interest in Y&Y Company to her daughters. (ER 4; Br. 8.) The creation of the GRAT resulted in a taxable gift of the remainder interest, the value of which, under I.R.C. § 2702, was equivalent to the fair market value of the assets initially transferred to the GRAT, reduced by the present value of the annuity payments decedent was expected to receive. *See also* I.R.C. § 7520. Decedent filed a gift tax return, reporting a gift of the remainder interest to her daughters, and paid gift tax of $180,606. (ER 507, 528, 616, 620-22.)

2. Operations during the term of the GRAT

Y&Y Company did not acquire or sell any properties between 1998 and 2012. (ER 3.) From 2002 to 2012, Y&Y Company 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), $1,325,478 (2008),

$1,125,718 (2009), $994,642 (2010), $1,179,989 (2011) and $1,219,227 (2012), and it allocated half of its income to the GRAT. (ER 4-5.) Y&Y Company made cash distributions to the GRAT during this time that ranged from $435,000 to $730,000. (ER 5.) The GRAT was able to pay decedent's $302,259 annuity without affecting Y&Y Company's holdings because of the income generated by those holdings. (ER 4-5.)

Decedent's control over Y&Y Company remained unchanged after she transferred her interest in it to the GRAT. (ER 5.) She continued to make decisions on a range of Y&Y Company matters, such as the hiring of office staff, the approval of rental agreements for Y&Y Company properties and the timing and amount of Y&Y Company partnership distributions. (ER 5, 204.) As trustee of the GRAT, decedent controlled the funds distributed from Y&Y Company. (ER 5.) She used them to pay the quarterly annuity payments into her personal accounts. (*Id.*) And she invested the remaining funds. (*Id.*)

Each year, decedent reported the GRAT's share of Y&Y Company's income on her individual income tax return. (ER 205.) She also claimed depreciation deductions of $116,539 on her individual tax

return each year, based on depreciation of the Y&Y Company property. (ER 205, 385-488, 1038, 1123, 1181.)

Decedent was the trustor and trustee of the GRAT, and her daughters were special trustees. (ER 4.) Two days before decedent's death, her daughters obtained a doctor's note stating that she was no longer able to manage her financial affairs. (ER 205.) They did this to obtain access to decedent's personal bank account in order to pay bills that were due. (*Id.*) The quarterly annuity payment had been paid on September 30, 2012, and the next one was not due until December. (*Id.*) Neither daughter needed to take any action as successor trustees of the GRAT before or after decedent's death. (ER 205-06.)

3. Decedent's death, the estate tax return and the claim for refund

If decedent had died after the end of the annuity's 15-year term, the assets remaining in the GRAT, including any appreciation in value and other accretions remaining after payment of the annuity, would have passed to her daughters free of estate tax. Decedent died, however, at the age of 80 on November 2, 2012, before the 15-year annuity period expired. (ER 6, 205.) Before her death, decedent had explained to her daughters that her half interest in Y&Y Company

would pass to them, but that if she did not outlive the GRAT's 15-year term, the property "would probably go back into her estate." (ER 203, 251.)

In January, 2014, the estate filed an estate tax return for decedent's estate. (ER 6, 206.) The return reported a total gross estate of $36,829,057. (*Id.*) That amount included the value of the assets held in the GRAT, which totaled $10,411,000. (ER 206.) The GRAT contained decedent's one-half interest in Y&Y Company, which had grown in value to $6,409,000. (*Id.*) It also included $1,384,558 held in a bank account and $3,193,471 held in an investment account. (*Id.*) The estate paid the reported taxes due of $11,187,475, as well as $19,219 later assessed by the IRS, which was unrelated to the GRAT. (*Id.*) In May 2016, the estate filed a claim for refund with the IRS, seeking to recover $3,810,004 in estate tax allegedly overpaid by the estate as a result of the inclusion of the full value of the GRAT. (ER 6, 206.) The IRS did not act on the claim within six months. (ER 6.)

4. The proceedings in the District Court

The estate then brought this suit for refund. (ER 6.) The Government took the position that, under I.R.C. § 2036(a)(1), decedent's

retained right to an annuity that did not end until she died brings into the value of the GRAT at her death ($10,987,029) into the gross estate.[3] The estate maintained, however, that the GRAT's assets are includible in the gross estate only to the extent of the net present value of the remaining unpaid annuity amount at decedent's death ($101,903.86). (Br. 3.) The estate contended that Treas. Reg. § 20.2036-1(c)(2)(i), which supports the Government's position, is invalid.

On cross-motions for summary judgment, the District Court ruled for the Government. (ER 2.) The court focused first on cases interpreting I.R.C. § 2036. It concluded that "the U.S. Supreme Court has adopted a substance-over-form approach that favors a finding that [decedent's] annuity comprises some possession, enjoyment, or right to

---

[3] Under Treas. Reg. § 20.2036-1(a)(2) (26 C.F.R), the fair market value of the GRAT at decedent's death is the upper limit on the amount includible in the gross estate. That limitation applies here because that amount was less than the amount that would otherwise have been includible under the regulation, *i.e.*, the amount necessary to provide the annuity without reducing or invading principal, actuarially determined under the valuation tables prescribed by I.R.C. § 7520 and the formula set forth in Treas. Reg. § 20.2031-7 (26 C.F.R.). *See* ER 211 (calculating the amount necessary to provide the annuity under that formula, under the low then-prevailing 1 percent interest rate, as $30,337,773.47). *See generally* Blattmachr, Slade and Zeydel, 836-2nd T.M., *Partial Interests — GRATs, GRUTs, QPRTs (Section 2702)* at A-47.

income from the transferred property." (ER 9.) The court determined that the annuity was, by implication, a "right to the income from, the property" held in the GRAT under I.R.C. § 2036(a) because (i) decedent funded the GRAT with her one-half interest in Y&Y Company; (ii) Y&Y Company held the same three income-producing properties throughout the course of the GRAT's existence; and (iii) decedent's share of the Y&Y Company income was always sufficient to pay the annuity. (ER 14.)

The District Court then addressed the validity of Treas. Reg. § 20.2036-1(c)(2)(i), which provides expressly that the retention of an annuity "constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036." The court concluded that the regulation is valid under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Concerning *Chevron* step one (whether Congress has directly addressed the precise question at issue), the court concluded that Section 2036 "does not expressly address whether annuity payments constitute some possession, enjoyment, or right to income from the transferred property." (ER 16.) Turning to *Chevron* step 2 (whether the regulation

is arbitrary or capricious in substance or manifestly contrary to the statute), the court concluded that the regulation reasonably interprets the statute's text in a way that is consistent with the case law and legislative history and is in keeping with sound tax administration. (*Id.*)[4]

Finally, the District Court rejected the estate's challenge to the formula used to determine the extent of inclusion of trust property over which a decedent retained an annuity interest. The court accepted as "persuasive and well-reasoned" the Government's position that the inclusion formula "reasonably 'looks to the amount of property needed, given the interest rate at the time of death, to fund the annuity.' " (ER 18.) The court also noted that "the high taxation rate in the instant case is partly a result of interest rate fluctuation." (*Id.*)

SUMMARY OF ARGUMENT

The estate tax imposed by I.R.C. § 2001 taxes the value of the property passing from an individual at death. To ensure that the tax

[4] The District Court did not find it necessary to address the Government's alternative argument that decedent retained sufficient control over and benefit from the transferred property to constitute "possession or enjoyment" of the property even apart from the retained annuity. (ER 15.)

cannot be avoided by means of testamentary substitutes that effectively dispose of property at death while allowing the decedent to continue using it during his lifetime, I.R.C. 2036(a)(1) includes in the gross estate the value of property that the decedent has transferred, but in which she retained possession, enjoyment or the right to income.

In this case, decedent transferred property into a trust, but retained an annuity interest, payable from the property or the income from it, for 15 years or her prior death. She died before the term of the annuity expired. That retained annuity "constitutes the retention of the possession or enjoyment of, or the right to the income from, the property." Treas. Reg. § 20.2036-1(c)(2)(i). The estate disagrees. It contends that decedent's retained annuity did not amount to possession or enjoyment of, or the right to the income from, the property. Indeed, the estate contends—as, under the applicable standard, it must—that such an interpretation is decisively foreclosed by the statute.

