

TOP TEN DEVELOPMENTS OF 2006

19 Probate Practice Reporter 1 (Jan. 2007)

The past year was full of cases and administrative actions that may be significant to estate planners, but relatively few legislative developments. The following is a summary of what I believe to be the ten most important estate planning tax developments during the 12 months ending December 20, 2006. Please visit our website, at www.probatepracticereporter.com and express your own views on the relative importance of these and any other developments.

Tenth. IRS (Again) Approves Spousal Power of Appointment Trust B But Still Only in a PLR. In PLR 200604028 (Jan. 27, 2006), the IRS approved favorable estate and gift tax treatment for a revocable trust that gives the grantor's predeceasing spouse a general power of appointment over enough of the grantor's assets to allow the predeceasing spouse to take full advantage of the available applicable exclusion amount. The husband in the ruling created a revocable trust to hold his share of the marital assets, and the wife created a similar trust to hold her share of their assets. Each trust gave the first spouse to die a testamentary power over the surviving spouse's trust fund to appoint an amount equal to his or her remaining applicable exclusion amount, reduced by the value of his or her own taxable estate (determined by excluding the amount of the assets to which this power of appointment applied.) The IRS stated that the predeceasing spouse's gross estate included the assets of the surviving spouse's revocable trust, over which the predeceasing spouse holds a general power of appointment, that the nonmarital trust created from the appointment of those assets would not be included in the surviving spouse's gross estate, and that the portion of the predeceasing

spouse's assets appointed by that spouse would be treated as a deductible marital gift from the surviving spouse to the predeceasing spouse. See discussion in the March, 2006 issue of this Reporter.

This ruling further confirms the validity of an excellent tool for taking full advantage of both spouse's applicable exclusion amounts, when the spouses lack sufficient non-IRD assets to assure otherwise that the first spouse to die will be able to use the entire exclusion amount. The IRS reached similar conclusions in TAM 9308002 (Nov. 16, 1992); PLR 200101021 (Jan. 8, 2001), and PLR 200403094 (Jan. 16, 2004). These are only private rulings, however, and taxpayers should consider seeking their own rulings.

If the IRS changed its view and argued that the lapse of the general power of appointment was really a transfer at the moment after the first spouse's death, rather than the moment before the first spouse's death, the transfer would be a gift by the surviving spouse to the beneficiaries of the special nonmarital trust. One can control the damage from such a change of view by having the surviving spouse retain both the right to veto distributions to other family members and a special testamentary power of appointment. This would render any deemed gift incomplete for gift tax purposes. Treas. Regs. ' 25.2511-2(c).

Ninth. IRS Approves Unlimited Gift and GST Tax Exclusion for Prepaid Educational Costs.

In PLR 200602002 (Jan. 13, 2006), the IRS approved the unlimited gift and GST tax annual exclusion for a donor's prepayment of educational costs of the donor's grandchildren for all years through graduation from 12th grade. The donor entered into six separate arrangements with the school to pay at one time an amount equal to the tuition for each of the donor's six grandchildren to

attend through 12th grade. The payments were nonrefundable, and the donor or the donor's children would separately have to pay any increases in tuition during that term. See discussion in the February, 2006 issue of this Reporter.

The IRS approved a similar arrangement in PLR 199941013 (Oct. 18, 1999). This could be an extraordinarily useful death-bed gift for an elderly grandparent, because the total exclusion is unlimited, and there appears to be no requirement that the donor be alive during the entire educational period.

Eighth. IRS Eases Rule on When Spousal Election Rights Interfere With Charitable Remainder Trust Qualification. In Notice 2006-15, 2006-8 I.R.B. 501 (Feb. 21, 2006), *modifying* Rev. Proc. 2005-24, 2005-16 I.R.B. 909 (April 18, 2005), the IRS provided relief from what had promised to be a serious problem for many donors to charitable remainder trusts. Rev. Proc. 2005-24 stated that the existence of a surviving spouse's right to renounce the provisions of a decedent's will and claim an elective share of the decedent's estate that extended to assets transferred by the decedent to a charitable remainder trust would disqualify the trust, unless timely waived by the spouse. The IRS stated that this rule would not apply to trusts in existence on June 28, 2005; such trusts would be disqualified only if the surviving spouse actually exercised the elective share rights at the donor's death. See discussion in May, 2005 issue of the Reporter.

