

TAX MANAGEMENT ESTATE, GIFTS, AND TRUSTS JOURNAL
ARTICLES

Subscriber Notice
January 11, 2007

RECENT TAX DEVELOPMENTS: AN ESTATE PLANNING PERSPECTIVE

by Howard M. Zaritsky, Esq. Pitcairn Financial Group Vienna, Virginia

INTRODUCTION

The past 12 months have witnessed substantial changes in the estate, gift and generation-skipping transfer taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other IRS and Treasury documents from the past year. Because of publication deadlines, this outline includes only those developments reported publicly from October 1, 2005 through November 17, 2006.

This outline is divided into five categories of tax developments: (1) estate taxes, (2) gift taxes, (3) generation-skipping transfer taxes, (4) special valuation rules, and (5) income taxes.

Each category is divided generally by Internal Revenue Code section, except that special consolidated discussion examine the various developments relating to the taxation of family holding companies (corporations, limited partnerships, and limited liability companies), and charitable remainder trusts.

There are also two additional sections, "Other Important Developments" and "Selected Attachments." The former includes discussions of several other important estate planning developments that affect tax planning, but that may not fit easily into any other category. The latter includes sample forms illustrating some of the planning techniques discussed in this outline.

ESTATE TAXES

CODE SECTION 2001. ESTATE TAX REPEAL AND RATES

ESTATE TAX REPEAL FAILS IN SENATE; REFORM RESTARTS IN THE HOUSE

H.R. 8, 109th Cong., 2d Sess. (Senate Cloture Failed, June 8, 2006); H.R.

5638, 109th Cong., 2d Sess. (Passed House of Representatives, June 22, 2006); H.R. 5970, 109th Cong., 2d Sess. (Passed House of Representatives, July 27, 2006; Senate Cloture Failed, Aug. 3, 2006); S. 3626, 109th Cong., 2d Sess. (June 28, 2006)

H.R. 8. On April 13, 2006, the House of Representatives passed H.R. 8, a bill that would make permanent the repeal of the estate and GST taxes on January 1, 2010. The bill, known as the Death Tax Repeal Permanency Act of 2005, passed by a vote of 272 to 162. The bill failed a cloture vote in the Senate, that would have led to a vote on outright repeal. The cloture vote failed to garner the needed 60 votes in the Senate, on June 8, 2006, falling just three votes short.

Kyl Proposal. Sen. Jon Kyl (R-Ariz.), the author of the Senate version of the Death Tax Repeal Permanency Act of 2005 (S. 420), has proposed a reform that would include:

- Immediately increasing in the unified credit to the equivalent of a \$5 million exclusion;
- Indexing of the unified credit for inflation after 2010;
- Reducing the estate and GST tax rates (not the gift tax rate) to a flat 15%, on January 1, 2010;
- Eliminating the January 1, 2010 repeal and the January 1, 2011 revival of the estate and GST taxes; and
- Retaining the present basis step-up rules.

H.R. 5638. Working with Senator Bill Frist (R-Tenn.), Representative Bill Thomas (R-Cal.), chairman of the Committee on Ways and Means, introduced H.R. 5638, which would reform the estate tax. H.R. 5638, as amended before it passed the House, includes the following proposed changes, all of which would be effective January 1, 2010:

- Increasing the unified credit to the equivalent of a \$5 million exclusion;
- Reunifying the estate and gift tax exemptions, so that the unified credit provides a \$5 million exemption for both taxes (as well as a \$5 million GST exemption);
- Indexing the unified credit for inflation;
- Reducing the estate and gift tax rates to the top capital gains tax rate (currently 15%, to increase to 20% January 1, 2010) on estates between \$5 million and \$25 million, and twice that rate on estates above \$25 million;

- Permitting the executor of the estate of a deceased spouse to elect to give any unused applicable exclusion amount to the surviving spouse (usable for gift and estate tax purposes, but not for GST tax purposes);
- Eliminating the scheduled repeal of the estate and GST taxes;
- Retaining the present basis step-up rules; and
- Repealing the state death tax deduction.

The bill passed the House of Representatives on June 22, 2006, by a vote of 269-156, but was unable to get support of the required 60 Senators needed to pass the bill in the Senate, and was not actually put to a vote there.

H.R. 5970. On July 28, 2006, the House of Representatives passed H.R. 5970, which combined estate tax reform with an increase in the minimum wage and the extension of several expiring deductions and credits. This estate tax reform bill was quite similar to H.R. 5638, but it phased in the increased unified credit and the top tax rate over six years, and indexed the top tax rate for inflation. H.R. 5970 included the following proposed changes, which would be effective January 1, 2010, except as noted:

- Increasing the unified credit to the equivalent of a \$5 million exclusion, phased in as follows:
 - \$3.75 million in 2010;
 - \$4 million in 2011;
 - \$4.25 million in 2012;
 - \$4.5 million in 2013;
 - \$4.75 million in 2014; and
 - \$5 million after 2014;
- Reunifying the estate and gift tax exemptions, so that increased unified credit applies to the estate, gift and GST taxes;
- Indexing the unified credit and GST exemption for inflation after 2014;
- Reducing the estate and gift tax rates to the top capital gains tax rate (currently 15%; increasing to 20% January 1, 2010) on estates between \$5 million and \$25 million, and twice that rate on estates above \$25 million. The 30% top rate was phased-in as follows:
 - 40% in 2010;
 - 38% in 2011;

- 36% in 2012;
- 34% in 2013;
- 32% in 2014; and
- 30% after 2014.

- Indexing the \$5 million definition of the top rate bracket for inflation after 2014;

- Reducing the GST tax rate to the same as the top estate tax rate, as phased-in;

- Permitting the executor of the estate of a deceased spouse to elect to give any unused applicable exclusion amount to the surviving spouse (usable for gift and estate tax purposes, but not for GST tax purposes);

- Repealing the state death tax deduction in 2010;

- Making permanent the 2001 Act (EGTRRA) provision (as modified by Section 411 of the Job Creation and Worker Assistance Act of 2002) under which certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust rules;

- Eliminating the scheduled repeal of the estate and GST taxes; and
- Retaining the present basis step-up rules.

The bill passed the House of Representatives on July 28, 2006, by a vote of 230 to 180, but on August 3, 2006, received only 56 votes in the Senate, failing to pass a cloture vote (to cut off debate.) The Joint Committee on Taxation estimated that this bill would have reduced tax revenues by \$267.6 billion per year, when fully phased-in.

It should be noted that the spouse-to-spouse portable unused applicable exclusion amount was not indexed and that the surviving spouse could take advantage of a carryover of unused applicable exclusion amounts from more than one predeceasing spouse, but not more than a total of \$5 million. Also, the carried-over exemption was not available for GST exemption purposes.

Other Proposals. On June 27, 2006, Senator Mary Landrieu (D-La.), one of the swing votes that the Republicans hoped to obtain in support of H.R. 5638, introduced her own compromise proposal, S. 3626, which included the following changes:

- Increasing the unified credit to the equivalent of a \$5 million exclusion;

- Reunifying the estate and gift tax exemptions, so that the unified credit provides a \$5 million exemption for both taxes (as well as a \$5 million GST exemption);
- Indexing the unified credit for inflation after 2010;
- Reducing the estate, gift and GST tax rates to 35% for estates over \$5 million;
- Five percent surtax on estates over \$100 million and under \$200 million, then flat 35% tax;
- \$2.5 million additional Qualified Family Owned Business Interest deduction.

Senator Max Baucus (D-Montana), ranking Democrat on the Senate Finance Committee, is known to have circulated among key Senators an alternate reform proposal, coupling a \$3.5 million exemption with tax rates of 15% on estates between \$3.5 million and \$5 million, 25% on estates between \$5 million and \$10 million, and 35% on estates over \$10 million. Senator Chuck Grassley (R-Idaho) is said to have circulated a reform proposal that included a \$5 million exemption, a 15% rate up to \$30 million and a 30% rate above \$30 million.

Note. See Staff of the Joint Committee on Taxation, 101st Cong., 2d Sess., "Technical Explanation of H.R. 5638, The 'Permanent Estate Tax Relief Act of 2006' As Introduced in the House on June 19, 2006," (6/20/06) (Committee Print); Staff of the Joint Committee on Taxation, 101st Cong., 2d Sess., "Technical Explanation of H.R. 5970 The "Estate Tax And Extension Of Tax Relief Act Of 2006 ("ETETRA")" As Introduced In The House On July 28, 2006" (7/28/06) (Committee Print). See also Noto, "Indexing the Estate Tax Exemption for Inflation" Cong. Res. Serv. Rpt. No. RL33501 (6/29/06).

CODE §§2031, 2032, 2032A AND 7520. VALUATION

TAX COURT VALUATION AND FRAUD PENALTY FOR RARE COINS AFFIRMED

Trompeter Est. v. Comr., 170 Fed. Appx. 484 (9th Cir. 3/13/06), aff'g, T.C. Memo 2004-27, on rem'd from 279 F.3d 767 (9th Cir. 2002), vac'g & rem' g, T.C. Memo 1998-35. Emanuel owned the stock of a valuable privately-held corporation that, among other things, made components for air-to-ground missiles. Emanuel sold a controlling interest in the corporation to a holding company for \$28 million in cash and 3,000 shares of a newly-issued class of preferred stock. The decedent's two daughters became coexecutors of his estate, replacing a longtime attorney and accountant, and assisted in preparing the estate tax return. The executors valued the gross estate at \$26.4 million and the taxable estate at \$12 million. The IRS claimed the omission of \$14 million in diamonds, jewels, gems, art and artifacts, and the undervaluation of the

estate, including rare coins that had been consigned for auction, and the preferred stock, by \$22.8 million. The undervaluations had been made by the estate's new accountant, who had not been informed of much higher appraisals that had been earlier obtained.

The Tax Court (Judge Laro) determined that various assets had been omitted, determined the value of certain rare coins, determined the value of the preferred stock and sustained the imposition of a civil fraud penalty. *Trompeter Est. v. Comr.*, T.C. Memo 1998-35, supplemented 111 T.C. 57 (1998).

The Ninth Circuit vacated the decision of the Tax Court and remanded the case for further consideration, finding that the Tax Court had not sufficiently explained the basis for its ruling on the omitted assets and its rationale for valuing the preferred stock.

On remand, the Tax Court redetermined the value of the omitted and undervalued coins, rejecting the IRS presumption that the auction price of an item of tangible personal property could be its retail sales price, because jewelry and gemstones are not frequently obtained by members of general public at public auction, and auction prices did not reflect commissions that would have been paid by buyers. The court also set the discount rate for valuing the preferred stock at 12.5%, to account for risk that stock would be redeemed at lesser than agreed amount. The court also sustained the civil fraud penalty because of the omitted and undervalued assets.

The Ninth Circuit, in a brief opinion, affirmed the Tax Court, other than one factual conclusion regarding unreported coins.

WHEN DOES A BUY-SELL AGREEMENT FIX ESTATE TAX VALUES UNDER §§2031 AND 2703? --
INQUIRING MINDS WANT TO KNOW

Blount Est. v. Comr., 438 F.3d 1338 (11th Cir. 10/31/05), aff'g in part, rev'g in part, T.C. Memo 2004-116; *Amlie Est. v. Comr.*, T.C. Memo 2006-76 (4/17/06); *Smith v. U.S.*, 2005 WL 3021918, 96 AFTR2d 2005-6549 (W.D. Pa. 7/22/05), request for new trial denied, 2006 WL 1984646, 98 AFTR2d 2006-5402 (W.D. Pa. 7/13/06) (slip opinion)

Blount Est. William Blount and his brother-in-law, James Jennings, each owned 50% of the outstanding shares of a closely-held corporation. In 1981, William, the corporation and James entered into a buy-sell agreement restricting transfers of the corporation's stock, both during the shareholders' lifetimes and at death. Lifetime transfers required the consent of the other shareholders. At death, a shareholder's estate was required to sell, and the corporation was required to buy, the deceased shareholder's shares at a price set in the agreement. The agreement further provided that it could be modified only by the written consent of the parties, but it did not define "parties" or contain any mechanism for adding parties. The corporation bought insurance policies to comply with the agreement, and started an employee stock ownership program (ESOP), and valuations were made by a third party to facilitate the

purchases. In January 1996, James died, owning 46% of corporation's outstanding shares. The corporation received \$3 million from the insurance proceeds and paid a little less than that figure to William's estate. William, at that time, owned a controlling interest in the corporation. In 1996, without obtaining the ESOP's consent, William and the corporation modified the agreement, changing the price and terms under which the corporation would buy William's shares at his death, and (albeit ambiguously) leaving unchanged the provision requiring the consent of other shareholders for lifetime transfers. The modified price was substantially below the price that would have been payable pursuant to the unmodified agreement. William died in 1997, owning approximately 83% of the corporation's shares. The corporation bought his stock for \$4 million. The estate valued the stock at \$4 million, and the IRS disagreed and assessed a deficiency based on a \$7.9 million valuation.