The estate's position is untenable. Even in the absence of any specific regulation, a plain-language reading of "the possession or enjoyment of, or the right to the income from, the [transferred] property" would include a retained annuity funded by the transferred

property, income from the property or both. And that contention is not just hypothetical. Before the issuance of the regulation here at issue, this Court was called upon to apply Section 2036(a)(1) to a situation quite similar to the one at issue in this case. It determined that the statute required that the property that funded the decedent's defined monthly payments be included in his estate.

Certainly, the Treasury Department's determination that a retained annuity "constitutes the retention of the possession or enjoyment of, or the right to the income from, the property" is, at least, a reasonable one and is therefore entitled to *Chevron* deference. Before the final regulation was issued, a commentator advanced an argument for excluding GRATs from the coverage of Section 2036(a)(1) that is very similar to the one the estate now makes. The Treasury Department carefully considered the argument, but rejected it as inconsistent with the language of the statute, the case law interpreting it and the legislative history. All three strongly support the conclusion that Treas. Reg. § 20.2036-1(c)(2)(i) reasonably construes the statute.

Although this Court need not reach the argument if it agrees that decedent's retention of the annuity brings the GRAT within the gross

estate, there is another, alternative ground for affirming the judgment that was not reached by the District Court. Decedent retained possession and enjoyment of the transferred property within the meaning of Section 2036(a)(1) in two important ways. Decedent continued to exercise management control over Y&Y Company after she transferred her interest in it to the GRAT. She also continued to enjoy depreciation deductions from the business to reduce her personal income tax liability. She therefore possessed and enjoyed the transferred property sufficiently to bring it into the gross estate.

ARGUMENT

I

The District Court correctly held that the value of decedent's grantor retained annuity trust is includible in the gross estate under I.R.C. § 2036 as a retained interest by which decedent enjoyed the right to income from the transferred property for a term of years that did not in fact end before her death

Standard of review

The District Court's grant of summary judgment is reviewed *de novo*.

A. Introduction

1. The inclusion of retained interests in the gross estate

Section 2001 of the Code imposes a graduated estate tax measured by the value of the property passing from a decedent at his death. The gross estate includes "[t]he value of all property to the extent of the interest therein of the decedent at the time of his death." I.R.C. § 2033. Since the estate tax could be defeated unless it also reaches property that a decedent gives away during his life by transfers of an essentially testamentary character—transfers which leave him with a significant interest in, or control over, the property until he dies—the estate tax

provisions have long included in the comprehensive statutory definition of "gross estate" inter vivos gifts that are essentially testamentary substitutes. *Helvering v. Hallock*, 309 U.S. 106, 114 (1940).

Perhaps the most common device in that mold is one where a donor makes an inter vivos gift of income-producing property, reserving a life interest therein. A life estate in income-producing property, such as stock, is generally a "most valuable property right," one that as a practical matter postpones the donee's enjoyment of the asset until the donor dies. *Commissioner v. Church's Estate*, 335 U.S. 632, 644-45 (1949). Section 2036 of the Code covers that transaction, as well as similar ones. It brings within a decedent's gross estate the date-of-death value of property to the extent the decedent has made a transfer, other than a sale at adequate and full consideration, but "retain[s] 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" the possession or enjoyment the property or the right to its income. I.R.C. § 2036(a)(1).

Section 2036 and its companion provisions (*see* I.R.C. §§ 2035 (transfers within three years of death), 2037 (transfers taking effect at

death), and 2038 (revocable transfers)) extend the reach of the estate tax to any property interest that a decedent gives away for less than full consideration during his life while retaining an economic interest or control that prevents the gift from becoming "complete" before he dies. *Helvering v. Hallock*, 309 U.S. at 114; *United States v. Estate of Grace*, 395 U.S. 316 (1969). Because of the testamentary nature of such transfers, the property is taxed in the estate at its value at the time the decedent dies. The time of death is when the "string" that the decedent had tied to the transferred asset is cut, and the full benefits of ownership pass to the transferee. The effect of Section 2036 is that the estate tax cannot be avoided by a testamentary substitute, "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." *Church's Estate*, 335 U.S. at 645.

The "retained interest" provisions of the estate tax each contain an exception for "a bona fide sale for an adequate and full consideration in money or money's worth." *E.g.*, I.R.C. § 2036(a). A like exception applies in the case of the federal gift tax, which applies only to the

extent that property is transferred "for less than an adequate and full consideration in money or money's worth." I.R.C. § 2512(b). The basic purpose of this exception is to relieve from estate and gift taxes a transfer in which the transferor receives consideration of a kind and in an amount that will prevent the depletion of his estate. *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 215-16 (1973) (citing cases); *see Estate of Magnin v. Commissioner*, 184 F.3d 1074, 1079 (9th Cir. 1999) (determining amount of adequate and full consideration). Accordingly, property transferred by way of any of the testamentary dispositions described in I.R.C. §§ 2035-2038 will not qualify for the bona fide sale exception "unless replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate." *Frothingham*, 60 T.C. at 216; *accord*, *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 313 (3d Cir. 1996). As the court noted in *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963), "section 2036 explicitly prohibits a retained life estate in one's own property from serving as consideration for estate tax purposes, since the

transferor has retained the benefit of the property and is in effect only transferring same at death."[5]

2. GRATs and the Treasury Regulation addressing the proper extent of inclusion of a GRAT in the gross estate

i. This case concerns an estate planning vehicle known as a grantor retained annuity trust (GRAT). A GRAT is a trust to which a grantor transfers property, while at the same time retaining the right to an annuity from the trust property for a specified period. After the term of the annuity expires, the remainder passes to another beneficiary, such as the grantor's children or grandchildren. For purposes of valuing the gift to a family member of a remainder interest in such a trust, I.R.C. § 2702 recognizes that the value of the gift is

[5] The estate does not argue that the transfer of the decedent's 50 percent interest in Y&Y Company to the trust and retention of the annuity was "a bona fide sale for an adequate and full consideration in money or money's worth." I.R.C. § 2036(a). It does, however, assert that, contrary to the District Court's determination, that "[t]he annuity constituted some consideration for [the Y&Y Company] partnership interest." (Br. 12.) This statement reflects a misunderstanding of the statute. The estate does not contend that decedent sold her interest in Y&Y Company to some third party (such as a bank or insurance company) in exchange for the annuity. As a result, the bona fide sale exception has no application. Indeed, it would not apply even if the value of the annuity had been equal to the value of the property transferred into the trust.

equivalent to the fair market value of the assets initially transferred to the GRAT, reduced by the present value, determined actuarially, of the future annuity payments that the grantor is expected to receive during the annuity term. *See also* I.R.C. § 7520. After the annuity period ends, the assets remaining in the trust, including any accretions in value that may remain after payment of the annuity, pass to the remainder beneficiary free of further tax. *See* Blattmachr, Slade and Zeydel, 836-2nd T.M., *Partial Interests — GRATs, GRUTs, QPRTs (Section 2702)* at A-55–A-56.

But using a GRAT is not without risk. One risk is that the grantor—*i.e.*, the taxpayer seeking to use the GRAT—will not live to see the annuity period expire, but will die while still retaining the annuity interest. That is what happened here. Decedent transferred an asset (her one-half interest in a real estate partnership) into a GRAT while retaining the right to an annuity that would pay her a sum equal to 12.5 percent of the value of the property on the date of transfer ($302,259) for 15 years or until her prior death. (ER 3-4.) But decedent died shortly before the expiration of the 15-year period, while she still owned the annuity interest. (ER 6.)

Property transferred to a trust is included in the transferor's estate when the transferor "has retained" "the possession or enjoyment of, or the right to the income from, the property" "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." I.R.C. § 2036(a)(1). The term of decedent's annuity was to last 15 years, unless she died sooner, which she did. The annuity she retained, which was for a period which did not in fact end before her death, clearly gave decedent the type of right that sweeps the corpus of the GRAT into her estate under § 2036(a)(1).

ii. In 2008, the Treasury Department—understanding itself merely to be making a clarification consistent with prior regulations, guidance and longstanding Supreme Court precedent—issued a regulation that expressly states that a retained annuity qualifies as a retained interest in transferred property for purposes of I.R.C. § 2036(a)(1). Treas. Reg. § 20.2036-1(c)(2)(i); T.D. 9414, *Grantor Retained Interests Trusts—Application of Sections 2036 and 2039*, 73 FR 40173-01 (July 14, 2008). To that end, Treas. Reg. § 20.2036-1(c)(2)(i) provides in pertinent part as follows:

> If a decedent transferred property into [a GRAT] and retained or reserved . . . the right to an annuity . . . 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 . . . retained annuity . . . (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.