Notice 2006-15 stated that the IRS is currently reviewing this issue and that, until further guidance is issued, all charitable remainder trusts, regardless of whether they were in existence on June 28, 2005, will be disqualified only if the surviving spouse actually exercises the elective share

rights at the donor's death; the mere existence of unexercised elective share rights against the trust will not disqualify the trust.

This reflects substantial criticism the IRS received from various professional organizations and practitioners for its 2005 position. Critics claimed that the procedure presumes an application of the augmented estate rules to pre-marital transfers that is not the law in any state, and that the procedure creates a trap for donors whose marital status, state of residence, or applicable state law changes after the creation of the trust. Notice 2006-15 does not hint at what the future IRS guidance will be, or when it will be released, but it does presently eliminate this potential tax trap.

Seventh. New Guidelines on Deferral of Estate Taxes Attributable to Real Estate Business Interests (Section 6166). In Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (June 26, 2006), the IRS greatly liberalized the rules under which the management of real estate will be deemed an active business the estate taxes on which are eligible for payment over fifteen years, under Section 6166. The ruling provides five illustrative situations in which Section 6166 eligibility is examined, and it sustained eligibility in all but one situation. See discussion in the August, 2006 issue of this Reporter.

The ruling is notable for the general liberality exhibited by the IRS in applying the estate tax deferral rules. In particular, the IRS stated that a decedent would be deemed to have managed real estate actively to the extent that the property was actively managed by a company in which the decedent held at least a 20 percent equity interest. This is an extremely generous interpretation of the active business requirement, for which there is no statutory, regulatory, or case law precedent.

Sixth. Appeals Court Sustains Defined Value Gift. In *McCord v. Comm'r*, 461 F.3d 614, 2006 WL 2411543 (5th Cir. Aug. 22, 2006), *rev'g and rem'g*, 120 T.C. 358 (2003), the Fifth Circuit sustained the use of a clause that gave to the donor's children that number of units of a limited partnership that would produce a set dollar gift. The donor transferred a number of units of partnership interest and required that the donees, including trusts for the donor's children and certain charities, independently divide the shares so that the children's trusts received \$6,910,933 worth of partnership interests, the Shreveport Symphony received \$134,000 worth of partnership interests, and the University of Texas received the balance of the partnership interests.

The Tax Court, in a reviewed decision with several dissents, stated that the IRS was not bound by the donees' valuation and that no charitable deduction was allowed for the additional amount passing to the charity, because the gift relied on the valuation fixed by the donees, rather than one fixed by the courts. See discussion in the July 2003 issue of this Reporter.

The Fifth Circuit reversed, stressing that there was no suggestion that the charities had agreed to value the partnership interests at anything other than their fair market value, even though the University of Texas had foolishly declined to hire its own appraiser. The court stated that the Tax Court wrongly measured the gift based on donees' post-transfer Confirmation Agreement, because the gift tax must be based on the events at the time of the gift, and not on later agreements. See discussion in the October, 2006 issue of this Reporter.

McCord would be far more important were the opinion written a bit more broadly and adopted by other courts. Nonetheless, it represents what may be the first approval of a technique that would add much-needed gift tax certainty to gifts of hard-to-value assets.

Fifth. Second Circuit Limits Trust's Income Tax Deduction for Investment Advice. *Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 139 (2nd Cir. Oct. 19, 2006), *aff'g*, 124 T.C. 304 (2005) represents the fourth appellate opinion of the limited deductibility of trust expenditures for investment advice. The Second Circuit stated that the two percent floor on such deductions applied to any expenses that could be incurred if the property were held individually, and that the exemption for trust expenses applied only to expenses that individuals are incapable of incurring. See discussion in the November, 2006 issue of this Reporter.