The Tax Court (Judge Gale) held that the modified agreement is disregarded for purposes of determining the value of William's shares for Federal estate tax purposes because he had the unilateral ability to modify the agreement, rendering the agreement not binding during his lifetime, as required by Regs. Section 20.2031-2(h). The court noted that William did not obtain the consent of the only other shareholder (the ESOP), in connection with the 1981 modification, demonstrating that he and the corporation did not believe that the ESOP's consent was required. The court also held that Section 2703 applied to the modified agreement, even though the original agreement was executed before the 1990 effective date, because the 1996 modification, which occurred after the effective date, was a substantial modification. The Tax Court stated that the modification was substantial because it was not de minimis. Regs. Section 25.2703-1(c)(1). The court further held that the modified agreement would be disregarded under Section 2703(a), because it did not consist of terms comparable to similar arrangements entered into by persons in an arm's-length transaction. The court also stated that the \$4 million of life insurance on William's life had to be included as an asset of the corporation in determining its value.

The Court of Appeals for the Eleventh Circuit affirmed in part and reversed in part. The court agreed with the Tax Court, that the 1981 agreement, as amended in 1996, must be ignored in determining the value of the corporate shares, both because William's control over the corporation rendered the agreement not fixed and binding during his lifetime, and because the estate had not proven that the terms of the agreement were comparable to those that would be entered into among unrelated parties. The court stated, however, that the Tax Court erred in including the life insurance proceeds in the value of the corporation. The court stated that the insurance proceeds paid upon the death of the insured shareholder should not be included in the computation of the company's fair market value, because they were offset by the liability under the agreement to purchase William's stock.

Note. The Eleventh Circuit's opinion in Blount was the first time that an appeals court discussed the evidence required to satisfy the comparability test

of Section 2703. The taxpayer presented testimony of an appraiser that the formula contained in the revised agreement was similar to those used in arm's-length agreements. The Eleventh Circuit stated that the Tax Court was correct in rejecting this testimony, because the appraiser had not considered "noneconomic factors that would lead to truly comparable transactions." Apparently, the courts want the expert to attest to the comparability of the agreement terms other than the price, even though the price terms are the primary concern of the courts in estate tax cases.

See also Bogdanski, "Stock Buyouts Funded by Life Insurance: The Blount Conundrum," 33 Estate Planning 40 (June 2006).

Amlie Est. Pearl Amlie's estate included stock of a closely-held bank corporation. She left some of the stock to a trust for one of her sons, Rod, and gave the trust the first right to buy the balance of the stock from the estate. Pearl became unable to manage her own affairs, and a conservator was appointed. The conservator entered into a 1991 buy-sell agreement with the corporation and the controlling shareholder, that prohibited Pearl from transferring her stock without first offering it to the other parties or obtaining their consent, and that gave Pearl put options to require the corporation to buy all of her common shares for their book value. The corporation was given a call option, exercisable for one year after Pearl's death, to buy all of her shares for the same prices. The agreement also prohibited Mr. Hill, the majority shareholder, from selling his controlling interest to a third party unless Pearl were offered the opportunity to sell her shares to the same third party for the same consideration per share. In 1994, Mr. Hill sold his shares to another bank corporation, for book value, plus an employment contract, a signing bonus, retirement of certain capital notes, and an option to exchange his stock of the acquiring corporation for stock of a loan subsidiary corporation after five years. Pearl's conservator was allowed to exchange her stock for the acquiring corporation's shares, based on their respective book values. The conservator also entered into a new buy-sell agreement that set the price of Pearl's shares at 1.25 times book value, reflecting the value of Mr. Hill's ancillary rights under the merger agreement (the "Hill Rights.") Rod contested the agreement, and a local court rejected it as providing an inadequate price. The conservator settled these disputes by entering into a 1995 Family Settlement Agreement (the "1995 FSA"), which, in part, restricted Pearl's lifetime transfers of stock, required that all bequests to Rod (or his trust) be satisfied with shares of the stock at a fixed dollar value, and gave Rod's trust the right to buy the rest of the stock at that same price.

The Tax Court (Judge Gale) held that the 1995 FSA established the fair market value of Pearl's shares. The court explained that the agreement set a fixed and determinable price, because all of the decedent's shares had either to be sold to Rod at the fixed price, or distributed to him in satisfaction of a pecuniary bequest, based on that same value. The court found that the 1995 FSA was a bona fide business arrangement, because it furthered

the conservator's goals of securing a guaranteed price and buyer for the decedent's minority interest in a bank corporation. The court rejected the IRS argument that there could be no bona fide business purpose under Section 2703(b)(1), because Pearl's stock was not an actively managed business interest, but rather an investment asset. The court stated that hedging the risks to Pearl's investment asset was itself a business purpose, as was planning for the future liquidity needs of her estate. The court held that the 1995 FSA, though entered into with Rod, was not a mere testamentary device to transfer the property subject to the agreement to members of Pearl's family for less than full and adequate consideration in money or money's worth. The court noted that it was entered into by the conservator, an independent bank, acting as representative of Pearl's interests, and that it set a price that was fair, taking into account discrepancies in the expert opinions over the value of her entitlement to compensation for the Hill Rights. Most importantly, the Tax Court also held that the 1995 FSA's terms were comparable to similar arrangements entered into by persons in an arm's-length transaction. The estate's expert, an attorney with extensive experience in the purchase and sale of closely held equity interests, testified that the 1995 FSA was comparable to arrangements entered into by persons in arm's length transactions, because the price and structure for the sale of the bank stock in the 1995 FSA was virtually identical to the terms of the earlier agreement that had been reached in arm's length negotiations between the conservator and the corporation. The IRS stated that this was insufficient for purposes of Section 2703(b)(3), because it relied on an "isolated comparable." The Tax Court noted that the Code requires only a showing that the agreement's terms are comparable to similar arrangements entered at arm's length. The regulations caution against using isolated comparables, but the court stated that this really creates only a safe harbor, rather than a requirement that multiple comparables be shown. The court added that the price terms included in the 1995 FSA was based on a survey of comparable corporations. The court also cited several other factors as supporting the conclusion that the terms of the 1995 FSA were comparable to arrangements entered into at arm's length. First, identical price terms in the rejected 1994 agreement and the 1995 FSA were reached by negotiations between the conservator, who had a fiduciary duty to safeguard the decedent's interests, and the corporation. The negotiations among the prospective heirs to reach the 1995 FSA were also arm's length, because the interests of the prospective heirs other than Rod were adverse to his interests with respect to the price terms for the stock. An understated price in the 1995 FSA would have penalized the other prospective heirs.

Note. This is the first case ever to hold that a buy-sell agreement had actually complied with the requirements of Section 2703.

The case also involved the valuation of the decedent's farmland, which included two fractional interests. The court allowed only slight discounts, because the estate's appraiser produced no good comparables to support a more substantial discount.

Smith. Sidney E. Smith, Jr. gave various family members fractional interests in a family limited partnership that he and his son had formed, the only asset of which was all of the common stock of an operating company, Erie Navigation Company, Inc. At its formation, the partnership had two general partners, Sidney, Jr., who owned a 2% general partner interest, and his son, Sidney E. Smith, III, who owned a 1% general partner interest. Sidney, Jr. also owned a 95.15% limited partner interest, and his son owned a 0.9% limited partnership interest. Sidney, III's wife also owned a 0.95% limited partner interest. In 1998, Sidney, Jr. decedent gave his son and daughter-in-law each two gifts of a 26.92% limited partner interest. Sidney, Jr. filed federal gift tax returns valuing the gifts at a total of \$1,025,392. The IRS disagreed with the decedent regarding the value of the limited partnership interests, and assessed a deficiency of \$360,803.00, based on a disagreement regarding the impact on the value of the partnership interests of certain transfer restrictions contained in the partnership agreement. The partnership agreement stated that the partnership had a right of first refusal that it could exercise if a partner sought to sell his or her partnership interest. Sidney, Jr.'s appraiser substantially discounted the value of the limited partnership interests because of provisions in the agreement limiting the price and terms at which the partnership would be required to pay a partner for his or her partnership interests. The partnership was directed to pay for any purchased partnership interest with a non-negotiable promissory note of the partnership and/or the buying partners, payable over 15 years, with interest at the applicable federal rate for long-term debt instruments.

A U.S. magistrate recommended that the taxpayer's unilateral ability to amend or modify the family limited partnership agreement, including the buy-sell provisions, should cause the restrictions to be disregarded for purposes of valuing the interests given away. The magistrate granted the IRS summary judgment, finding that the agreement was not binding and that, therefore, it did not fix gift tax values. The partnership agreement stated that "[t]he General Partner or General Partners shall make all decisions and otherwise act by the majority vote of the total general partnership interests." At all times prior to his death, the taxpayer owned two-thirds of all general partnership interests and, thus, was able unilaterally to make all general partner decisions under the partnership agreement. As the decedent could amend the agreement, its restrictions on transfer should be disregarded.

Note. Courts have traditionally refused to give much weight to buy-sell agreement provisions in gift tax cases, because the agreements do not usually restrict lifetime gifts. See, e.g., *Ward v. Comr.*, 87 T.C. 78 (1986); *Berzon v. Comr.*, 63 T.C. 601 (1975), aff'd on other issues, 534 F.2d 528 (2d Cir. 1976); *James v. Comr.*, 3 T.C. 1260 (1944), aff'd, 148 F.2d 236 (2d Cir. 1945); *Kline v. Comr.*, 30 F.2d 742 (3d Cir. 1942). Courts have traditionally held that these agreements, in appropriate situations, can be a factor in determining the valuation of the transferred interests, however. *Spitzer v. Comr.*, 153 F.2d 967 (8th Cir. 1946); *Comr. v. McCann*, 146 F.2d 385 (2d Cir. 1949), rev'g and rem'g 2 T.C. 702 (1943), nonacq. 1943 C.B. 36.

See also prior report of the same magistrate, adopted by the district court: (a) granting the IRS a partial summary judgment that Section 2703(a) applies to the restrictive provision contained in organic documents, as well as to provisions contained in a separate agreement; (b) denying both parties summary judgments regarding whether the agreement was a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth, because this would require actual findings of fact; (c) granting the taxpayer a partial summary judgment that the buy-sell agreement was a bona fide business arrangement, because it facilitated the maintenance of family ownership and control of a business; and (d) denying both parties summary judgment regarding whether the terms of the agreement were comparable to those contained in agreements entered into at arm's length by unrelated persons. *Smith v. U.S.*, 2004 WL 1879212, 94 AFTR2d 2004-5283 (W.D. Pa., Mag. Rpt., 2004), adopted, 2004 WL 2051218, 94 AFTR2d 2004-5627 (W.D. Pa., 2004).

Note. See also discussion in Aghdami, Mancini & Zaritsky, Structuring Buy-Sell Agreements: Analysis with Forms, ¶6.07.

ESTATE TAX VALUE OF IRAS CANNOT BE DISCOUNTED FOR INCOME TAXES OR LACK OF MARKETABILITY

Kahn Est. v. Comr., 125 T.C. 227 (11/17/05). Doris' estate filed an estate tax return including in the gross estate Doris' individual retirement account (IRA). The estate discounted the IRA by the expected Federal income tax liability that would result from distributing the IRA's assets to the beneficiaries. Alternatively, at trial, the estate argued that a discount should be available for lack of marketability.

The Tax Court granted summary judgment for the IRS. The court stated that the underlying assets of the IRA, rather than the account itself, are included in the gross estate. A sale of those assets would simply change the investments of the IRA, and no income tax would be imposed. Also, the question of unfair double taxation is addressed by the deduction in Section 691(c). The court also held that no discount should be allowed for lack of marketability, because the assets in the IRAs are publicly traded securities. The estate argued that payment of the tax upon the distribution of the assets was a prerequisite to making the assets marketable, but the court disagreed, noting that the IRA would be the seller of the assets, rather than the beneficiaries.

Note. See similar holding in *Smith Est. v. U.S.*, 391 F.3d 621 (5th Cir. 2004), aff'g, 300 F. Supp.2d 474 (S.D. Tex. 2004), and TAM 200247001.

TAX COURT VALUES S CORPORATION STOCK WITHOUT TAX ADJUSTING AND REDUCES VALUE OF PROMISSORY NOTE FOR SCIN PROVISION

Dallas v. Comr., T.C. Memo 2006-212 (9/28/06). Robert sold 55% of the nonvoting stock of an S corporation to trusts for the benefit of his two sons. One of the sales was made in exchange for a self-cancelling installment note

(SCIN.) The IRS disagreed with Robert regarding the valuation of the stock, primarily rejecting the use of tax-affecting to reduce the net earnings of the corporation for valuation purposes. The IRS also insisted that the value of the SCIN must be discounted to reflect the self-cancelling feature.