The regulation also explains that the entire corpus of the trust is not necessarily the amount includible in the gross estate. Rather, the portion of the trust that is includible "is that portion of the trust corpus necessary to provide the . . . retained annuity . . . (without reducing or invading principal) as determined in accordance with § 20.2031–7 (or § 20.2031–7A, if applicable." *Id.* The amount includible, however, "shall not exceed the fair market value of the trust's corpus at the decedent's date of death." *Id.*

In the preamble to the final regulations, the Treasury Department noted that one commentator had "suggested that section 2036 is not applicable to a retained annuity interest in a GRAT to the extent the retained annuity interest is not payable from trust income." 73 FR 40173-01. According to this commentator, when an "annuity is defined as a fraction or percentage of the value of the GRAT's original

principal," then "only the present value of any unpaid annuity payments . . . should be includable in the deceased grantor's gross estate." *Id.*

The preamble states, however, that the Treasury Department concluded that this position is "not consistent with the language of section 2036(a)(1), its legislative history, and the case law interpreting this section, which require the inclusion in the gross estate of property over which a decedent has retained a 'string' (the possession or enjoyment of, or the right to the income from the transferred property)." 73 FR 40173-01, 40174. The preamble explains that Section 2036 "was enacted in response to a concern that a donor might otherwise be able to remove property from the donor's gross estate by giving that property away before death while retaining the use or benefit of the property" and therefore that the includable amount must be "the property subject to the 'string', rather than the 'string' itself." *Id.* The preamble concludes as follows (*id.*):

> . . . based on the broad statutory language in section 2036, as well as its legislative history and relevant case law, that under section 2036, every type of lifetime interest in property (annuity, income, use or enjoyment of the transferred property, etc.) retained for the requisite time period constitutes the retained possession and enjoyment of

the transferred property or the income therefrom, causing inclusion of the transferred property in the transferor's gross estate.

Against this backdrop, the estate challenges the validity of Treas. Reg. § 20.2036-1(c)(2), under which the fair market value of the GRAT at the date of decedent's death is includible in the gross estate. It contends, instead, that only the present value of the remaining annuity payment under the GRAT is includible in the gross estate. As we demonstrate below, there is no merit to the estate's contention. The District Court correctly held that the corpus of the GRAT was swept into the gross estate under Section 2036(a)(1) and that the regulation is valid.

B. Under Section 2036(a)(1) and Treas. Reg. § 20.2036-1(c)(2), the property held in decedent's grantor retained annuity trust was includible in her gross estate

This case turns upon the proper construction of I.R.C. § 2036(a)(1) and Treas. Reg. § 20.2036-1(c)(2). The estate does not dispute that decedent transferred her one-half interest in Y&Y Company into the GRAT and reserved an annuity. Nor does the estate dispute that the annuity period did "not in fact end before" decedent's death, a phrase that appears in both Section 2036(a)(1) and Treas. Reg. § 20.2036-

1(c)(2)(i). It cannot reasonably be disputed that, under the plain language of the regulation, "the retained annuity . . . constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036." *Id.* And under the regulation, the "portion of the trust corpus necessary to provide the decedent's . . . retained annuity," which—because of the applicable interest rate—was the entire corpus of decedent's GRAT, was includible in the gross estate. *See* p. 12 n.3, *supra*.

The regulation also sets out an example that is materially identical to this case. In the example: "D transferred $100,000 to a GRAT"; "The trust agreement provides for an annuity of $12,000 per year to be paid to D for a term of ten years or until D's earlier death"; "At the expiration of the term of years or on D's earlier death, the remainder is to be distributed to D's child (C)"; and, "D dies prior to the expiration of the ten-year term." Treas. Reg. § 20.2036-1(c)(2)(iv) (Example 2). The regulation explains that, in this example, "the amount includible in D's gross estate under section 2036, is that amount of corpus necessary to yield the annual annuity payment to D (without reducing or invading principal)." *Id.* The only differences

between this example and the present case are the amount of the annuity, term of the annuity and the number of children. Because none of those differences is significant, the result here, as in the example, is that the amount of the trust assets needed to yield the annuity without invading principal is includible in decedent's gross estate.

The regulation's clear support of the Government's position means that the success of estate's refund claim turns upon the supposed invalidity of the regulation. The Supreme Court's decision in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), set out a two-step framework for determining the validity of regulations.[6] Under the *Chevron* framework, this Court's first task is to determine whether Congress has "directly spoken to the precise question at issue." *Id.* at 842. If so, that ends the matter. But if not, this Court then "proceed[s] to step two and ask[s] if the agency's action is 'based on a permissible construction of the statute.' " *Oregon Rest. & Lodging Ass'n v. Perez*, 816 F.3d 1080, 1086 (9th Cir. 2016) (quoting *Chevron*, 467 U.S. at 843). In making that determination, "[e]ven if [this Court]

[6] The *Chevron* analysis applies with equal force to Treasury Regulations. *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 57 (2011).

believe[s] the agency's construction is not the *best* construction, it is entitled to 'controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute.' " *Id.* (quoting *Chevron*, 467 U.S. at 844). As we demonstrate below, the regulation is valid.

1. I.R.C. § 2036(a)(1) does not specifically address retained annuity interests, but its application to such interests is clear

The estate contends (Br. 19) that the statute not only contains no gap, but, in fact, directly conflicts with the regulation. According to the estate, the statute unambiguously excludes from a decedent's gross estate trust property that is merely used to fund an annuity. We disagree. As relevant here, Section 2036(a)(1) provides that property that a decedent has transferred to a trust is included in the gross estate when the decedent has "retained" for a defined period "the possession or enjoyment of, or the right to income from, the property."

The estate advances a kind of divide and conquer argument. First it contends (Br. 22-23) that "possession and enjoyment" of trust property should be interpreted narrowly to mean enjoyment of non-income-producing property such as artwork. Then it argues (Br. 26-33) that "the right to the income from" the transferred property must be

interpreted narrowly and, consequently, that a right to annuity payments counts as a right to the income from the property only when the payments must be made out of the income. The estate then concludes that, because decedent's annuity does not fit within either of these narrow definitions, it is not a retained interest in property that triggers inclusion under Section 2036(a)(1).

The estate's crabbed reading of the statute is at odds with the main thrust of the broad statutory language. Rather than reading any word or phrase in isolation, the statute must be read as a whole and in the context of the statutory scheme of which it is a part. *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*¸529 U.S. 120, 132-33 (2000); *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 809 (1989). Congress sought to sweep within the gross estate "any interest" transferred by the decedent under which he has retained, for the prescribed periods, "the possession or enjoyment of, or the right to the income from, the property." I.R.C. § 2036(a)(1). The estate's narrow interpretation cannot be sustained when the statute is read as a whole and against the background of the statutory scheme designed to bring testamentary substitutes into the gross estate. *See* pp. 19-20, *supra*,

and 41-46, *infra*. The economic benefit of an annuity, whether or not payable solely from the income derived from the GRAT's property, simply cannot be dismissed as falling beyond the statute's encompassing language. In either case, the payments constitute enjoyment of that transferred property. Indeed, the right to income from property is really just a type of enjoyment of property that the statute makes express. *See* Treas. Reg. § 20.2036-1(a) (referring to "use, possession, right to income, or other enjoyment").

The estate may be correct that the statute is unambiguous and that, as a result, this Court need not reach step two of the *Chevron* test. But contrary to the estate's belief, if the statutory text is clear, it is in requiring the retained interest to be included in the gross estate. For Section 2036(a)(1) to apply here, it need only be recognized that decedent's retention of the right to annuity payments funded entirely by the transferred property is a way of enjoying that property. And this is true whether those payments come from the property itself (such as by way of a sale of the property or a portion of it) or from income from that property (whether from Y&Y Company's current income or that of a prior year, even if added to principal).

As a result, although the statute does not specifically address annuities, its application here is straightforward. Even if no regulation addressed the issue, the right to annuity payments funded by property placed in a trust constitutes retention of "the possession or enjoyment of, or the right to the income from, the property." I.R.C. § 2036(a)(1). But we need not speculate about how this Court would have applied Section 2036(a)(1) to the facts at issue here in the absence of any regulation. This Court already has applied Section 2036(a)(1) to materially similar facts in *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985).