The Second Circuit's incapable of incurring standard is undistinguishable from the Tax Court requirement that the expense be unique to the administration of a trust or estate, but it differs materially from the standard adopted by the Fourth Circuit in *Scott v. U.S.*, 328 F.3d 132 (4th Cir. 2003), that the two-percent floor applies to "expenses commonly incurred by individual taxpayers," and the standard adopted by the Federal Circuit in *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001), that allows an unrestricted deduction only for expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." It is also vastly different from the pro-taxpayer standard adopted by the Sixth Circuit in *O'Neill v. Comm'r*, 98 T.C. 227 (1992), *rev'd*, 994 F.2d 302 (6th Cir. 1993), *nonacq.* 1994-2 C.B. 1, that the expense must merely be "caused by" the fiduciary duty of the trustee.

The Second Circuit's standard is the harshest of any of the standards, arguably denying deduction for such common expenses as legal fees, because individuals are also capable of incurring them.

Fourth. Prop. Regs. Would Eliminate Deferral Of Gain on Sales Of Appreciated Property for An Annuity. In Prop. Reg. ' ' 1.72-6(e)1, 1.1001-1(j)(1), 71 Fed. Reg. 61441 (October 18, 2006), the Treasury stated that, if appreciated property is exchanged for a private or commercial annuity: (a) the amount realized is the fair market value of the annuity contract determined under Section 7520; (b) the amount of any gain or loss is recognized at the time of the exchange, regardless of the taxpayer's accounting method; and (c) the initial investment in the annuity contract under Section 72(c)(1) (the amount that determines the taxation of future payments from the annuity contract), is determined by treating the aggregate amount of premiums or other consideration paid for the annuity contract as equal to the amount realized attributable to the annuity contract (the fair market value of the annuity contract).

The proposed regulations generally apply to exchanges of property for an annuity contract after October 18, 2006 (the publication date of the proposed regulations), but not to amounts received after October 18, 2006 under annuity contracts that were received in exchange for property before that date. The effective date is delayed until April 18, 2006 for exchanges in which the issuer is an individual, the obligations are not secured, either directly or indirectly, and the property transferred in the exchange is not sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. See discussion in the November, 2006 issue of this Reporter.

The new rules will significantly undermine the utility of traditional private annuity sales, by requiring that all gain in the asset be recognized on the date of the exchange, to the extent of the actuarial fair market value of the annuity contract. This will not, however, pose a significant problem for exchanges of assets with little or no appreciation, the purchase of an annuity for cash, or the purchase of an annuity from a grantor trust. Thus, while these regulations reduce significantly

the estate planning utility of private annuities, they will not eliminate them as useful estate planning tools.

Third. Irrevocable Life Insurance Trust Lacks Insurable Interest. *Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (ED Va. 2005), *aff'd in part, vac' d in part*, 440 F.3d 639, 2006 WL 538993 (4th Cir. March 7, 2006) is not a tax case, but it should dramatically affect the use of a standard estate planning technique B the irrevocable life insurance trust. The district court in *Chawla* held, in part, that an irrevocable trust had no insurable interest in the life of the grantor and sole lifetime beneficiary, and that the insurer was not obliged to pay the beneficiary the promised proceeds. The Fourth Circuit affirmed the holding, but vacated that part of the opinion that involved the insurable interest, because it had not been necessary for the lower court to reach that conclusion. See discussion in the April, 2006 issue of this Reporter.

Chawla has caused practitioners to focus on the insurable interest rule, which exists some form in every state and the District of Columbia. Very few courts have discussed how one ascertains whether a trust has an insurable interest in the life of its grantor and these decisions have been inconsistent. Only a few states have statutes giving a trust an insurable interest in its grantor or beneficiaries. *Chawla* now forces practitioners in most states to consider how a trustee will be assured of an insurable interest, and whether it is prudent for the trustee to be the initial purchaser of a policy of insurance on the life of the grantor.