The Tax Court (Judge Colvin) agreed with the IRS on both points, though it valued the stock in between the value suggested by the taxpayer and that suggested by the IRS. The Tax Court held that the value of S corporation stock was determined without "tax adjusting" because there was no indication that the corporation would lose its S corporation status upon a sale of its stock. Distinguishing *Gross v. Comr.*, T.C. Memo 1999-254, aff'd 272 F.3d 333 (6th Cir. 2001). The court also held that a promissory note given to the decedent by his children in an intrafamily installment sale, must be valued below its face amount, because the note had a self-cancelling feature that terminated the buyer's obligation to pay if the seller died before the note was repaid in full.

VALUATION OFFSET FOR C CORPORATION UNRECOGNIZED CAPITAL GAINS REDUCED TO REFLECT UNLIKELIHOOD OF ACTUAL LIQUIDATION

Jelke Est. v. Comr., T.C. Memo 2005-131 (5/31/05), app. filed (11th Cir. 10/5/05). Frazier Jelke, III's gross estate included a 6.44% interest in a company substantially all of the assets of which were marketable securities. The company had been in existence for many years, was well managed and had a relatively high rate of return in the form of annual dividends coupled with capital appreciation of approximately 23% annually for the five-year period before Frazier's death, and during this same period there was no action taken to liquidate the company. The company's securities turnover averaged only 6% per year. On the date of death, the company's net asset value was approximately \$178 million and it had a built-in capital gain tax liability of approximately \$51 million. The estate valued Frazier's interest by reducing the company's net asset value by the entire \$51 million potential capital gain, and then applying discounts for lack of control and marketability.

The Tax Court (Chief Judge Gerber) held that the built-in capital gain tax liability must be discounted to reflect the fact that the company was unlikely to be liquidated for many years after the decedent's death. The court noted that, while it is now well-settled that the liquidation value of a C corporation should include an offset for the capital gains tax that would be due when the company is liquidated, there was disagreement between the Tax Court and several circuits regarding whether a discount was appropriate when the estate could not establish a likelihood of prompt liquidation or sale. *Davis Est. v. Comr.*, 110 T.C. 530, 552-554 (1998); *Welch Est. v. Comr.*, T.C. Memo 1998-167, rev'd without published opinion 208 F. 3d 213 (6th Cir. 2000); *Eisenberg v. Comr.*, T.C. Memo 1997-483, rev'd 155 F. 3d 50 (3d Cir. 1998), acq. 1999-1 C.B. xix; *Gray v. Comr.*, T.C. Memo 1997-67; *Dunn Est. v. Comr.*, T.C. Memo 200012, rev'd 301 F. 3d 339 (5th Cir. 2002); *Jameson Est. v. Comr.*, T.C. Memo 1999-43, rev'd 267 F.3d 366 (5th Cir. 2001). This case was not appealable

to a circuit that had already addressed this issue, and the Tax Court held that the company's profitability suggested that it would not be liquidated or sold quickly. The court discounted the capital gains tax offset for the 16 years it estimated would be required to sell all of the company's securities, at the present turnover rate. This reduced the capital gains tax offset from \$51 million to \$21 million for the entire company, and the decedent's share of that discount from \$3,284,400 to \$1,352,400. The court also rejected the 25% minority discount and 35% marketability discount, and allowed a 10% minority discount and a 15% marketability discount (23.5% aggregate discount).

Note. The court's reasoning seems flawed, because the estate tax should take into account only those facts extant on the date of death. In valuing a C corporation at liquidation values for estate tax purposes, it seems more appropriate to value the company as if it were liquidated on the date-of-death, for this purpose.

See also Bogdanski, Federal Tax Valuation, ¶6.03.

DISTRICT COURT SAYS THAT RIGHT TO RECEIVE NONASSIGNABLE LOTTERY WINNINGS IS VALUED CONSIDERING ALL RELEVANT FACTS, NOT STRICTLY UNDER SECTION 7520

Davis v. U.S., 2005 WL 3464384, 2005 TNT 250-8 (D.N.H. 12/19/05), order corrected on reconsideration, 2006 WL 213761, 2006 TNT 22-9 (1/27/06). Kenneth won the Massachusetts lottery and received the first of 20 annual payments of \$209,220 before his death. At his death, Kenneth was entitled to receive 10 more annual payments. Kenneth's estate valued the remaining 10 payments under the Section 7520 actuarial tables, though they erred slightly and undervalued them at \$1,584,690, rather than the \$1,607,164 that the IRS determined was the correct value. The estate sued for a refund, claiming that the value of the lottery annuity should be reduced to \$800,000, to reflect the lack of marketability, because the annuity cannot be assigned, sold, transferred or pledged as collateral. Both sides moved for summary judgment.

The district court denied summary judgment to both sides. Both sides stipulated that the lottery winnings were an "annuity" as defined in §§2039 and 7520, that they were an "ordinary annuity interest" under Regs. Section 20.7520-3(b)(1)(I)(A), and that they were neither marketable nor assignable. The court stated that it agreed with the courts that have held that marketability should be taken into account in valuing an annuity, and that the Section 7520 actuarial tables do not take into account marketability in determining the present value of an annuity. See Shackleford v. U.S., 262 F.3d 1028 (9th Cir. 2001); Gribauskas Est. v. Comr., 342 F.3d 85 (2d Cir. 2003). The court distinguished between the present value of the annuity, determined under Section 7520, from its fair market value, as determined for purposes of Section 2039. Nevertheless, the court denied the IRS partial summary judgment because it could not conclude, as a matter of law, that the annuity tables were an appropriate measure of the fair market value of the annuity in question. It denied the estate its partial summary judgment because the fair market value of

the annuity was a question of fact that was inappropriate for summary judgment.

Thereafter, the government asked the court to reconsider its order, citing the regulations statement that all ordinary annuity interests must be valued under Section 7520. The court reaffirmed that this rule will not be applied when the result is patently unreasonable.

Note. Compare, *Donovan Est. v. U.S.*, 2005 WL 958403, 95 AFTR3d 2005-2131 (D. Mass. 2005), also involving a winner of the Massachusetts lottery, where the District Court for Massachusetts granted summary judgment to the IRS, holding that as a matter of law, the value of a nonassignable annuity is determined under Section 7520, rather than on the basis of all relevant facts and circumstances. The court followed the decision of the Tax Court in *Gribauskas Est. v. Comr.*, 116 T.C. 142 (2001), and that of the Fifth Circuit in *Cook Est. v. Comr.*, 349 F.3d 850 (5th Cir. 2003), aff'g T.C. Memo 2001-170, and rejected that of the Second Circuit in *Gribauskas Est. v. Comr.*, 342 F.3d 85 (2d Cir. 2003), rev'g 116 T.C. 142 (2001), and of the Ninth Circuit in *Shackleford Est. v. U.S.*, 262 F.3d 1028 (9th Cir. 2001), aff'g, 84 AFTR2d 99-5902, 1999 WL 744121 (E.D. Cal. 1999).

If *Donovan*, *Cook*, and the Tax Court view in *Gribauskas* are wrong, and *Davis*, *Shackleford* and the Second Circuit view in *Gribauskas* are correct, does this preclude the use of the Section 7520 tables to value a private annuity that prohibits assignment, or an interest in a GRAT the spendthrift clause of which prohibits assignment? If so, there may be a substantially increased gift tax associated with both of these transactions.

SECTION 2032A LIMITATION ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/27/06); Rev. Proc. 2005-70, 2005-70 I.R.B. 979 (11/21/05). An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up to \$900,000 for estates of decedents dying in 2006, or \$940,000 for estates of decedents dying in 2007.

CODE SECTION 2033. ASSETS OWNED BY DECEDENT

GROSS ESTATE INCLUDES VALUE OF ANNUITIES CREATED UNDER LITIGATION SETTLEMENT AGREEMENT

Davenport Est. v. Comr., T.C. Memo 2006-215 (11/5/06). Sarah suffered serious injuries in the process of her birth and she (through a "next friend") and her parents sued the attending physician and the hospital in which she was born. In settlement of that litigation, the defendants agreed, in applicable part, to pay Sarah \$2,500 per month for life, or for 30 years, whichever was longer, with a 5% compound interest, and to pay her parents a similar sum during Sarah's lifetime or for 30 years, whichever was longer, with a 5% compound interest. The hospital satisfied its portion of the obligations by buying a single-premium life annuity from an insurer. At Sarah's death, her

executors did not include the annuity in her gross estate, and the IRS assessed a deficiency.

The Tax Court (Judge Wherry) held that both annuities were includible in Sarah's gross estate under Section 2033, as an asset beneficially owned by her on the date of her death. The court explained that the annuities includible in Sarah's gross estate were those created under the settlement agreement, rather than the insurance annuity contracts purchased to satisfy those obligations. See *Arrington v. U.S.*, 108 F.3d 1393 (Fed. Cir. 1997). The court heard parole evidence to construe ambiguities in the settlement agreement, and concluded that the annuities were payable to Sarah's estate at her death, absent a valid beneficiary designation. The court noted that the annuities were payable because of litigation to redress damages to Sarah, that she was the annuity measuring life and that the benefit checks were made payable to her, through her parents as co-conservators. The court rejected the contention that Sarah's parents also held beneficial interests in the annuities (which would have reduced the amount includible in Sarah's gross estate), noting that Sarah's parents were expressly named payees of a smaller lump-sum payment under the settlement agreement, but that Sarah was named as the recipient of the annuity payments. The court rejected as probative testimony of Sarah's parents that they viewed the settlement agreement as resolving joint claims that they had with Sarah with respect to her injuries, noting that Sarah's parents did not demonstrate any way in which they would directly benefit from the annuities during Sarah's lifetime. The court valued the annuities under the actuarial tables promulgated under Section 7520, and declined to base the valuation on the cost of a comparable commercial annuity on the date of death, at least in part because Sarah's executors offered no evidence of such comparable policy costs.

Note. The funeral following Sarah's death included a luncheon reception for friends of the deceased and of her parents. Sarah's executors deducted the cost of that luncheon as a funeral expense, and the IRS disallowed the deduction. The Tax Court held that the costs of the luncheon were not deductible under Section 2053(a)(1), because the luncheon was not necessary in connection with the funeral. See *Berkman Est. v. Comr.*, T.C. Memo 1979-46; *Tuck Est. v. Comr.*, T.C. Memo 1988-560.

FAMILY HOLDING COMPANIES (CODE §§2031, 2036-2038, 2512, ET AL.)

SECTION 2036(A) AND FAMILY PARTNERSHIPS

Abraham Est. v. Comr., T.C. Memo 2004-39, aff'd 408 F.3d 26 (1st Cir. 5/25/05), cert. denied sub nom. *Cawley v. Comr.*, ___ U.S. ___, 126 S.Ct. 2351, 165 L.Ed. 2d 278 (6/5/06). Ida received three significant properties from the estate of her deceased husband. Ida's children, her guardians and guardians ad litem entered into a court-approved plan to rearrange her financial affairs to reduce estate taxes. The plan required that the three

properties be transferred to three family limited partnerships, each having a corporate general partner the stock of which would be owned by a trust for Ida. The children were not to receive partnership income until the general partner had set aside sufficient sum to pay for the partnership's administration and the support of the decedent. One daughter testified at trial:

[T]he partnerships assured ... that [Mrs. Abraham] would be constantly protected. She would never want for anything. There would always be money there. And if there wasn't money in her partnership fund, it had to come out of my partnership shares or my brother's, but the protection was there for her as a guarantee that she would live status quo.

The corporate trustees (Ida's guardians ad litem) ran the partnerships, acting in a fiduciary capacity for Ida, and they had complete discretion to determine how much money Ida should take from the partnerships to meet her needs. Ida initially held a 98% limited partnership interest in two of the partnerships, the corporate general partners each held a 1% interest, and one of Ida's daughters each held a 1% interest. Ida initially held a 99% limited partnership interest in the other partnership, and the corporation held the remaining 1%. Ida later gave 30% limited partnerships to three of her children, two in exchange for cash transfers and the third in exchange for the settlement of certain claims. The IRS included the value of the properties in Ida's gross estate under Section 2036(a), because she had retained the lifetime income and beneficial enjoyment of those assets.

The Tax Court (Judge Ruwe) agreed with the IRS, stating that Ida continued to enjoy the right to support and maintenance from all the income of the partnerships, because the decree that authorized the creation of the partnerships stated that her needs for support were contemplated first from the partnership income, and only thereafter, could the children receive their proportionate shares of income from the partnerships. Ida's support needs were actually treated as an obligation of the partnerships. The court also noted that one of Ida's children admitted the existence of a pre-arrangement to maintain the status quo with respect to her mother's financial situation.