The question in *Ray* was whether a trust set up during divorce proceedings that paid the decedent and his former wife a set monthly amount for life ($400 and $300, respectively) was includible in the decedent's gross estate under Section 2036. 762 F.2d at 1361-62. This Court held that the trust property was includible in the gross estate. In so doing, it relied significantly on a test developed to determine whether the grantor is the owner of a trust under I.R.C. § 677. *Id.* at 1362-63 ("Although section 677 deals with the taxation of income paid from a trust to its grantor, the court's analysis in those cases applies to our

analysis under section 2036."). Under that test, this Court looked, *inter alia*, at whether the following was true: "(1) the property the taxpayers transferred to the trust was, in effect, the only source for their 'annuity' payments; (2) since the trust's income was designed to equal the annual payments to the taxpayers, the 'annuity' payments would not be paid from the trust corpus; and (3) the trust corpus would be available for 'ultimate distribution to the trust beneficiaries.' " *Id.* at 1363 (citation omitted). This Court focused on the facts that "the payments to the Rays closely approximated the trust's income" and that the payments appeared to have been calculated "so that the trust corpus would remain intact." *Id.*; *see also Estate of Trombetta v. Commissioner*, 106 T.C.M. (CCH) 416 (2013) (relying on *Ray* to determine that a retained annuity in property transferred to a GRAT made the property includible in the decedent's gross estate under Section 2036(a)(1)).

The estate dismisses *Ray* as a case involving a GRAT that "is in substance a disguised [grantor retained income trust]," conceding that, for such a GRAT, the trust property would be includible in the decedent's gross estate. (Br. 32.) But if the trust in *Ray* was truly an income trust, so is this one. The GRAT at issue here unquestionably

meets the first and third prongs of the *Ray* test: the property transferred into the trust (the 50 percent partnership interest in Y&Y Company) is the only source of the annuity payments. And the estate does not dispute, as the District Court found, that the GRAT was set up so that the trust corpus would be available for ultimate distribution to the trust beneficiaries—that is, "the Y&Y partnership interest was to pass to [decedent's] two living daughters." (ER 4.)

The GRAT at issue here also satisfies the test's second prong. Concerning that prong, this Court in *Ray* explained that "[t]he parties apparently calculated the payments so that the trust corpus would remain intact because the trust operated at a breakeven point from its inception until Mr. Ray's death." 762 F.2d at 1363. As a result, "it appear[ed] that the size of the payments was initially determined to approximate the expected income from the trust property." *Id.* at 1364.

Although the *Ray* opinion does not say precisely how close the trust's income was to the fixed monthly payment amount, it indicates that they were very close. That likely means that, in establishing the trust, the parties in *Ray* intended to retain nearly all of the income from the trust property while at the same time leaving the trust corpus

intact. Suppose, however, that the parties had put a higher priority on leaving the trust corpus intact and had therefore been willing to take smaller monthly payments to ensure that that would occur. There is no reason to think that such a modification would have changed this Court's analysis.

That is the situation we have here. It is true that the income generated by the 50 percent interest in Y&Y Company varied somewhat from year to year. But it did not fluctuate very much. In half of the years from 2002 to 2012, the partnership allocated between $550,000 and $600,000 in income to the GRAT. (ER 5.) Taking all the years into account, it distributed "from $435,400 to $730,000." (*Id.*) It is therefore evident that Y&Y Company reliably produced significant income from its rental property. It appears that decedent conservatively selected an annuity amount ($302,259) that would not exceed the income distribution of the partnership interest she placed in trust, thereby effectively guaranteeing that that property would remain intact for transmission to her heirs. This is a sufficient " 'tie' between the amount of the payments and the trust income." *Ray*, 762 F.2d at 1363.

In sum, this Court should reject the estate's position that Section 2036(a)(1) unambiguously compels exclusion from the gross estate of the trust property that funded the annuity that decedent was receiving up until her death. Indeed, if the statute has a clear imperative, it supports the opposite conclusion—that the text unambiguously compels inclusion of the trust property in decedent's gross estate. Indeed, even in the absence of any regulation dealing with the issue, this Court in *Ray* has already interpreted the statute to require inclusion of trust property in the decedent's gross estate in materially similar circumstances.

2. The regulation reasonably interprets Section 2036(a)(1)

In the event this Court were to prefer to resolve this case at step two of the *Chevron* test, the regulation also passes muster. It is true that Section 2036(a)(1) does not expressly address the specific issue whether assets subject to a retained annuity are includible in the gross estate when the decedent dies during the annuity period. As a result, the statute is arguably "silent or ambiguous with respect to the specific issue." *Chevron*, 467 U.S. at 843. In analyzing this case under the rubric of *Chevron* step two, this Court is not interpreting and applying

Section 2036(a)(1) on a blank slate, and it is not called upon to search for the "the *best* construction" of its terms. *See Oregon Rest. & Lodging Ass'n*, 816 F.3d at 1086. Instead, this Court's task is to decide whether the Treasury's construction of I.R.C. § 2036(a)(1) is a permissible one—*i.e.*, a construction that is not arbitrary, capricious or manifestly contrary to the statute.[7] *Id.*

a. Treas. Reg. § 20.2036-1(c)(2)(i) reasonably interprets Section 2036(a)(1) because it is in harmony with *Ray*

As an initial matter, Treas. Reg. § 20.2036-1(c)(2)(i) interprets Section 2036(a)(1) in a way that is, at least, in harmony with this Court's interpretation of the statute in *Ray*. In other words, even supposing that *Ray* is not controlling, it is at least an instance of this Court construing Section 2036(a)(1) as the regulation does in a similar

---

[7] The main thrust of the estate's argument against the validity of the regulation is that it conflicts with (and therefore does not reasonably interpret) Section 2036(a)(1). But the estate also implies that a lower level of deference would apply here because Congress has not delegated authority to the Treasury Department to promulgate "legislative" regulations to interpret Section 2036. (Br. 34-35.) This argument is meritless. In fact, Congress has explicitly authorized the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code. I.R.C. § 7805(a); *see also Mayo*, 562 U.S. at 56 (citing Section 7805(a) in upholding an interpretative Treasury regulation under *Chevron*).

context. Certainly, an agency's interpretation of a statute that corresponds with this Court's prior interpretation of that same statute cannot be an unreasonable one.

b. When it issued Treas. Reg. § 20.2036-1(c)(2)(i), the Treasury Department carefully considered and rejected the argument the estate makes here

The preamble to the final regulation makes a compelling case that the construction adopted reasonably interprets the retention of an annuity interest to be a kind of retained "possession or enjoyment of, or the right to the income from" property transferred into a trust within the meaning of Section 2036(a)(1). In making that case, the preamble grappled with and rejected the same argument the estate makes here.

One commentator argued, in response to the proposed regulation, that a retained annuity interest payable from principal or income and defined as a fraction of the trust's original principal should be includible in a decedent's gross estate under Section 2036 "only to the extent that the trust's income must be used to pay the retained annuity." 73 FR 40173-01, 40173. After carefully considering this argument, the Treasury Department rejected it as inconsistent with "the language of section 2036(a)(1), its legislative history, and the case law" interpreting

it. *Id.* at 40174. The preamble explains that the statute's text, its legislative history and the case law confirm that Section 2036(a)(1) "requires inclusion in the gross estate of the property subject to the 'string', rather than the 'string' or retained interest itself." *Id.* After discussing the relevant authorities, the preamble concludes that annuities, like other lifetime interests in property, constitute "the retained possession and enjoyment of the transferred property or the income therefrom, causing inclusion of the transferred property in the transferor's gross estate." *Id.*

The preamble also notes that a rule interpreting Section 2036 to apply "only to the extent that the trust principal alone is insufficient to fully satisfy the annuity payment" would be problematic because it would "condition the estate tax treatment on the nature and performance of the investments selected by the trustee." *Id.* at 40175. Isolating this portion of the preamble, the estate infers (Br. 24-25) that the Treasury Department must have believed that retained annuities do not satisfy the "possession and enjoyment" language of the statute, because otherwise, it would have been unnecessary to refute the commentator's argument against treating such annuities as retained

rights to income. The estate's argument is meritless. First, the fact that the Treasury Department took the trouble to address whether retained annuities constitute rights to income in no way implies its acceptance of the notion that a retained annuity interest is not a form of possession or enjoyment of trust property. Second, the preamble's discussion of the cases and legislative history made abundantly clear that the Treasury Department considered a retained annuity interest as a form of possession or enjoyment of trust property.[8]

c. The cases discussed in the preamble, as well as others, reject the narrow reading of Section 2036 advanced by the estate