Second. Estate Tax Repeal and Reform B House is Good-to-Go, Bills Stall in Senate. A series of bills to reform the estate tax and eliminate the one-year repeal scheduled for January 1, 2010,

passed the House of Representatives, only to stall in the Senate. H.R. 8, 109th Cong., 2nd Sess. (Fails on Senate Cloture Vote, June 8, 2006); H.R. 5638, 109th Cong., 2nd Sess. (Passes House of Representatives, June 22, 2006); H.R. 5970, 109th Cong., 2nd Sess. (Passes House of Representatives, July 27, 2006; Fails on Senate Cloture Vote, Aug. 3, 2006); S. 3626, 109th Cong., 2nd Sess. (June 28, 2006). See discussions in the July and September, 2006 issues of this Reporter.

No one knows what Congress will ultimately do or when they will do it, but it appears likely that no reform of the estate tax will occur in 2007, and that any final reform will include: (a) a significant increase in the estate tax applicable exclusion amount (likely to at least \$5 million, though probably phased-in over several years); (b) reunification of the estate and gift tax exemptions, (c) preservation of the current basis rules and elimination of the threat of carryover basis; and (d) a significant reduction in the estate and gift tax rates. It is also very possible that the final reform bill will include a provision to make a spouse's unused applicable exemption amount available to a surviving spouse.

Had Congress actually passed one of these bills, this would certainly have been the most important development of the year. As Congress did not pass any of these bills, however, the most important development of the year was left to the Tax Court.

First. Divided Tax Court Sustains Validity Of GST Effective Date Regulations. *Estate Of Gerson v. Comm'r*, 127 T.C. ____ (No. 11) (Oct. 24, 2006) raised interesting questions regarding the proper GST tax treatment of certain general powers of appointment, but it may have raised greater questions about the weight generally to be given to interpretative regulations of the Secretary of the Treasury. The Tax Court upheld regulations that treat the post-September 25, 1985 exercise of a

pre-September 25, 1985 general power of appointment as a transfer to which the GST tax applied. The majority followed the court's earlier holding in *Peterson Marital Trust v. Comm'r*, 102 T.C. 790 (1994), *aff'd* 78 F.3d 795 (2d Cir. 1996), which involved the treatment of the lapse of a general power of appointment under the temporary effective date regulations. See May, 1996 issue of this Reporter. The court stated that the effective date rules were intended to protect "reliance interests" of settlors who established irrevocable trusts before the GST tax was introduced, and that the holder of a general power of appointment had no such reliance interest, because he or she could divert the assets to whomever the holder desired. See discussion in the December, 2006 issue of this Reporter.

The Tax Court recognized that the Second Circuit had affirmed its holding in *Peterson Marital Trust*, but that the Eighth and Ninth Circuits had rejected it in cases involving the exercise of a general power of appointments under facts very like those in *Gerson*. See *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999), *revg. and rem'g*, 17 F. Supp. 2d 972 (W.D. Mo. 1998); and *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002), *revg. and rem'g* 126 F. Supp. 2d 1279 (N.D. Cal. 2000). The majority declined to follow the Eighth and Ninth Circuits and noted that those cases predated the final regulations. that the regulations have the force of law and that they must be sustained if reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982).

Of the several concurring and dissenting opinions, the most interesting was the opinion of Judge Vasquez, who concluded that interpretative regulations of the Treasury are not due the broad deference granted them by the majority. Rather, he stated, Treasury interpretative regulations promulgated under Section 7805 lack the force of law, because to hold otherwise would recognize

no distinction between such regulations and those issued pursuant to an express grant of quasi-legislative authority. These regulations are sustained only if they are persuasive.

This case is appealable to the Sixth Circuit and may provide the Supreme Court with a good reason to grant certiorari. Pending the ultimate determination, practitioners advising taxpayers in circuits other than the Second, Eighth and Ninth, should seriously consider adopting Judge Vasquez's well-reasoned analysis.