The U.S. Court of Appeals for the First Circuit affirmed, finding both that the purchase of the partnership interests by the children were not bona fide sales for adequate and full consideration, and that the decedent retained lifetime rights in the income from all of the partnership assets. The estate argued that the partnership's payments for Ida's maintenance never exceeded what she was legally entitled to by virtue of her ownership of a substantial percentage of the partnership interests. The court rejected this argument, noting that Section 2036(a)(1) is applicable because the guardian ad litem had the option to divert all of the partnership income to the decedent's maintenance, whether or not the option was ever exercised. In addition, the estate did not prove that the two daughters paid adequate consideration for

their partnership interests. The estate produced no admissible evidence concerning the adequacy of the discounted value of the partnership interests purchased, and on appeal, the estate changed its argument to show that the daughters bought present fee interests in the partnerships. On appeal, the estate argued that the daughters had bought remainder interests, and that the fair market value of those interests should be actuarially determined. The court disagreed, noting that the daughters paid the purchase prices to the partnership, rather than to the decedent, suggesting that they had bought fee simple interests.

The U.S. Supreme Court denied certiorari.

Planning Points. Estate planners should pay careful attention to how partnerships are structured and administered, because Section 2036(a) is a potent basis for IRS challenge, even in light of the broad application of the bona fide sale rule in *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004), vac'g & rem'g, 244 F. Supp. 700 (N.D. Tex. 2003). For other recent examples where the assets transferred to a family limited partnership were included in the deceased partner's gross estate under Section 2036(a)(1), see *Bigelow Est. v. Comr.*, T.C. Memo 2005-65, app. filed (9th Cir. Nov. 11, 2005); *Korby Est. v. Comr.*, T.C. Memo 2005-103, app. filed; *Korby Est. v. Comr.*, T.C. Memo 2005-102; and *Rosen Est. v. Comr.*, T.C. Memo 2006-115.

See also August, Dawson & Maxfield, "The IRS Continues Its Section 2036 Assault on Family Limited Partnerships," 7 *Bus. Entities* 20 (Part 1) (Sept./Oct. 2005); August, Dawson & Maxfield, "The IRS Continues Its Section 2036 Assault on Family Limited Partnerships," 8 *Bus. Entities* 6 (Part 2) (Jan./Feb. 2006); Bogdanski, "Bye Bye Byrum, Bonjour Bongard," 32 *Est. Plan.* 47 (June 2005); Korpics, "How Estate Planners Can Use Bongard to Their Advantage," 32 *Est. Plan.* 32 (July 2005); Korpics, "Qualifying New Flps for the Bona Fide Sale Exception: Managing Thompson, Kimbell, Harper, and Stone," 102 *J. Tax'n* 111 (Feb. 2005); Updike, "Making Sense of Family Limited Partnership Law After Strangi and Stone: A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception," 50 *S.D. L. Rev.* 1 (2005).

Practical estate planners should consider the following steps to minimize or avoid the application of Section 2036(a) to their own family limited partnerships:

Section 2036(a)(1)

- The general partners should keep detailed contemporaneous records of their activities, and send copies to the limited partners (for information purposes, only);
- Have partnership stationery, to assure that the general partner never acts in a different capacity;
- Never, never, never commingle partnership and personal assets;

- Never, never, never pay personal expenses from the partnership assets, even if capital account adjustments are made;
- Do not transfer personal use assets to the partnership;
- Never put too much of the donor's wealth in the partnerships; the donors should retain enough assets on which to live comfortably;
- Try to fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets;
- Limited partners should pay for their partnership assets with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership;
- Family members or trusts to whom the client wishes to pass the bulk of the partnership assets should themselves be general partners and participate in the operations of the enterprises;
- All partners should be represented by counsel and consulted in the preparation of the governing instruments;
- Consider a provision, like one used in the Stone documents, that precludes anyone voting for a general partner through a power of attorney (Contrast the emphasis in Strangi that the general partner's son-in-law ran the partnership under a power of attorney);
- Create and fund the partnership as early as possible, to minimize any appearance that it is testamentary in nature;
- Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees.

Section 2036(a)(2)

- Eliminate discretion regarding distributions -- either preclude distributions during the donor's lifetime (preferred), or require distribution of all income;
- Create two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter. See Gans & Blattmachr, " Strangi: A Critical Analysis and Planning Suggestions," 100 Tax Notes 1153 (9/1/03).

TRANSFERS OF STOCK TO FAMILY LIMITED PARTNERSHIP VALUED WITHOUT DISCOUNTS, AS GIFTS OF STOCK, RATHER THAN GIFTS OF PARTNERSHIP INTERESTS

Senda v. Comr., 433 F.3d 104 (8th Cir. 1/6/06), *aff'g*, T.C. Memo 2004-160. Mark and Michele created a family limited partnership to hold over \$5 million worth of MCI WorldCom stock. They signed the partnership agreement on (or near) April 1, 1998, and the certificate was issued the following June 3. The partnership agreement recited that the interests were initially held by Mark and Michele, their revocable trusts, and irrevocable trusts created for their children, but there were no written trust agreements for the children's trusts until more than a year later. Mark and Michele assigned the stock to the partnership on December 28, 1998, in exchange for the partnership interests, and the children's trusts were granted partnership interests in exchange for oral accounts receivable, which were never reduced to writing, which had no terms for repayment, and which had not been paid by the trial. Mark and Michele, on that same day, gave the trusts for their children additional limited partnership interests, though the documents supporting the transfers were not executed for several years. The partnership agreement requires that the general partner provide annual financial statements and that the partners meet at least annually to discuss the financial condition of the partnership, but neither was done. On December 2, 1999, Mark and Michele formed a second family limited partnership, and the trusts for their children were finally signed by the trustees on December 4, 1999. Mark and Michele signed the trusts in May, 2000, and Citicorp Trust South Dakota (Citicorp), which was listed as a trustee, never signed the trusts. On December 20, 1999, Mark and Michele gave more stock to the second partnership and gave each child's trust an 18% partnership interest. The certificates of ownership reflecting these transfers were not prepared and signed for several weeks, and additional gifts of partnership interests were purportedly made on January 31, 2000. The agreement for the second partnership states that the general partner will keep the financial statements of the partnership for the most recent three fiscal years, but no such records were prepared or maintained. Mark and Michele claimed substantial valuation discounts on their gifts of partnership interests.

The Tax Court (Judge Cohen), relying on *Shepherd v. Comr.*, 115 T.C. 376, 389 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002), and *Jones Est. v. Comr.*, 116 T.C. 121 (2001), stated that there were never real allocations to various partnership capital accounts, and that the real gifts were made by transfers of assets to partnerships in which the children (or their trusts) were already partners. The court noted that Mark and Michele were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form, than they were that the formalities of the partnership should be honored. The court stated that the informality with which partnership affairs were conducted "was not surprising, inasmuch as petitioners alone, individually, or on behalf of their minor children were united in purpose and acted without restraint by any adverse interest."

The Eighth Circuit affirmed, finding that the couple had "presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children." The court

explained that the sequence was critical, because a contribution of the stock to the partnership after the children had become limited partners, was an indirect gift of the stock to the children, rather than a gift of partnership interests. The court, giving great weight to the factual findings of the Tax Court, applied the step-transaction doctrine to the transfers in question. The court stated that gift tax returns and other after-the-fact documentation that were executed "as of" the date of the transfers were not dispositive.

TAX COURT ALLOWS 35% DISCOUNT FOR FLP HOLDING CASH AND CERTIFICATES OF DEPOSIT

Kelley Est. v. Comr., T.C. Memo 2005-235 (10/11/05). Webster created a family limited partnership with a limited liability company as general partner. Webster contributed cash and certificates of deposit, and his daughter, Patricia, contributed cash. Patricia and her husband, John, held 2/3 of the interests in the general partner limited liability company, but only a 4% interest in the partnership itself. When Webster died, the partnership held cash and certificates of deposit. The decedent's estate claimed a 53.5% discount, and the IRS countered with a proposed 25.2% discount.

The Tax Court (Judge Vasquez) allowed a discount of 35%, comparing the limited partnership to a closed-end mutual fund. The court rejected the estate's appraisal, because it considered only the bottom quartile of all closed-end mutual funds, and instead chose to use the arithmetic mean of all of the closed-end funds, because shareholders in all closed-end funds lack control. The court allowed a 12% discount for lack of control. The court rejected the 38% lack-of-marketability discount claimed at trial by the estate, which was based on restricted stock studies. It also rejected a 15% discount claimed by the IRS, based on the Bajaj study of the private placement of unregistered shares. The court allowed a 23% discount for lack of marketability, producing a total discount of 35%.

Note. One must be impressed by the lawyering in a case where the losing taxpayer still receives a 35% valuation discount for interests a partnership that holds, essentially, cash. Many a practical estate planner would have accepted the 25% discount offered by the IRS. This is one case where a bit of aggression and testosterone produced a great result.

CODE §§2036-2038, 2043. TRANSFERS WITH RESERVED POWERS

RESIDENCE CONTRIBUTED TO GENERAL PARTNERSHIP INCLUDED IN DECEASED PARTNER'S GROSS ESTATE

Disbrow Est. v. Comr., T.C. Memo 2006-34 (2/28/06). When she was 72 years of age and her health was failing, Lorraine formed a general partnership with her children and children-in-law. Each partner and his or her spouse (except Lorraine and her unmarried son) received an equal 7.2% general partnership interest; the single son received an interest worth about 14% and Lorraine received a 28% interest. No partner contributed any asset to the partnership upon its formation. Lorraine later transferred her entire interest in her

valuable residence on Long Island Sound to the partnership, Funny Hats, without consideration. On that date, the other partners assured Lorraine that she could continue to live at the home as long as she furnished the funds necessary to maintain it. A few months later, Lorraine gave her 28.125% general partnership interest to her children and children-in-law, increasing the interest of each of the children (and children-in-law) to 10%. The partnership conducted no business, but just held the residence in which Lorraine resided, and a small amount of cash. Lorraine signed a form lease for the residence and paid rent to the partnership, in an amount set by Lorraine's attorney. The partnership maintained the residence and made capital improvements while Lorraine paid (directly or indirectly) most of the expenses connected with the residence. The partners of Funny Hats did not want to incur out-of-pocket costs as to the residence, and they asked Lorraine to pay "rent" greater than that stated in the lease agreements to the extent that the stated rent was insufficient to pay expenses connected with the residence. Lorraine did not designate on the face of any of the checks that they were for "rent," and the parties did not report these amounts as rental income. Lorraine directly paid the bills for utilities and upkeep, as she had before the partnership owned the residence. Lorraine did not pay rent on a regular basis, she did not always pay the amounts specified in the leases, the partnership never notified Lorraine when she was behind in her rent, and never sued for eviction. After Lorraine died, the partnership sold the residence to Lorraine's son for less than its fair market value.

The Tax Court (Judge Laro) held that Lorraine had transferred the residence to the partnership for less than full and adequate consideration, and that she had reserved its lifetime beneficial enjoyment. The court stated that it was "plainly inferable that decedent's children meant for her to stay at the residence until she died, unless, of course, they had to put her in an assisted living facility or a nursing home." The court stressed that the parties did not properly document the rental relationship as they would have done had Lorraine been a stranger, and they did not treat her as a true renter.

ODD PRIVATE RULINGS RAISE QUESTIONS ABOUT ESTATE TAX TREATMENT OF SOME GRANTOR TRUSTS

PLR 200603040 (1/20/06) and PLR 200606006 (2/10/06). The grantor created an irrevocable trust that was intended to be an intentionally defective grantor trust. The trustee was neither a descendant of the grantor nor a related or subordinate person under Section 672(c). The trust permitted the trustee to distribute trust income and principal to the grantor's spouse and issue, in the trustee's discretion, and after the grantor's death, to distribute trust property to the grantor's issue. The spouse was given a 30-day power to withdraw each contribution to the trust, up to the gift tax annual exclusion available to the grantor with respect to gifts to the spouse for each such calendar year. The trust reserved to the grantor the power to reacquire trust assets by substituting assets of equivalent value, but provided that the power could be exercised in a fiduciary capacity.

The IRS ruled, in applicable part, that the exercise of the power of substitution would not cause the trust property to be included in the grantor's gross estate under Section 2033, 2036(a), 2036(b), 2038 or 2039. The IRS relied on *Jordahl Est. v. Comr.*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1, noting that the power in this ruling, like the one in *Jordahl*, was exercisable only in a fiduciary capacity. The IRS stated:

Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.

Note. The IRS also ruled that the exercise of the power of substitution should not be a taxable gift, because the trust would receive assets of equivalent value, and that no gain or loss should be recognized on the substitution, because the trust was a wholly-owned grantor trust.