The Supreme Court, in interpreting Section 2036 and its predecessor statutes, has read "possession and enjoyment" broadly and has taken a dim view of legal niceties that seek to obscure what is—in

[8] Also without merit is the estate's further contention (Br. 25) that the regulation itself signals that the Treasury Department believed that retained annuities do not amount to possession or enjoyment. Notwithstanding the estate's emphasis on the statute's "two separate word-groups," *i.e.*, "possession and enjoyment" and a "right to income," the regulation clearly states that a retained annuity "constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036." Treas. Reg. § 20.2036-1(c)(2)(i). It cannot reasonably be read as resting the inclusion of a retained annuity interest in the gross estate solely on the "right to income" prong.

actual and practical effect—possession and enjoyment of property. In *Church's Estate*, the Court held that a person who transfers property to a trust does not relinquish possession and enjoyment of the property unless the person "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; *see also id.* at 646 (explaining that, to avoid the estate tax, a transfer to a trust "must be immediate and out and out, and must be unaffected by whether the grantor lives or dies"); 73 FR 40173-01 (discussing *Church's Estate*). The Court explained, quoting *Goldstone v. United States*, 325 U.S. 687, 691 (1945), that "[t]estamentary dispositions of an inter vivos nature cannot escape the force of [the provision now codified in I.R.C. § 2036(a)(1)] by hiding behind legal niceties contained in devices and forms created by conveyancers." *See also Ray*, 762 F.2d at 1362 ("The general purpose of this section is 'to include in a decedent's gross estate transfers that are essentially testamentary' in nature.") (citations omitted).

In *Church's Estate*, the decedent transferred stocks into a trust, but reserved the right to the income from those stocks for his life. Upon

his death, the trust was to terminate, and the stocks were to pass to his relatives. *Id.* at 634, 646. The Supreme Court concluded that such a trust "was intended to and did postpone until the settlor's death the right of his relatives to possess and enjoy his property." *Id.* The Court noted that, indeed, "the purpose of this settlor as expressed in his trust papers was to make 'provision for any lawful issue' he might 'leave at the time of his death as well as provide an income for himself for life.' " *Id.* The Court ruled that the interest retained by the decedent fell within the "possession or enjoyment" language of the statute and was therefore subject to the estate tax.

The same analysis applies here. While she lived, decedent received a substantial portion of the income from the property she transferred to the trust. During that time, her heirs did not possess, enjoy or have any right to income from that property. As in *Church's Estate*, decedent's heirs obtained the right to possess and enjoy those assets only upon her death. It also true here, as it was in *Church's Estate*, that the true purpose of the GRAT was testamentary. Indeed, the estate has conceded this point: "Decedent's purpose for creating the GRAT was to make a gift to her daughters . . . of the GRAT corpus

remaining after paying Decedent an annuity of $302,259 per year for a term of 15 years or until her earlier death." (Br. 8.)

The preamble also cites *Spiegel's Estate v. Commissioner*, 335 U.S. 701 (1949), and *Helvering v. Hallock*, 309 U.S. 106 (1940). *See* 73 FR 40173-01. In *Speigel's Estate*, which was a companion case to *Church's Estate*, the Supreme Court also emphasized the broad sweep of "possession or enjoyment, and right to income from property" as used in I.R.C. § 2036(a)(1). The Court stressed that property transferred to a trust will be subject to estate taxes under the statute unless there is a showing that the transferor "has certainly and irrevocably parted with his 'possession or enjoyment.' " 335 U.S. at 705. The Court explained that the extent of the retained interest is not significant: "The question is not how much is the value of a reservation, but whether after a trust transfer, considered by Congress to be a potentially dangerous tax evasion transaction, some present or contingent right or interest in the property still remains in the settlor so that full and complete title, possession or enjoyment does not absolutely pass to the beneficiaries until at or after the settlor's death." *Id.* at 707.

In *Hallock*, the Supreme Court laid the groundwork for *Church's Estate* and *Spiegel's Estate*. Most significantly, it laid the foundation for the Court's emphasis on the substance of a transfer of assets to a trust, or other conveyance. The Court explained that the estate tax applied to "not merely those interests which are deemed to pass at death according to refined technicalities of the law of property," but also to "inter vivos transfers that are too much akin to testamentary dispositions not to be subjected to the same excise." 309 U.S. at 112.

In *McNichol's Estate v. Commissioner*, 265 F.2d 667 (3d Cir. 1959), which was not cited in the preamble, but on which the District Court relied, the Third Circuit addressed the "possession or enjoyment" of property for purposes of Section 2036(a)(1) in a context that is relevant here. There, the decedent transferred income-producing real estate to his children, but he had an oral understanding with them that he would "retain for his lifetime the income from the real estate." *Id.* at 669. When he died, his estate argued that this oral understanding was not a retained interest because it was not legally enforceable and, consequently, was not a "right to the income" from the property. *Id.* at 670.

The Third Circuit rejected that argument. It explained that the purpose of the words "right to" was to cover situations in which the decedent "was entitled to income even though he did not actually receive it."[9] *Id.* at 671. More generally, the court explained that the words "right to the income" do not constrict the meaning of "possession or enjoyment," but instead confirm the broad sweep of those terms. *Id.* The court accordingly concluded that "[h]e who receives the rent in fact enjoys the property." *Id.* So, too, here, decedent enjoyed the trust property when she retained an annuity, payments of which were made from the rental income from the Y&Y Company partnership interest held in trust.

---

[9] Because the Third Circuit pointed out that even an unexercised right to income from transferred property counts as enjoyment under Section 2036, the estate is clearly misguided in contending (Br. 23) that *Estate of McNichol* stands for the proposition that "there can be no enjoyment of property without either possession or income." *See also Pardee's Estate v. Commissioner*, 49 T.C. 140, 148 (1967) (holding that a transferor's right to use income or principal of a trust to support his ex-wife and children was a retained interest under Section 2036(a)(1) even if the transferor never exercised that right, and explaining that the statute "does not require that the transferor pull the 'string' or even intend to pull the string on the transferred property; it only requires that the string exist") (citations omitted). Moreover, even if the estate's interpretation of *Estate of McNichol* were correct, it would be unavailing here, because decedent's annuity was actually paid out of income from the transferred property.

d. The cases relied upon by the estate do not support its position

The estate attempts to wave away the Supreme Court's prior broad construction of "possession or enjoyment" in Section 2036(a)(1) as irrelevant *dicta*. (Br. 39.) Relying on *Wisconsin Cent. Ltd. v. United States*, 138 S. Ct. 2067 (2018), and *United States v. Byrum*, 408 U.S. 125 (1972), the estate implies that *Church's Estate*, *Spiegel's Estate* and *Hallock* are merely the product of an outmoded analysis that puts policy goals ahead of a statute's plain language.

The estate's extensive discussion of *Wisconsin Central* boils down to the proposition that a statute may not be interpreted in a manner that is inconsistent with its plain language in order to achieve a desired policy result. That is true, but it does not undermine the Supreme Court's prior construction of "possession or enjoyment" in *Church's Estate*, *Spiegel's Estate* and *Hallock*. As explained above, those cases concluded that the words "possession or enjoyment" must be interpreted in a commonsense manner.

Moreover, the estate misses the point of the Court's invocation of the substance-over-form doctrine in those cases. The Supreme Court was not talking about ignoring the plain language of Section 2036 in

order to get to a result the Court believed to be correct. Instead, the Court explained that it would not be prevented from applying the ordinary meaning of "possession or enjoyment" by state-property-law labels. For example, in *Church's Estate*, the Court determined that a transfer of legal title did not prevent the transferor from retaining enjoyment of the property because, in reality, the decedent retained the right to get and spend the income from that property. 335 U.S. at 632. In other words, the transferor continued to enjoy the transferred property under any ordinary understanding of that term.

The estate misplaces its reliance (Br. 32) on the Supreme Court's statement in *United States v. Byrum*, 408 U.S. 125, 145 (1972), that the word "enjoyment" connotes present economic benefit. *Id.* at 145. The estate takes issue (Br. 31) with the District Court's observation (ER 12) that the fact that the GRAT's assets could be sold to fund the annuity "constitutes some 'use and enjoyment' of the property sufficient for section 2036" because, the estate insists, Section 2036(a)(1) requires "*present* enjoyment." The District Court correctly pointed out, however, that an annuitant enjoys property that is available to fund an annuity payment even if the annuitant intends and hopes that subjecting the

property to sale to fund the annuity will not be necessary. And, of course, another type of enjoyment of property is having a right to receive or actually receiving income from the property. Both types of enjoyment apply here.