Some concern should be noted regarding the grantor trust issues. The IRS ruled that the trust was a grantor trust because of the power to distribute income and principal to the spouse. See Section 677(a). Grantor trust status could not be based on the substitution power, because it was exercisable only in a fiduciary capacity. The spousal interest creates a fine grantor trust, only as long as the grantor's spouse is alive. The trust would cease to be a grantor trust if the spouse predeceased the grantor, which could result in recognition of gain, if the trust property were subject to debt in excess of basis.

CODE SECTION 2039. ANNUITIES

ROLLOVER IRA NOT EXCLUDED UNDER FORMER SECTION 2039(E)

Sherrill v. U.S., 415 F. Supp. 2d 953 (N.D. Ind. 1/27/06). Walter retired on October 1, 1981, and rolled over into an IRA the lump sum qualified plan distribution he received from his qualified plan. Walter began to withdraw \$1,000 per month from the IRA before his death in 1989. The IRA agreement stated that Walter managed the IRA, and did not state that the election to receive the annuity was irrevocable. Walter's executor included the IRA in Walter's gross estate, and later filed an amended return excluding the IRA under Section 2039(e).

The district court granted summary judgment to the IRS, that Walter's IRA did not qualify for the repealed estate tax exclusion, under the transition rules. The \$100,000 estate tax exclusion for qualified plan retirement benefits and IRAs was repealed in 1984, and the transition rule was amended in 1986.P.L. 98-369, Section 525, 98th Cong., 2d Sess. (1984);P.L. 99-514, Section 1852(e)(3), 99th Cong., 2d Sess. (1986). The Tax Reform Act of

1984 preserved the exclusion with respect to estates of decedents who died after December 31, 1984, but who: (1) were in pay status on December 31, 1984; and (2) irrevocably elected the form of the retirement benefit and any survivor benefit before July 18, 1984. P.L. 98-369, Section 525(b)(2). The Tax Reform Act of 1986 rewrote the transition rule, to preserve the exclusion for estates of an individual who died after December 31, 1984, and who: (1) separated from service before January 1, 1985; and (2) did not change the form of the benefit before death. P.L. 99-514 Section 1852(e)(3). The court agreed with the IRS, that the decedent's benefits would have been excludible under the transition rule had the funds been left in the qualified plan, but that because he rolled the amounts into his IRA, they were not excludible. The court noted both the legislative history, that distinguished a qualified plan from an IRA (S. Rep. No. 99-313, 99th Cong., 2d Sess. 1019 (1986)), and Rev. Rul. 92-22, 1992-1 C.B. 313, which stated that IRAs were not covered by the transition rule because their qualification did not require "separation of service."

CODE SECTION 2041. POWERS OF APPOINTMENT

IRS AGAIN APPROVES SPOUSAL POWER OF APPOINTMENT TRUST

PLR 200604028 (1/27/06). The IRS again approved favorable estate and gift tax treatment for a revocable trust that gives the grantor's predeceasing spouse a general power of appointment over the grantor's assets sufficient to assure that the predeceasing spouse can 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 provided that the first spouse to die would hold 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 would include 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.

Note. This is 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. See similar conclusions in TAM 9308002, PLR 200101021, and PLR 200403094.

This approach may also be desirable even if the "other" spouse has ample assets to take advantage of the applicable exclusion amount, because the irrevocable trust created from the surviving spouse's revocable trust when the

deceased spouse fails to exercise the general power of appointment is a grantor nonmarital trust. The surviving spouse owns the trust for income tax purposes, but not for estate tax purposes. Thus, the surviving spouse can pay the income taxes on the trust income and, thereby, increase the net amount passing to the other family members.

There are only private rulings on point, however. The IRS could possibly change its view and argue that the lapse of the general power of appointment is really a transfer at the moment after the first spouse's death, rather than the moment before the first spouse's death. This would mean that the transfer was a gift by the surviving spouse to the beneficiaries of the special nonmarital trust. One can help 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. Regs. Section 25.2511-2(c). This would not cause the nonmarital trust to be included in the surviving spouse's gross estate, however, because the deceased spouse, rather than the surviving spouse, was the transferor of that trust for estate tax purposes.

See sample form in Selected Attachments; also Zaritsky, Tax Planning for Family Wealth Transfers: Analysis With Forms, ¶8.07[6] [1]; Zaritsky, Waiting Out EGTRRA's Sunset Period: Practical Planning While Congress Debates Estate Tax Repeal ¶3.04[6][b][1]; Zaritsky, Practical Estate Planning Under Circular 230 ¶3.02[1][f] [1]; Cason, "IRS Approves 'Poorer Spouse' Funding Technique," 31 Est. Plan. 234 (May 2004); and O'Sullivan & Weaver, "Using Two Trusts With Reciprocal Spousal General Powers of Appointment," 30 Est. Plan. 283 (June 2003).

CODE SECTION 2042. LIFE INSURANCE

IRS FOLLOWS GRANTOR'S INTENT, RATHER THAN POLICY FACTS, TO EXCLUDE PROCEEDS FROM GROSS ESTATE

PLR 200603002 (1/20/06). Two spouses each owned a life insurance policy on his or her own life. In Year 1, they both transferred the policies to an irrevocable life insurance trust for the benefit of the children. They all signed an instrument entitled "Transfer by Gift," stating that the couple were transferring the policy to the trust, and that one of their children, as trustee, accepted the policy on behalf of the trust. The trust instrument also declared that insureds would assign the policies to the trust, and that the trustee would then exchange them for a joint-and-survivor policy insuring the lives of both insureds. The insureds sold the policy to the trust, in exchange for a two-year promissory note, to help finance the insurance premiums. The face amount of the note was the fair market value of the two policies that had been transferred to the trust, less two times the available gift tax annual exclusions for transfers from the couple to their children. The trust also stated that each of the four children acknowledged the gift to the trust, and

that each intended to contribute to the trust enough money to satisfy the deferred balance and to pay ongoing premiums on the policy, to keep it in force. The trust instrument included the usual provisions giving broad powers to the trustee with respect to the policies, and it also directed any insurer to recognize the trustee as the absolute owner of the policy and as empowered to exercise all options, rights, privileges and interests under the policy. The trust sought to obtain the gift tax annual exclusion by a particularly broad form of Crummey withdrawal power. The instrument stated that the trust was revocable by any of the couple's children who may, at any time, revoke his or her participation in the trust. In effect, any child could withdraw his or her share of the trust at any time. The insureds then directed their insurance agent to exchange the two individual policies for a joint and survivor policy. They directed the agent to title the new policy in the name of the trust. The agent prepared documents and presented them to the couple, who signed them without a careful review. The documents did exchange the two individual policies for a joint and survivor policy, but unfortunately, it listed the insureds as the owners of the new policy. The insureds did not file a gift tax return for the year in which they funded the trust. They believed that their transfer of the policy to the trust represented a combination of annual exclusion gifts and an installment sale, none of which required a gift tax return. On January 1 of the next year, the insureds executed an instrument entitled "Declaration of Gift and Forgiveness of Note," that forgave the balance of the note, which was less than their annual exclusion for gifts to their children in that year. The trust never made any payments on the note. At all times after the issuance of the joint and survivor policy, the insurer sent premium notices to the trustee, who paid the premiums from trust funds. Some time later (and after the agent's death), someone discovered that the policy listed the insureds as the policy owners, rather than listing the trustee as the owner. The couple decided to reform the policy to "clarify" that the trust owned the policy, and that it had always owned the policy. They proposed to make this clarification by executing a valid assignment of the policy to the trust.

The IRS ruled that the reformation and assignment of the joint and survivor policy to show that the trustee owned the policy would not itself be a taxable gift of the policy to the trust or its beneficiaries, and that the proceeds of the joint and survivor policy would not be includible in the gross estate of either insured if either or both died within three years of the reformation and assignment. The IRS explained that, generally, ownership of a life insurance policy for estate and gift tax purposes is presumed to be determined from the terms of the policy itself. The IRS referred to this as the "policy facts," and noted that the parties have a heavy burden to overcome this presumption. *Comr. v. Noel*, 380 U.S. 678 (1965); *U.S. v. Rhode Island Hospital Trust Co.*, 355 F.2d 7 (1st Cir. 1966). The IRS noted, however, that Rhode Island Hospital Trust Co. created an exception "where the insurance contract itself does not reflect the instructions of the parties, as where an agent, on his own initiative, inserts a reservation of right to change a

beneficiary contrary to the intentions which had been expressed to him, no incidents of ownership are thereby created." 355 F.2d at 11. This exception, the IRS noted, had been expanded by the Tax Court in *Fuchs Est. v. Comr.*, 47 T.C. 199 (1966), acq., 1967-1 C.B. 2, to include situations where the insurance agent made a mistake about the ownership or beneficiary designations. In this ruling, the IRS stated that the intent facts, rather than the policy facts, should determine whether the reformation and assignment of the joint and survivor policy to reflect the trust as owner would constitute a transfer subject to gift tax, or cause the proceeds to be includible in the estates of Husband and Wife, if either or both died within 3 years of the assignment. The IRS stressed that the intent of the parties had been set forth in contemporaneous instruments (the "Transfer by Gift" instrument and the trust instrument). The IRS also noted that the insureds instructed their insurance agent to title the new policies in the trust's name, and he had failed to follow their instructions.

Note. See also similar conclusion in PLR 9651004.

In PLR 200603002, the IRS also added an unrequested ruling regarding the treatment of the installment sale of the policy to the trust. The IRS stated that this bonus ruling was needed "for purposes of sound tax administration." The IRS treated the sale and forgiveness as an installment gift arrangement. The IRS stated that:

We view the initial transfers of the policies, made subject to a deferred debt obligation, and the subsequent forgiveness of such debt obligation a few months later, in a different tax year, without any payments having been made on such debt obligation, as part of a prearranged plan to avoid owing gift tax with respect to the transfers of the policies. Accordingly, we conclude for gift tax purposes that, as part of a prearranged plan, Husband and Wife intended to forgive the note executed by the Trust that was received by Husband and Wife at the time of the transfer of the life insurance policies.

The IRS has long taken the position that it will ignore a purported loan (or installment sales obligation) if the loan and the forgiveness of the debt are part of an integrated, prearranged plan. Rev. Rul. 77-299, 1977-2 C.B. 343. The Tax Court, however, has twice rejected this argument, where the notes were legally enforceable. *Kelley Est. v. Comr.*, 63 T.C. 321 (1974), nonacq. 1977-2 C.B. 2; *Haygood v. Comr.*, 42 T.C. 936 (1964), acq. in result 1965-1 C.B. 4, nonacq. 1977-2 C.B. 2. Thus while the IRS may dislike an installment sale as an attempt to finance life insurance premiums, the Tax Court may be more receptive.

Also, if one plans to sell an insurance policy to an irrevocable life insurance trust, one should be very, very sure that the trust is a grantor trust deemed owned by the insured. Otherwise, the proceeds could become ordinary income, under the transfer-for-value rule.

CODE SECTION 2053. ADMINISTRATIVE EXPENSES

TAX COURT DENIES DEDUCTION FOR OUTSTANDING CLAIM HELD BY DECEDENT'S WHOLLY-OWNED CORPORATION

Hughes Est. v. Comr., T.C. Memo 2005-296 (12/27/05). When Bob died in 1996, his widow, Winifred, became the sole stockholder of Advanced Leasing, a corporation that he had founded and that sold and leased used cars. Thereafter, Dean McBride (Bob's long-time friend) became the sole officer and director of the corporation. Winifred granted Dean a durable power of attorney, with which he executed an agreement and promissory note under which she promised to pay \$400,000 to the corporation on demand, in exchange for 4,000 shares of its common stock. Purportedly, this arrangement was needed to provide capital to the corporation, where Winifred's son, Billy, was employed. Billy was a very good salesman, but he had alcohol and drug problems. The promissory note was not paid until after Winifred's death, when Dean, Winifred's executor, paid the \$400,000 to the corporation. Winifred's estate deducted the \$400,000 as a bona fide claim against her estate, under Section 2053(a)(3). The IRS denied the deduction, and claimed that \$21,782 owed by the corporation to the decedent on certain promissory notes was includible in her gross estate.