In *Byrum*, the Court held that Section 2036(a)(1) did not apply to a set of facts far afield of those at issue here. The decedent there had transferred stock in three closely held corporations to a trust for the benefit of his descendants, naming an independent bank as trustee. As relevant here, however, he retained the right to vote the shares of unlisted stock held in the trust, which, together with stock he had retained in those same corporations, gave him controlling interests in the corporations. The Supreme Court rejected the proposition that the decedent had thereby retained a substantial present economic benefit, reasoning that the decedent's use of his control to assure his continued employment or to effectuate a merger or liquidation was constrained by his duty to the minority stockholders. 408 U.S. at 148-50; *see also Estate of Strangi v. Commissioner*, 85 T.C.M. (CCH) 1331, 2003 WL 21166046 at *16-17 (2003) (distinguishing *Byrum* based on its unique

facts).[10] That situation is far afield from the facts here, where decedent had a right to annuity payments funded solely by the property she transferred into the trust and that, consequently, could only be paid using the property or income from the property.

Finally, the estate's reliance on *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), and *Becklenberg's Estate v. Commissioner*, 273 F.2d 297 (7th Cir. 1959), is misplaced. In *Fidelity-Philadelphia Trust*, the Court considered whether the proceeds of irrevocably assigned life insurance policies were includible in the decedent's estate. 356 U.S. at 275. The argument in favor of inclusion depended on a theory that payments from separate annuities the decedent had been required by the insurance company to purchase along with the life insurance policies "were derived as income from the entire investment"—*i.e.*, from the joint purchase of the life insurance policies and annuities. But the Court concluded that the annuities were

[10] Notably, Congress has overridden *Byrum* to the extent provided in Section 2036(b). *See* Revenue Act of 1978, Pub. L. No. 95-600, § 702(i), 92 Stat. 2763, 2931. Section 2036(b)(1) generally provides that "the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property."

separate and that, as a result, "the annuity payments arose solely from the annuity policies." *Id.* at 280-81. It was undisputed that the annuity standing alone was not includible because it was purchased from an insurance company and was therefore exempt from inclusion under the statute. *See* I.R.C. § 2036(a) (exempting from the statute's inclusion rule a transfer that amounts to a "bona fide sale for an adequate and full consideration").

The focus of the estate's discussion of *Fidelity-Philadelphia Trust* is footnote 8, where the Court noted that "[w]here a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime," lower courts had ruled that Section 2036(a)(1) does not require inclusion of the transferred property in the decedent's estate. 356 U.S. at 281 n.8 (citing cases). The Court then set out three additional conditions typically present in the cases reaching this conclusion: "the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made." *Id.*

The first sentence of the footnote makes it clear that the Court was not talking about a decedent's transfer of money to a trust, and certainly not a grantor trust the decedent controls. Rather, the Court was describing conditions that apply where a decedent "has transferred property to *another*." *Id.* (emphasis added). And, indeed, the first of the cases the Court cited in footnote 8, *Estate of Bergan v. Commissioner*, 1 T.C. 543, 552 (1943), is a case where the decedent transferred property to her sister, with whom she lived, in consideration of an agreement that the sister would support her financially during her life. In concluding that the transferred property was not includible in the decedent's estate, the Tax Court focused both on its determination that the transfer was not made in contemplation of death and also—critically—on the fact that "[t]he title [to the property] vested in [the decedent's sister] and *not in any trustee*." 1 T.C. at 552 (emphasis added).

Footnote 8 of *Fidelity-Philadelphia Trust* is simply inapplicable here, where the transfer was made to a trust controlled by the decedent. But it is also worth noting that the retained annuity interest here does not satisfy two of the three conditions identified in the second sentence

of footnote 8. First, the promise of annuity payments for a period of years or decedent's life was plainly not a "personal obligation of the transferee." There is no independent third party here who would be obligated to make the annuity payments if, for some reason, they could not be made out of the assets in the trust.

Second, here the obligation to make annuity payments to decedent *was* "chargeable to the transferred property." *See Fidelity-Philadelphia Trust*, 356 U.S. at 281 n.8. The only property transferred into the trust was the 50 percent interest in Y&Y Company, and so the only assets in the trust were that property and the income it produced. There was no provision for payment of the annuity out of any other asset. It follows that the annuity payments had to be made out of the income from the property or by liquidating the property (or a portion of it). And, in fact, the payments were all made from income from the property, and no property was sold to fund the annuity payments.

The estate's argument (Br. 27-31) that, at the time of decedent's death, the "GRAT ha[d] sufficient property other than the transferred property with which to pay the annuity" relies on a misunderstanding of the plain language of Section 2036(a)(1). The estate appears to

contend that, when the income from the 50 percent interest in Y&Y Company not needed to pay decedent's annuity was reinvested and became trust principal, it somehow became "additional property" that could not "be directly linked to the Y&Y Company partnership interest." (Br. 28.)[11] But Section 2036(a)(1) does not speak in terms of trust income or trust principal. It speaks in terms of property transferred to a trust, and then states that a retention of "the right to the income from, the property" makes it includible in the gross estate. I.R.C. § 2036(a)(1). When the excess income from the Y&Y Company partnership interest not needed to pay the annuity was reinvested at the end of each year, it became trust principal. It did not thereby cease to be income from the Y&Y Company partnership interest.[12] In short,

---

[11] Whether the excess income was transferred to the GRAT as an initial matter along with Y&Y Company, or constituted an additional transfer, it clearly was income from the property transferred to the GRAT by decedent. *See United States v. O'Malley*, 383 U.S. 627, 632 (1966); *see also Horner v. United States*, 485 F.2d 596, 597 (Ct. Cl. 1973) (determining that a life tenant was the transferor of the accumulated income from trust property under Section 2036(a)(1)).

[12] This is the point the District Court was making when it used the term "accumulated income." (*See* ER 12, 14, 16.) The District Court was not denying that accumulated income is trust principal. It was saying that "[t]he income *from Y&Y Co.*, whether accumulated or current" funded the annuity. (ER 14 (emphasis added).)

the estate's argument depends on the notion that there is some property available to pay her annuity other than the transferred property and its income. But there is none.

Finally, in *Ray*, this Court rejected a very similar argument likewise based on footnote 8 of *Fidelity-Philadelphia Trust*, as well as *Estate of Becklenberg*, 273 F.2d at 300-01, a case applying the footnote 8 framework in a situation in which the decedent had transferred only a portion of the property held in a trust, but had a right to receive payments that were "not limited to the property transferred by her or the income therefrom." In fact, the argument was stronger in *Ray* because, in that case, there was an independent trustee, and the estate contended that the trustee "felt obliged to make the payments even if the income and principal would not support the payment." *Ray*, 762 F.2d at 1363. This Court nevertheless ruled that the transferred property was includible in the gross estate under Section 2036(a)(1), explaining that footnote 8 of *Fidelity-Philadelphia Trust* and *Estate of Becklenberg*, were inapplicable because, as a legal matter, the trustee was not personally obliged to make the payments. Rather, "the

payments were chargeable solely to the transferred property and income therefrom." *Ray*, 762 F.2d at 1364. That is also true here.

e. The legislative and regulatory history supports the validity of Treas. Reg. § 20.2036-1(c)(2)(i)

The legislative and regulatory history, on which the Treasury Department expressly relied, further supports the regulation's validity. As the Supreme Court explained in *Church's Estate*, from 1916 (when the federal estate tax was first enacted) until 1930, it was understood that "trust transfers which were designed to distribute the corpus at the settlor's death and which reserved a life income to the settlor" were testamentary and subject to the tax. 335 U.S. at 639. But in 1930 and 1931, the Supreme Court issued four opinions that appeared to reject this settled understanding, in the words of the *Church's Estate* opinion, thereby "upsetting the century-old historic meaning and the long standing Treasury interpretation of the 'possession or enjoyment' clause." *Id.* (citations omitted). The disruption was temporary, however, because Congress quickly restored the status quo. It passed a resolution that made it plain that property transferred to a trust in which the transferor "retained for his life or any period not ending

before his death the possession or enjoyment of, or the income from, the property" would be subject to the estate tax. *Id.* at 639-40 & n.7 (quoting Joint Resolution of March 3, 1931, 46 Stat. 1516, 1517); *see also* 74 Cong. Rec. 6902, 7078-79 (March 3, 1931) (Statement of Senator Smoot) (describing the Supreme Court's change of course as a "bombshell" that, if permitted to stand, would cause serious hardship to the federal estate tax regime); 74 Cong. Rec. 6902, 7198-99 (Statement of Congressman Hawley) (similar).