The Tax Court (Judge Colvin) denied the estate a deduction for the outstanding debt. The court explained that an estate may deduct the value of a claim based on a decedent's promise to pay, if the liability was contracted bona fide and for full and adequate consideration in money or money's worth. Section 2053(c)(1)(A); Scholl Est. v. Comr., 88 T.C. 1265, 1279 (1987); Davis Est. v. Comr., 57 T.C. 833, 835 (1972). The estate argued that the stock given to Winifred was adequate consideration, and that it was a bona fide transaction intended to reduce the corporation's debt, made the balance sheet cleaner, and facilitate securing outside financing. The court disagreed, noting that the corporation's financial situation remained poor after the transaction, and that the company had negligible, if any, value when the agreement was entered into. Therefore, Winifred did not receive full and adequate consideration as required by Section 2053(c)(1)(A). The court also concluded that the stock subscription agreement was not a bona fide contract, because it was not made in good faith and bargained for at arm's length. Regs. §§20.2043-1(a), 20.2053-4. The court stressed that: (1) the terms of the agreement were not negotiated at arm's length; (2) the corporation's business was not appraised, and the corporation had annual net losses and a negative net worth the years before, during, and after the transaction; (3) the 4,000 shares and the \$400,000 demand note payable to the corporation were not reflected on the corporation's financial statements or on its tax returns; (4) the corporation's bookkeeper and its certified public accountant did not know about the stock subscription agreement and the \$400,000 note payable, and (5) Dean did not demand payment of the \$400,000 before Winifred's death. The court, however, held that the interest on the loan was not an asset of the estate, because the corporation was insolvent on the date of death, and the fair market value of the accrued interest was

zero.

CODE SECTION 2055. CHARITABLE DISTRIBUTIONS

NONQUALIFYING CHARITABLE REMAINDER TRUST COULD NOT BE REFORMED FOR ESTATE TAX PURPOSES

Tamulis Est. v. Comr., T.C. Memo 2006-183 (8/29/06). Anthony left the residue of his revocable trust in further trust to pay specific amounts to several of his relations, remainder to the Catholic Church. The trust was to continue for 10 years (or, if longer, the joint lives of the decedent's brother and sister-in-law), after the decedent's death, during which time the trustee was directed to pay: (a) all real estate taxes on the decedent's residence, which was left to Anthony's brother and sister-in-law for life, remainder to their children; (b) \$5,000 per year to Anthony's brother and sister-in-law, to defray the costs of utilities and repair on Anthony's residence; (c) \$5,000 per year to Anthony's grandniece, while she was making "reasonable progress" in pursuit of a Ph.D. in education; (d) \$2,000 per year and the balance of the trust's net income to two other grandnieces; and (e) \$10,000 per year to one of Anthony's grandnieces, "until she graduates from medical school." At termination of the trust, the trust funds were to pass to the Roman Catholic Diocese of Fall River, Massachusetts. The IRS denied the \$1,495,526 claimed estate tax deduction for the charitable remainder interest.

The Tax Court (Judge Gale) agreed with the IRS, finding that the trust was not a qualified charitable remainder trust and that the noncharitable interests were not reformable under Section 2055(e). Section 2055(e)(3)(C) permits a qualified reformation of a split-interest trust by a judicial reformation begun within 90 days after filing the estate tax return, or otherwise if the noncharitable interests are "basically expressed as an annuity interest or a unitrust interest." The reformation, in this case, had not been brought in a timely manner, and the noncharitable interests were not expressed as fixed dollar amounts or a fixed percentage of the initial value of the assets.

ESTATE TAX DEDUCTION DENIED FOR NONQUALIFIED SPLIT-INTEREST TRUST DISGUISED AS SHARE OF RESIDUE

Galloway v. U.S., 2006 WL 1233683, 97 AFTR2d 2006-2458 (W.D. Pa. 5/9/06) (slip opinion). James' revocable trust provided that the residue would pass in four equal shares, with two shares passing to specified individuals and two shares to specified charities. The four shares would each be paid out in two installments, with one share being distributed on January 1, 2006, and the other on January 1, 2016, when the trust would terminate. The instrument stated that the share for any individual beneficiary who was not alive on the date of a distribution would lapse and be reallocated among the other surviving beneficiaries. The IRS denied the estate tax charitable deduction for the \$399,079.33 that would ultimately pass to charity, and the decedent's estate paid the tax and sued for a refund.

The U.S. District Court for the Western District of Pennsylvania held for the IRS, finding that the residuary disposition was a non-qualifying charitable split-interest trust, under Section 2055(e)(2), which denies an estate tax deduction for a charitable split-interest charitable trust, other than a charitable remainder or lead annuity trust or a unitrust, a pooled income fund, and certain other interests. The court stressed that the trust fund was created under one document from one set of property,

Note. This disposition looked at first glance like a simple quartile division of the residuary share of the trust, which would have permitted a charitable deduction for the charitable share. In this case, however, the amount that the charities would receive depended upon the survival of the individual beneficiaries, and so was part of a true split-interest arrangement. Sadly, in this situation, no deduction is allowed even for the one-half of the residuary estate that the charities would be assured of receiving. Citing *Johnson Est. v. U.S.*, 941 F.2d 1318, 1321 (5th Cir. 1991) (no deduction for charitable share of trust to support decedent's three sisters, to maintain the graves of his family members, and to create a charitable trust to pay for religious education in certain Catholic parishes); and *Zabel v. U.S.*, 995 F. Supp. 1036 (D. Neb. 1998) (no deduction for trust whose income was to be split between charitable and individual beneficiaries for 21 years, with the remaining corpus to be distributed to the charitable beneficiaries at that time); *Edgar Est. v. Comr.*, 74 T.C. 983 (1980), aff'd, 676 F.2d 685 (3d Cir. 1982) (no deduction for assets added to trust created by the decedent's sister, providing for regular payments from income to non-charitable individuals, with the remainder passing to various charities upon the death of the non-charitable beneficiaries, even though the income from the trust to which the estate poured-over would be sufficient to pay all noncharitable amounts).

ESTATE TAX DEDUCTION ALLOWED FOR OUTRIGHT PAYMENT TO CHARITY ON VOLUNTARY EARLY TERMINATION OF SPLIT-INTEREST TRUST MADE TO AVOID CONFLICTS OF INTEREST

Jackson Est. v. U.S., 408 F. Supp.2d 209 (N.D. W.Va. 11/23/05). Mildred's revocable trust, at her death, provided \$150,000 outright distributions to each of her three nieces and to her nephew, and then left one-quarter of the trust income to each of them. A church was made remainder beneficiary. Floyd Estridge, Jr. and Davis Trust Co. were co-trustees, but trust investment decisions were made by the Trust Committee, on behalf of Davis Trust Co., and the Trust Committee included two members of the remainder beneficiary-church. After Mildred's death, her attorney became concerned about potential conflicts of interest arising from the family beneficiaries' dissatisfaction with the diminished income from the trust and Estridge's marriage to one of Mildred's nieces. To avoid possible disputes arising from such conflicts, the attorney proposed that the trustees and beneficiaries voluntarily terminate the trust. Slightly more than six months after Mildred's death, the trustees, the family beneficiaries and the church all signed an agreement terminating the trust, and dividing the distribution based on the actuarial values of the various shares, using IRS tables. The IRS denied an estate tax deduction for the charitable

distribution, noting that the termination was not a qualified reformation under Section 2055(e)(3) and the trust was not a qualified split-interest trust under Section 2055(e)(2).

The district court held for the taxpayer, noting that the deduction is allowable for the amount paid outright to the church, and that the requirements for a qualified split-interest charitable trust were not relevant. The IRS argued that the qualified reformation requirements applied unless the nondeductible split-interest trust was terminated in a settlement of a will contest or to avoid an imminent breach of fiduciary duty, but the court held that such a narrow interpretation was not supported either by the history or purpose of the section. The statute was designed to ensure that an estate's charitable deduction corresponds with the amount the charity actually receives, and that the change in the trust not have been made merely to circumvent the split-interest rules of Section 2055(e). In evaluating whether these requirements are met, the courts usually look at four factors: (a) whether property is directly transferred to the charitable beneficiary; (b) whether a noncharitable beneficiary maintains an interest in that property; (c) whether the deduction is sought for the actual benefit received by the charitable entity; and (d) whether the estate is merely trying to gain a charitable deduction by skirting the split-interest rules. In this case, the property is transferred outright to the charity, the noncharitable beneficiary retains no interest in the transferred property, the claimed deduction is precisely equal to the amount distributed to the charity and there was a bona fide non-tax reason for terminating the trust.

Note. As the court noted, several other courts have held that the split-interest rules of Section 2055(e) do not apply when intervening acts destroy the split-interest arrangement. Moreover, several courts have held that Section 2055(e) does not apply when an intervening event destroys the charitable split-interest and causes a direct transfer of property to a charitable organization. See *Flanagan v. U.S.*, 810 F.2d 930, 935 (10th Cir. 1987); *First Nat'l Bank of Fayetteville v. U.S.*, 727 F.2d 741, 746 (8th Cir. 1984); *Oetting v. U.S.*, 712 F.2d 358, 361-63 (8th Cir. 1983); see also *Strock Est. v. U.S.*, 655 F. Supp. 1334, 1340-41 (W.D. Penn. 1987).

The estate certainly could have entered into a qualified reformation, converting the trust into a charitable remainder annuity or unitrust. This would have reduced the disagreements between the lifetime beneficiaries and the remainder beneficiary over the investment of the trust fund, because both would have had the same objective of maximizing total return. That would have avoided the tax litigation, though it would probably have left greater chance for litigation between the trust and beneficiaries over claimed partiality of the trustees to the remainder beneficiary.

CODE §§2056, 2044, 2519, 2523, 2207A. MARITAL DEDUCTION

MARITAL DEDUCTION ALLOWED DESPITE SURVIVORSHIP CONDITION UNTIL DISTRIBUTION OF

DECEDENT'S ESTATE

Sowder v. U.S., 407 F. Supp.2d 1230 (E.D. Wash. 11/10/05). Tony left a will that bequeathed \$600,000 to persons other than his widow, Marie, and the residue of his estate to his widow, "if she survives me, and if she does not survive me, or dies before my estate is distributed to her..." The IRS disallowed the estate tax marital deduction, claiming that the condition of survivorship rendered the residuary gift a nondeductible terminable interest. Section 2056(b)(3).

The district court held for the estate, applying a state law that requires construction of a bequest that was intended to qualify for the marital deduction in such a manner as to make it so qualify. Rev. Code of Wash. Section 11.108.020(1). The court stated that Tony's intent for his residuary gift to qualify for the marital deduction was shown by the facts that: (a) he was a taxwise businessman and individual who did not want to pay any more tax than necessary; (b) he died possessed of an article that explained the 1981 enactment of the unlimited marital deduction and state law presupposes a decedent to have known the law on the date of death; (c) he created an irrevocable life insurance trust holding a last-to-die life insurance policy, suggesting that he intended to defer estate taxes until both spouses had died.

Note. The same analysis could have been required (and the same result obtained) in a state that lacks such a generous statute, if the decedent's testamentary instruments contain a statement of the tax objectives, and a requirement that they be construed in such a manner as to achieve those goals. For example, the following language might be included in a conventional marital deduction will or revocable trust:

Tax Objectives. I intend that: (a) the Marital Share qualify for the Federal estate tax marital deduction [OPTIONAL FOR QTIP: except to the extent that my personal representative does not elect for it to be deductible]; and (b) the Family Share shall not be includible in the gross estate of my * husband/wife*, if *he/she* survives me. In all matters involving my estate, my will [OPTIONAL FOR REV. TRUST: and revocable trust] shall be construed in such a manner as to effectuate these tax objectives, and my personal representative [OPTIONAL FOR MARITAL TRUST: and trustees] shall exercise no power in a manner that would be inconsistent with these tax objectives.

TRUST FUND INCLUDIBLE IN SURVIVING SPOUSE'S GROSS ESTATE AS QTIP, AND TAX COLLECTIBLE FROM REMAINDER BENEFICIARIES

Warner v. U.S., 2006 TNT 166-11 (C.D. Ca. 7/31/06). William, Sr. died, leaving a portion of his estate in trust for his widow, Lura. The trust specified that all income be paid to Lura in "convenient installments as determined at the sole discretion of the Trustees" and it did not specify that the income must be distributed at least annually. Lura elected to treat the trust as a QTIP. At Lura's later death, her two children, William and James, argued that the trust never qualified as a QTIP, because it did not require

that income be paid at least annually. Therefore, they contended, the trust funds should not be included in Lura's gross estate, the taxes on the fund should have been due at William, Sr.'s death and they should have been collected from Lura and the children, equally.

The district court held that the intent that payments be made at least annually can be inferred, relying on *Cavanaugh Est. v. Comr.*, 51 F.3d 597 (5th Cir. 1995), in which a similar trust was held to qualify for the marital deduction, because trustees typically pay each quarter or semi-annually, the trust instrument gave the beneficiary the right to invade the trust principal each calendar year and a testator would not allow a beneficiary to raid the trust's corpus more frequently than he contemplated income payouts, and the lack of a provision for the accumulation of interest indicated a desire that the income be paid at least annually. In this case, the court also noted, Lura was a co-trustee, she was given the right to invade the trust principal each year to supplement her income and the trust had no provision regarding the accumulation of interest.