"[T]he long standing Treasury interpretation of the 'possession or enjoyment' clause," *Church's Estate*, 335 U.S. at 639, was manifest in the Treasury Regulations interpreting the earliest versions of Section 2036(a)(1). Of particular relevance here, those early regulations provided expressly that an annuity was a retained interest that would cause the transferred property to be includible in the decedent's gross estate. From 1919 to 1924, the applicable regulation provided that if the transferor of property "reserves an annuity, so much of the property as is necessary to produce the annuity should be included in the gross estate." *See* Regulations 37 (revised, 1919), Article 24 at 22 (Revenue Act of 1918); Regulations 37 (revised, January, 1921), Article 24 at 20

(Revenue Act of 1918); Regulations 63 (1922 Edition), Article 20 at 21 (Revenue Act of 1921); and Regulations 68 (1924 Edition), Article 18 at 27 (Revenue Act of 1924).

The 1929 regulation expanded on this point somewhat. After first explaining that the reservation of an income interest in transferred property would cause inclusion of the property in a decedent's gross estate, the regulation turned to annuities. It explained that "[t]he rule would be the same" for annuities. Regulations 70 (1929 Edition), Article 18 at 27-28 (Revenue Act of 1926). Specifically, the regulation provide that "if an annuity were reserved, whether out of the property transferred or the income therefore," the property is includible to the extent necessary to produce the annuity. *Id.* The regulation then went on the describe how this would work in more definite terms:

> Where the decedent reserved out of the property transferred a definite annuity and the income from the property was indefinite, or indeterminable, or the property was nonincome bearing, there should be included in the gross estate that portion of the value of the property transferred (not to exceed the entire value as of the date of the decedent's death) equal to the capitalization of the annuity at 4 per cent.

Id. In other words, the only difference between the way the applicable regulation treated retained annuities in 1929 and the way the

applicable regulation treats them now is that, now, the interest rate is variable. I.R.C. § 7520.

Although this specific discussion of retained annuities was not included in later regulations, the Treasury Department did not change its position that a retained annuity in transferred property triggers inclusion of that property in a decedent's gross estate. In Rev. Rul. 82-105, 1982-1 C.B. 133, for example, the IRS ruled that the part of the corpus of a charitable remainder annuity trust that was necessary to fund the annuity was includible in the gross estate under Section 2036(a)(1). Likewise, in Rev. Rul. 76-273, 1976-2 C.B. 268, 269, the entire value of the property in a charitable remainder unitrust in which the donor retained a life interest that was "equivalent to a full income interest in the trust assets" was includible in the gross estate under Section 2036(a)(1). This is, again, the same result required under Treas. Reg. § 20.2036-1(c)(2). *See* Blattmachr, Slade and Zeydel, 836-2nd T.M., *supra* at A-47. (noting that the regulation "incorporate[s] the guidance in (and, thus, obsolete[s]), Rev. Ruls. 76-273 and 82-105 and appl[ies] § 2036 (and not § 2039) to GRATs and GRUTs if the grantor does not survive the retained term.").

The estate argues (Br. 35) that it is "nonsensical" to contend that Congress left a gap in the statute when it was first enacted in 1916 for the Treasury Department to fill in 2008. The truth is that the Treasury expressly provided that retained annuities trigger inclusion when the statute was first enacted and for years after. Perhaps the language about annuities was dropped from the regulation because the Treasury considered this point to be so definitively settled. In any event, the Treasury Department never expressed any different view. And in the current regulation, the Treasury sets out the same interpretation of Section 2036(a)(1)'s application to retained annuities that it has maintained since the statute was first enacted. That interpretation was correct 100 years ago and remains correct today.

3. The regulation's formula for determining the amount of property to be included in the gross estate when an annuity is retained is reasonable

The estate also argues, very briefly (Br. 43-44), that the formula for calculating the amount of property that must be included in a decedent's gross estate when an annuity is retained is "flawed." But the estate does not argue that the formula is inconsistent with the language of the statute or that it is arbitrary. *See Chevron*, 467 U.S. at 844. On

the contrary, limiting the includible amount to the property needed to produce income sufficient to pay the annuity is reasonable. Indeed, it is the very same thing the government has always done, as was just explained. It is also worth noting that the estate's objection seems really to be that the inclusion formula has an adverse impact on a different kind of GRAT—a short-term GRAT that contemplates "the amortization of principal as the primary source for the annuity payment." (Br. 43 n.16.) But here, we have a long-term GRAT with an annuity that decedent expected to be paid (and was paid) solely out of income from the transferred property.

II

Independent of decedent's retained annuity interest in the property she transferred to the trust, she "possessed or enjoyed" the property for purposes of I.R.C. § 2036(a)(1) by continuing to control it and by obtaining tax benefits that flowed from it

In the alternative, decedent's control over Y&Y Company, which did not change when she transferred her interest in Y&Y Company to the GRAT, and her continued use of Y&Y Company depreciation deductions to reduce her personal income tax liability also amounts to "possession or enjoyment" of her interest in Y&Y Company for purposes

of I.R.C. § 2036(a)(1). Because it determined that Treas. Reg. § 20.2036-1(c)(2)(i) applied and was valid, the District Court had no need to "decide whether [decedent] retained 'some other interests and powers' in Y&Y Co. that are sufficient to show possession or enjoyment of the property." (ER 15 n.9.) If, as we have argued, the regulation is valid, then this Court also need not address this alternative theory. This Court, however, "may affirm a grant of summary judgment on any ground supported by the record, even one not relied upon by the district court." *Board of Trustees of Glazing Health & Welfare Tr. v. Chambers*, 903 F.3d 829, 845 (9th Cir. 2018) (citation omitted). As a result, if this Court were to declare Treas. Reg. § 20.2036-1(c)(2)(i) invalid and determine that a retained annuity interest in property transferred to a trust does not necessarily require inclusion of the property in decedent's gross estate, it should still affirm because decedent continued to control Y&Y Company and benefited from it after her interest was transferred to the GRAT.[13]

---

[13] To be sure, this Court could also choose to remand the case so that the District Court can address the alternative argument in the first instance. *See K.M. ex rel. Bright v. Tustin Unified Sch. Dist.*, 725 F.3d 1088, 1103 (9th Cir. 2013).

In *Church's Estate*, the Supreme Court interpreted "possession or enjoyment" broadly. It determined that "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." 335 U.S. at 645. It stands to reason, then, as the Tax Court has determined, that retained control over transferred property, when combined with other factors, can constitute "possession or enjoyment" of that property for purposes of Section 2036(a)(1). *See Estate of Trombetta v. Commissioner*, 106 T.C.M. (CCH) 416 (2013). Likewise, another court has relied partly on the fact that a decedent continued to claim a depreciation deduction on her personal tax returns that originated from transferred property in concluding that the decedent had retained "possession or enjoyment" of the property under Section 2036(a)(1). *See Tubbs v. United States*, 348 F. Supp. 1404, 1405 (N.D. Tex. 1972), *aff'd*, 472 F.2d 166 (5th Cir. 1973).

In *Estate of Trombetta*, the Tax Court considered a situation very much like this one. There, as here, a decedent had transferred rental

property to a GRAT and retained the right to an annuity funded by that property.[14] There, the decedent "retained de facto control over the [transferred] properties and their disposition." *Id.* at *12. She also had the ability, with her children, to make additional distributions of income to herself beyond the annuity. She also benefited when income from the transferred properties was used to discharge her personal loan obligations. The Tax Court determined that "[g]iven decedent's continued control over the transferred properties, her right to the excess income from the properties, and the use of the income from the properties to discharge her personal legal obligations, we are unable to find that decedent 'absolutely, unequivocally, irrevocably, and without possible reservations' parted with all of her title, possession, and enjoyment of the transferred properties." *Id.* (citing *Church's Estate*).[15]

---

[14] The decedent in *Estate of Trombetta* died before Treas. Reg. § 20.2036-1(c)(2)(i) went into effect, and so the Tax Court did not apply it. *See* 2013 WL 5708437, at *6.