Note. The children also argued that no intent to qualify the marital trust as a QTIP could be inferred, because the QTIP provisions were not enacted until after their father's death. This suggests that the IRS probably should never have allowed the marital deduction in the first estate. The court rejected this argument, however, noting that the question is whether the taxpayers' father intended that his wife have control over the income, not whether he intended that the trust be deductible.

IRS EXPLAINS HOW TO ASSURE MARITAL DEDUCTION WHEN SURVIVING SPOUSE'S INTEREST IN IRA IS TRANSFERRED TO QTIP MARITAL TRUST

Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (5/20/06). The IRS explained how a QTIP marital trust that is the named beneficiary of a decedent's individual retirement account (IRA) (or other qualified defined contribution retirement plan), will qualify for the estate tax marital deduction, under various state law definitions of "income." In all three situations examined, A dies in 2004, survived by spouse, B. A's will creates a residuary marital trust that is, at A's death, irrevocable and valid under applicable local law. During A's lifetime, A named B the beneficiary of all amounts payable from A's IRA after A's death. The IRA is currently invested in productive assets and B has the right (directly or through the trustee of the marital trust) to compel the investment of the IRA in assets productive of a reasonable income. The IRA document does not prohibit the withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under Section 408(a)(6). The marital trust qualifies as a QTIP, and B has the right to compel the trustee to invest the marital trust principal in assets productive of a reasonable income. On B's death, the marital trust principal would be distributed to A's children, who are younger than B. The marital trust complies with Rev. Rul. 2000-2, 2000-1 C.B. 305, and B has the annual power to compel the trustee to withdraw from the IRA an amount equal to all the IRA income for the year, and to require

distribution of that income to B. If B exercises this power, the trustee must withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under Section 408(a)(6), and distribute currently to B at least the income of the IRA. Any excess of the required minimum distribution amount over the income of the IRA for a year is added to the principal of the marital trust. The trustee must always withdraw the required minimum distribution amount in any year in which B does not exercise the power to compel a greater withdrawal from the IRA. A's executor elects to deduct both the marital trust and the IRA as QTIP. Before October 31, 2005, the trustee of marital trust provides to the IRA trustee a copy of A's will, which constitutes the marital trust's governing instrument, in accordance with A-6(b) of Regs. Section 1.401(a)(9)-4. The requirements of A-4 and A-5 of Regs. Section 1.401(a)(9)-4 are also met; there are no beneficiaries or potential beneficiaries that are not individuals, so the beneficiaries of the trust are designated beneficiaries of the IRA. In accordance with Section 408(a)(6) and the terms of the IRA, the trustee elects to receive annual required minimum distributions using the exception to the five year rule in Section 401(a)(9)(B)(iii) for distributions over the designated beneficiary's life expectancy. B is not treated as the sole beneficiary, so the special rule for a surviving spouse does not apply. The required minimum distribution from the IRA is based on B's life expectancy.

In Situation 1, state law adopted a version of the Uniform Principal and Income Act (UPIA) including provisions that: (a) authorize the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries; (b) permit adjustments between income and principal when trust assets are invested under state law prudent investor standard, the amount to be distributed to a beneficiary is described by reference to the trust's income, and the trust cannot be administered impartially after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal; (c) requires the trustee, when all of a payment made from an IRA to a trust must be distributed to the current beneficiary and no part of the payment is characterized as interest, a dividend, or an equivalent payment, to allocate 10% of the required payment to income and the balance to principal; (d) requires the trustee, when none of the payment made from an IRA to a trust must be distributed from the trust or the payment received by the trust is the entire amount to which the trustee is contractually entitled, to allocate the entire payment to principal; and (e) require the trustee to allocate to income any additional amount necessary to obtain the marital deduction. For each calendar year, the trustee determines the total return of the assets held directly in the marital trust, exclusive of the IRA, and then determines the respective portion of the total return that is to be allocated to principal and to income under state law, in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The amount allocated to income is distributed to B in accordance with the terms of the trust instrument. Similarly, for each calendar year the trustee

determines the total return of the assets held in the IRA and then determines the respective portion of the total return that would be allocated to principal and to income under state law in a manner that fulfills a fiduciary's duty of impartiality, and this allocation is made without regard to, and independent of, the trustee's determination with respect to the marital trust income and principal. If B exercises the withdrawal power, the trustee withdraws from the IRA the amount allocated to income and distributes to B the income of the IRA.

In Situation 2, state law provides that the income of the trust can be a 4% unitrust amount (based on the net fair market value of the trust assets valued annually). All interested parties authorize the trustee to adopt the unitrust approach for the marital trust and IRA withdrawals, and the trustee thereby determines the unitrust amount for the IRA assets separately from that for the marital trust. The IRA and trust distributions are based on this definition of income.

In Situation 3, state law does not have the UPIA rules, and requires only that traditional income be distributed to an income beneficiary. The trustee applies state law and distributes the net income of the marital trust to B, and separately determines and distributes the net income of the IRA to B.

In all three cases, the IRS stated that the marital trust was deductible as a QTIP under Section 2056(b)(7). In Situation 1, the IRS explained, the allocation of the total return of the IRA and the total return of marital trust pursuant to the trustee's state law authority constitutes a reasonable apportionment of the total return of the IRA and the marital trust between the income and remainder beneficiaries. The income of the trust determined in this manner is subject to B's withdrawal power, and the income of the marital trust, as so determined, is payable to B annually. Accordingly, B has a qualifying income interest for life in both the IRA and the trust. The IRS added, however, that the impact of the 10% allocation may have to be considered, depending upon the terms of marital trust itself. The state law (a version of UPIA Section 409(c)) requires allocation of 90% of a required minimum distribution to principal, and the 10% allocation to income does not, alone, satisfy the marital deduction requirement that all income be distributed currently, because the amount of the required minimum distribution is not based on the total return of the IRA (and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries). The 10% allocation to income also does not represent the income of the IRA under state law, without regard to the equitable adjustment power. If B exercises the withdrawal power, the trustee must withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount, and distribute at least the income of the IRA to B, however, and so because the marital trust's income is determined without regard to the IRA, it would not affect the determination of the amount distributable to B. Accordingly, in Situation 1, the IRA and the marital trust both qualify for the estate tax marital deduction. If the trust terms do not require the distribution to B of at least the income of the IRA if B exercises

the withdrawal right, then the IRA may not qualify for the marital deduction unless the trust terms provide that state law regarding the apportionment of the required minimum distribution between income and principal do not apply.

In Situation 2, the unitrust determination of income satisfies the requirements of the marital deduction, and because B can unilaterally access all income of the IRA, and the income of the trust must be paid to B annually, the IRA and the trust both qualify for the marital deduction. The IRS noted that the result would be the same if the state law enacted both the statutory unitrust regime and a version of the UPIA allowing the trustee reasonably to apportionment of the total return between the income and remainder beneficiaries. In such cases, the trust income and the IRA income are each determined under state statutory provisions applicable to the trust that conform with the marital deduction rules, and B has a qualifying income interest for life in both the IRA and the trust.

In Situation 3, B can compel the trustee to withdraw the greater of the required minimum distribution amount or the income of the IRA, and at least the income of the IRA must be distributed to B. Thus, in this situation, both the IRA and the trust meet the requirements of the marital deduction. The IRS noted that the result would be the same if the state permitted the trustee to make equitable adjustments, but the trustee decided that none were actually required. The IRS added that, in all three situations, the income of the IRA and the income of the marital trust (excluding the IRA) are determined separately and without taking into account that the IRA distribution is made to the trust. In order to avoid any duplication in determining the total income to be paid to B, the portion of the IRA distribution to the marital trust that is allocated to trust income is disregarded in determining the amount of trust income that must be distributed to B under the marital deduction rules. The results would be the same in all three situations if the trust terms directed the trustee annually to withdraw all of the income from the IRA and to distribute to B at least the income of the IRA (instead of granting B the power, exercisable annually, to compel the trustee to do so).

GIFT TAX ANNUAL EXCLUSION FOR GIFTS TO A NON-U.S. CITIZEN SPOUSE ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/27/06); Rev. Proc. 2005-70, 2005-47 I.R.B. 979 (11/21/05). The gift tax annual exclusion for gifts to a non-U.S. citizen spouse made in 2006 is \$120,000, and for gifts made in 2007 will be \$125,000, under Section 2523(i)(2).

QTIP ELECTION NOT EXTENDED TO ASSETS SUBJECT TO NONQUALIFIED DISCLAIMER

PLR 200612001 (3/24/06). The decedent's will and revocable trust establish a separate "Lifetime Marital Deduction Trust" (the "marital trust") for the surviving spouse, to hold all of the trust assets, less an amount sufficient to take advantage of the decedent's estate tax unified credit. The marital trust can be funded only with assets that qualify for the federal

estate tax marital deduction. The balance of the revocable trust is held as the "Family Trust," in a format that will not qualify for the estate tax marital deduction. After the decedent's death, the estate's attorney discussed with the decedent's children the possibility that the surviving spouse would disclaim part of the revocable trust fund, to pass assets directly to the children and grandchild. The attorney thought that the surviving spouse was not financially competent, and so prepared disclaimers for signatures by the two children, who held powers of attorney to act for the surviving spouse. The children did not discuss the disclaimers with the surviving spouse. On the estate tax return (Form 706), the attorney made a qualified terminable interest property (QTIP) election for all the property passing to the marital trust, excluding the disclaimed property, which assets were not listed on Schedule M. Later, the parties determined that the disclaimers were invalid and ineffective, under both state law and tax law. The family signed a "restitution agreement" that was approved by a local court, requiring the children and grandchild to return the "disclaimed" assets to the estate.

The IRS agreed that the disclaimers were invalid and ineffective, but stated that the QTIP election did not apply to the assets that were subject to the purported disclaimer. The will and trust added the disclaimed assets to the marital trust, as a matter of law, but the QTIP election specifically did not cover these assets. The IRS also stated that the estate would not be given additional time under Regs. §§301.9100-1 to 301.9100-3, to change the QTIP election, because those rules apply to failure to make an election, not failure to make the correct election.

NO RELIEF FOR INCORRECT PARTIAL QTIP ELECTION

PLR 20054003 (10/7/05). Decedent's will left a portion of the estate in trust for the surviving spouse and a charity. The spouse would receive current distributions of income for the rest of the spouse's life, and the remainder was distributed to the charity. The executor of the decedent's estate, a bank, relied on a law firm to file a correct federal estate tax return. The firm reported the trust by claiming the marital deduction for the actuarial value of the income interest, and claiming the charitable deduction for the actuarial value of the remainder interest. The executor requested either a determination that the QTIP election actually applied to the entire value of the trust fund, or an extension of the time within which to make a correct QTIP election.

The IRS rejected both analyses. The IRS noted that an election to deduct the actuarial fair market value of the spouse's income interest constitutes a partial QTIP election, but that this election is irrevocable. The IRS explained that, in appropriate circumstances, it will grant additional time to make a QTIP election when none was made on the estate tax return, but here a QTIP election was made. The IRS stated that it will not grant additional time to convert a partial election into a full election. Therefore, the estate received a marital deduction for only the actuarial fair market value of the income interest, and no charitable deduction, because the charitable remainder

was a nondeductible interest.

ESTATE TAX PROCEDURES

EQUITABLE RECOUPMENT ALLOWED AGAINST ESTATE THAT MADE ERRONEOUS QTIP ELECTION

Buder Est. v. U.S., 436 F.3d 936 (8th Cir. 2/7/06). Kathryn's husband had died in 1984, leaving a residuary trust for which his estate claimed the marital deduction. When Kathryn died, the IRS contended that the residuary trust must be included in her estate, despite the fact that the trust was ineligible for QTIP treatment.

The Eight Circuit affirmed a decision of a district court, that the doctrine of equitable recoupment applied, but that the IRS was not entitled to interest on the equitable recoupment. The courts held that the requirements of equitable recoupment were met, because (1) the residuary trust and the resulting tax on the trust assets resulted from a single event subject to inconsistent treatment; (2) the claim against the first spouse's estate was barred by the statute of limitations; and (3) there was sufficient identity of interest between the two estates.

Note. See also Gerzog, "Buder: The Extent of Equitable Recoupment," 2006 TNT 54-31 (3/20/06).