[15] The Tax Court then went on to apply the reasoning of this Court's decision in *Ray* and to conclude that the decedent's annuity interest in the transferred property also made it includible in the gross estate under Section 2036(a)(1). 2013 WL 5708437, at *13-*14.

Here, decedent's transfer of her interest in Y&Y Company and her relationship with it after the transfer is similar to that of the decedent in *Trombetta*. When her husband died in 1990, decedent became one-half partner in Y&Y Company, and she became more involved in its management. (ER 3.) Critically, her involvement did not change after she transferred her interest to the GRAT in 1998. (ER 5.) She had, for example, the authority to decide who managed Y&Y's properties before and after 1998, and she likewise had the authority to decide on the frequency and amount of partnership distributions of Y&Y Company before and after the transfer. (ER 5, 204.) In addition to deciding how much money Y&Y Company would distribute to her GRAT, decedent also decided how to manage and invest the funds that were not used to pay her annuity. (ER 5.)

Decedent also reported income from Y&Y Company on her personal income tax returns, even after the 1998 transfer, and claimed depreciation deductions attributable to Y&Y Company property on her personal income tax returns. (ER 205, 385-488, 1038, 1123, 1181.) These depreciation deductions had the effect of significantly lowering her gross income and ultimate tax liability. (*Id.*) To be sure, decedent

was required under the grantor trust rules to report trust income on her personal tax return. *See* I.R.C. §§ 671-677. But this fact does not eliminate her enjoyment of a significant economic benefit that flowed from the transferred property. Moreover, Y&Y Company, while under decedent's control, specifically gave her, and not the other partner, H. Frank Yoder III, the depreciation deductions. (ER 205, 385-488, 1038, 1123, 1181.)[16] In addition to this pecuniary benefit, the GRAT was

[16] The estate may argue, as it did below, that decedent ceased to be the trustee of the GRAT when her daughters, in order to pay her bills, obtained a doctor's note two days before her death, attesting to decedent's inability to manage her financial affairs. (ER 88-90, 205.) This argument misses the mark in several ways. First, what matters is decedent's continued control over the property placed in the trust, not her management of the trust itself. Second, decedent did not actually cease to be the trustee of the GRAT. She was never unwilling to act as the trustee because there were no trustee actions that needed to be taken during the short time of her incapacity. As a result, she remained the trustee under the terms of the GRAT. (ER 205-06.) Moreover, California law requires a person to sign the trust accepting a position as trustee or to knowingly exercise powers under the trust. Cal. Prob. Code § 15600(a). Decedent's daughters never knowingly exercised their powers as trustee before decedent's death, and they never signed the GRAT as successor trustees. They signed the trust at its creation only as special trustees, and their power as such was limited to approving special distributions to decedent. (ER 607-08, 612.) As a result, they never accepted their position as successor trustees. In addition, in California, a trustee must die, be removed or have a guardian appointed in order for there to be a vacancy. Cal. Prob. Code § 15643. Decedent had not yet died when her daughters claim to

structured as in *Trombetta* so that decedent could draw additional distributions, over and above the annuity, if her daughters approved. (ER 607-08, 612.)

In short, even apart from her annuity interest, decedent's continued control over the transferred property and the direct personal tax benefits that continued to flow to her from the transferred property amount to "possession or enjoyment" of that property. The transferred property is therefore includible in the gross estate under Section 2036(a)(1).

---

have become trustees, the daughters never did anything to remove her as trustee and decedent never had a guardian appointed. In these circumstances, decedent's daughters did not become trustees of the GRAT.

CONCLUSION

The judgment of the District Court should be affirmed.

Respectfully submitted,

RICHARD E. ZUCKERMAN
Principal Deputy Assistant Attorney General

/s/ Nathaniel S. Pollock

TERESA E. MCLAUGHLIN (202) 514-4342
NATHANIEL S. POLLOCK (202) 514-8139
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:

ALEX G. TSE
United States Attorney

NOVEMBER 2018

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the United States respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending in this Court.

ADDENDUM

I.R.C. § 2036 (excerpts) 71

Treas. Reg. § 20.2036-1 (excerpts)..71-72

Internal Revenue Code of 1986 (26 U.S.C.):

I.R.C. § 2036. Transfers with retained life estate (excerpts)

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

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

Treasury Regulations on Estate Tax (26 C.F.R.):

Treas. Reg. § 20.2036-1 Transfers with retained life estate (excerpts)

(c)(2) Retained annuity, unitrust, and other income interests in trusts—(i) In general. This paragraph (c)(2) applies to a grantor's retained use of an asset held in trust or a retained annuity, unitrust, or other interest in any trust (other than a trust constituting an employee benefit) including without limitation the following (collectively referred to in this paragraph (c)(2) as "trusts"): Certain charitable remainder trusts (collectively CRTs) such as a charitable remainder annuity trust (CRAT) within the meaning of section 664(d)(1), a charitable remainder unitrust (CRUT) within the meaning of section 664(d)(2) or (d)(3), and any charitable remainder trust that does not qualify under section 664(d), whether because the CRT was created prior to 1969, there was a defect in the drafting of the CRT, there was no intention to qualify the CRT for the charitable deduction, or otherwise; other trusts established by a grantor (collectively GRTs) such as a grantor retained annuity trust (GRAT) paying out a qualified annuity interest within the meaning of § 25.2702–3(b) of this chapter, a grantor retained unitrust (GRUT) paying out a qualified unitrust interest within the meaning of

§ 25.2702–3(c) of this chapter; and various other forms of grantor retained income trusts (GRITs) whether or not the grantor's retained interest is a qualified interest as defined in section 2702(b), including without limitation a qualified personal residence trust (QPRT) within the meaning of § 25.2702–5(c) of this chapter and a personal residence trust (PRT) within the meaning of § 25.2702–5(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. The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity, unitrust, or other payment (without reducing or invading principal). In the case of a retained annuity or unitrust, the portion of the trust's corpus includible in the decedent's gross estate is that portion of the trust corpus necessary to generate sufficient income to satisfy the retained annuity or unitrust (without reducing or invading principal), using the interest rates provided in section 7520 and the adjustment factors prescribed in § 20.2031–7 (or § 20.2031–7A), if applicable. The computation is illustrated in paragraph (c)(2)(iv), Examples 1, 2, and 3 of this section. The portion of the trust's corpus includible in the decedent's gross estate under section 2036, however, shall not exceed the fair market value of the trust's corpus at the decedent's date of death.

Form 8. Certificate of Compliance Pursuant to 9th Circuit Rules 28.1-1(f), 29-2(c)(2) and (3), 32-1, 32-2 or 32-4 for Case Number 18-16053

Note: This form must be signed by the attorney or unrepresented litigant *and attached to the end of the brief.*

I certify that (*check appropriate option*):

☐ This brief complies with the length limits permitted by Ninth Circuit Rule 28.1-1. The brief is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable. The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

☒ This brief complies with the length limits permitted by Ninth Circuit Rule 32-1. The brief is 13,925 words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable. The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

☐ This brief complies with the length limits permitted by Ninth Circuit Rule 32-2(b). The brief is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable, and is filed by (1) ☐ separately represented parties; (2) ☐ a party or parties filing a single brief in response to multiple briefs; or (3) ☐ a party or parties filing a single brief in response to a longer joint brief filed under Rule 32-2(b). The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

☐ This brief complies with the longer length limit authorized by court order dated [ ] The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6). The brief is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable.

☐ This brief is accompanied by a motion for leave to file a longer brief pursuant to Ninth Circuit Rule 32-2 (a) and is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32 (f), if applicable. The brief's type size and type face comply with Fed. R .App. P. 32(a)(5) and (6).

☐ This brief is accompanied by a motion for leave to file a longer brief pursuant to Ninth Circuit Rule 29-2 (c)(2) or (3) and is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable. The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

☐ This brief complies with the length limits set forth at Ninth Circuit Rule 32-4. The brief is [ ] words or [ ] pages, excluding the portions exempted by Fed. R. App. P. 32(f), if applicable. The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

Signature of Attorney or Unrepresented Litigant: s/ Nathaniel S. Pollock

Date: 11/14/2018

("s/" plus typed name is acceptable for electronically-filed documents)

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing brief 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 November 14, 2018. I further certify that participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Nathaniel S. Pollock
NATHANIEL S. POLLOCK
Attorney