TAX COURT CANNOT REQUIRE IRS TO APPLY OVERPAYMENT TO INTEREST

Smith Est. v. Comr., 429 F.3d 533 (5th Cir. 10/31/05), vac'g, 123 T.C. 15 (2004). The estate of Algerine Smith deducted an amount claimed by Exxon for allegedly receiving overpayments of royalties. The Tax Court held that the estate could deduct the value of the claim on the date of death, as determined by expert appraisal, regardless of the amount for which the claim was settled during the estate administration. The court entered a decision for an overpayment, based on the parties' agreed Rule 155 computations. The Fifth Circuit reversed and remanded. On remand, the Tax Court had held that the IRS proved a valuation of the Exxon claim at less than the \$680,000 the IRS previously allowed. A number of years passed before the parties. The Fifth Circuit affirmed.

After years of litigation, the IRS abated some of the assessed underpayment interest and estate tax, and issued the estate a \$210,467 refund. The computation agreed upon showed the amount of unpaid underpayment interest but did not include it in the computation of the amount of overpayment to be shown on the document submitted to the court. The document did not reduce the overpayment by the amount of the underpayment interest and the court adopted the document.

The Tax Court (Judge Ruwe), with five judges concurring and five dissenting, held that an overpayment of tax always include any underpayment of

interest, and so the IRS should not have reduced the amount of the refund by the amount of underpayment interest. The court stated that the IRS should have taken the interest into account in computing the amount of overpayment to be shown on the decision document.

The Fifth Circuit disagreed and vacated the Tax Court order. The court stated that the statutory scheme related to review of overpayments is designed to permit the offset of overpayments with interest liabilities even arising during the same year, and that issues related to overpayment or underpayment of interest can be raised in separate proceedings. §§7481(c)(1), 7481(c)(2)(B). Thus, the overpayment determination does not necessarily determine underpayment issues relating to interest, and it did not do so in this case.

Note. See also CC-2004-35 (9/16/04), in which the IRS Chief Counsel advised that assessed and unassessed underpayment interest should be taken into account when preparing overpayment decision documents and stipulations. For pending and entered decisions, the notice stated that all overpayment decision documents should take into account underpayment interest. For cases where the overpayment decision documents were computed without taking into account underpayment interest, a joint conference call should be made to the judge to explain the computational problem, the notice added.

ERRONEOUSLY OVERPAID ESTATE TAXES ARE NOT REFUNDABLE, DESPITE DEFERRED ESTATE TAX PAYMENTS

Leveroni v. U.S., 2006 WL 2850019, 98 AFTR2d 2006-7241 (N.D. Cal. 10/4/06). The executor for Louise's estate elected to pay her estate taxes in equal annual installments. After five payments, the executor discovered that the estate had made a mistake on the estate tax return and had overpaid its estate taxes. The executor claimed a refund of more than \$214,193, but the IRS rejected the claim in part, asserting that the claim was not timely, except for the final two payments of tax. The executor filed a claim for refund, and the IRS requested partial summary judgment on the statute of limitations issue.

The district court held for the claim for refund of the first three tax payments was barred by the statute of limitations, under Section 6511(b)(2)(B), which states that refund with respect to a claim filed more than three years after the return cannot "exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim." The executor argued the first three installments were merely deposits, rather than taxes, and that the statute of limitations did not begin to run until the IRS denied the claim. The court distinguished *Rosenman v. U.S.*, 323 U.S. 658 (1945), because the taxpayer in that case initially disputed the amount of tax and only delivered an estimated tax payment under protest to avoid penalties and interest. The payments in this case were made according to a return filed by the estate, and not under protest. The court also held that the statute of limitations was not altered by the failure of the IRS to issue a closing letter, and that neither the mitigation rules of Section 1311 nor the doctrine of equitable recoupment

applied in this case.

NEW ESTATE TAX RETURN RELEASED FOR ESTATES OF DECEDENTS DYING IN 2006

Form 706 (Oct. 27, 2006). The IRS issued a new Form 706, with the following updates and changes from the prior return:

- 46% maximum estate tax rate;
- Return must be filed with the Cincinnati IRS Center, regardless of the decedent's citizenship or residence;
- Requires disclosure of sales of partnership or LLC interests or closely-held stock to trusts that exist on the date of death;
- For returns filed after August 17, 2006, the Pension Protection Act of 2006 has amended the provisions used to determine substantial and gross misstatements of valuation of property. A 20% substantial estate tax valuation understatement is imposed if the value of property is 65% or less of the amount finally determined to be correct (Section 6662(g)(1)), and a 40% gross valuation understatement is imposed if the value claimed on the return is 40% or less of the correct amount (Section 6662(h)(2)(C));
- The state death tax deduction is allowed under Section 2058, rather than the now-repealed state death tax credit;
- The gift tax annual exclusion for gifts made in 2006 is increased to \$12,000;
- The ceiling on special-use valuation is increased to \$900,000;
- The amount used to compute the 2% portion of the estate tax attributable to closely-held business interests and payable in installments under Section 6166 is raised to \$1,200,000;
- The GST exemption is raised to \$2,000,000;
- An estate can request an automatic six-month extension of the time to file the return by filing Form 4768, with no need to state a justification;
- Beginning with the estates of decedents dying and generation-skipping transfers occurring after 2003, the generation-skipping transfer (GST) tax exemption is equal to the applicable exclusion amount. For 2006, that amount is \$2,000,000.

IRS PROVIDES NEW GUIDELINES FOR WHEN A REAL ESTATE INTEREST IS A CLOSELY-HELD BUSINESS FOR ESTATE TAX DEFERRAL PURPOSES

Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (6/26/06). The IRS has issued new guidelines, revising rulings issued in 1975, and explains the circumstances

under which a decedent's interest in a real estate enterprise will constitute an interest in a closely-held business, the estate taxes on which can be paid over ten years, following a five-year interest-only deferral period, under Section 6166. The new ruling provides five illustrative situations in which Section 6166 eligibility is examined. In each situation, the real property interests included in the decedent's gross estate exceed the requisite 35% of the adjusted gross estate, and the other eligibility requirements of Section 6166(b) (the number of partners, members or shareholders or the percentage of capital interest in the partnership or LLC or corporate voting stock) are satisfied. In each situation, the IRS stated that the six key issues examined would be: (a) The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business; (b) Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose; (c) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases; (d) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises; (e) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and (f) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints. The IRS added that no single factor is dispositive, and other factors may also be considered.

In Situation 1, the decedent died owning a ten-store strip mall titled in the decedent's sole name. The decedent personally handled the day-to-day operation, management and maintenance of the strip mall, and personally handled most repairs. When the decedent could not personally make a repair, the decedent selected, hired and approved the work of a third party independent contractor. The IRS stated that the ownership of the strip mall qualified as an interest in a closely-held business for purposes of Section 6166, stressing that the decedent provided significant services to the strip mall tenants, and personally handled the day-to-day operation, management and maintenance of the strip mall. The IRS stated that the decedent's activities went beyond those of a mere investor collecting profits from a passive asset. Using independent contractors when the decedent could not personally make repairs was permissible, because in those situations the decedent was involved in selecting the contractors and approving their work. (The result would be the same if the strip mall had instead been held in a disregarded single-member LLC owned by the decedent.)

In Situation 2, the decedent died owning a small office park titled in the

decedent's sole name. The office park consisted of five separate two-story buildings, each of which had multiple tenants. The decedent hired an independent management corporation to lease, manage and maintain the office park, and relied entirely on the management company to provide all necessary services. The primary duties of the management company's employees consisted of advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. The management company provided a monthly accounting statement to the decedent, along with a check for the rental income, net of expenses and fees. The IRS determined that the decedent's interest in the office park did not qualify as an interest in a closely-held business, taking into account the activities of the management corporation and its relationship with the decedent. The IRS stated that the decedent lacked any significant management participation, had no personal oversight of the property, and lacked any ownership interest in the management company. These, the IRS stated, all weigh heavily against a finding that the office park was used in an active trade or business.

In Situation 3, the facts were the same as in Situation 2, except that the decedent owned 20% in value of the stock of the management company. The IRS stated that the decedent's significant interest in the management company meant that the decedent was indirectly providing significant services with regard to the management and maintenance of the office park, including advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for third party independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. Thus, the office park was used in an active trade or business, for purposes of the decedent's estate.

In Situation 4, the decedent died owning the 1% general partnership interest and a 20% limited partnership interest in a limited partnership that owned three strip malls that, collectively, constituted 85% of the value of the limited partnership's assets. The partnership agreement required the general partner to provide the limited partnership with all services necessary to operate the limited partnership's business, including daily maintenance to and repairs of the strip malls. For more than thirteen years, the decedent received an annual salary from the limited partnership for the decedent's services as general partner. The decedent, either personally or with the assistance of employees or agents, performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing and approving the work of third party independent contractors for such work), and making decisions regarding periodic renovations of the three strip malls. The IRS ruled that the strip malls were used in carrying on the partnership's active trade or business, and thus qualified under Section 6166. The IRS noted that the determination of whether

the limited partnership was carrying on a trade or business for purposes of Section 6166 is made with reference to the partnership's activities, and that because the partnership, rather than the decedent, owned the strip malls, the nature and level of the activities of the limited partnership, rather than those of the decedent, are evaluated. The decedent's activities (both those done personally and those done with the assistance of employees or agents), which included performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls, were all done on behalf of the limited partnership, and thus it was carrying on an active trade or business. The decedent owned at least 20% of the partnership, so that the result would be the same if another employee, partner, or agent performed the same services, instead of the decedent.

In Situation 5, the decedent died owning all of the stock of a corporation that sold cars and automotive parts and supplies and that repaired cars. The decedent made all decisions regarding the company, including the approval of all advertising and marketing promotions, management and acquisition of inventory, and matters relating to dealership personnel. The decedent also supervised all corporate employees. The decedent also directly owned certain real property that had been constructed for the company, and that contained unique features tailored to an automobile dealership, including a showroom and office space and areas for servicing automobiles and storing inventory. The decedent leased the real property to the company under a net lease, and the company's employees performed all maintenance of and repairs to the property. The IRS ruled that the decedent's interest in the real estate constituted an active trade or business, because the corporation engaged in an automobile dealership business which is, clearly, an active trade or business, and the real property was used exclusively in the business of the corporation, albeit under a net lease from the decedent. The activities of the corporation are imputed to the decedent, because the decedent owned a significant interest in it, so the decedent is deemed to have actively managed the real estate.

Note: This ruling updates Rev. Rul. 75-366, 1975-2 C.B. 472, revokes Rev. Rul. 75-365, 1975-2 C.B. 471, and revokes the portion of Rev. Rul. 75-367, 1975-2 C.B. 472, that relates to eight rental homes.

TWO PERCENT INTEREST RATE ON DEFERRED ESTATE TAXES ON CLOSELY-HELD BUSINESS ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/27/06); Rev. Proc. 2005-70, Section 3.35, 2005-47 I.R.B. 979 (11/21/05). The value of a closely-held business interest, the deferred estate taxes on which bear interest at a 2% rate, is increased to \$1.2 million, with respect to estates of decedents dying in 2006, and \$1,250,000 with respect to estates of decedents dying in 2007.

IRS EXAMINES EFFECT OF RECORDING SPECIAL ESTATE TAX LIEN FOR DEFERRED ESTATE

TAXES ON GENERAL ESTATE TAX LIEN

CCA 200645027 (11/10/06). Decedent died owning a \$500,000 principal residence, \$500,000 worth of marketable securities, a \$1 million interest in a closely held real estate management corporation, three closely-held real estate management corporations worth \$1 million, and three other closely-held corporations worth \$3 million each and each having a \$4 million in cash equity. D's son is the sole heir and executor. D's estate elected to pay \$4.5 million of the \$5 million estate tax liability over a 15-year period, under Section 6166. Each real estate parcel is encumbered by a mortgage that includes a clause that the imposition of any lien on the subject property constitutes a default. Because of the mortgage clauses, the estate refused to designate the real property as Section 6166 property, to be security for the Section 6324A lien. Instead, the estate offered \$5,000,000 of shares from two of the closelyheld companies as security for the deferred estate taxes. The IRS raised the question of whether, if the corporate shares meet the requirements of Section 6324A(b), does accepting them as Section 6166 property extinguish the general Section 6324(a) estate tax lien on all of the property of the gross estate, such that a default on the Section 6324A special lien agreement will permit attachment of the other estate assets, if the Section 6166 property value is then insufficient to satisfy the amount of remaining deferred liability.

The IRS Chief Counsel's Office stated recording the tax lien under Section 6324A divests the Section 6324(a) lien with respect to the property designated on the latter lien agreement, but that it does not divest the rest of the property included in the gross estate from the general estate tax lien. If there is a default on the deferred estate tax lien agreement, and the shares designated as Section 6166 lien property are insufficient to satisfy the full unpaid estate tax liability, then collection action may be taken against the remaining gross estate property, because of the general Section 6324(a)(1) estate tax lien.

IRS CLAIMS THAT THERE IS NO LIMITATIONS PERIOD ON DEMANDING SECURITY FOR ESTATE TAXES DEFERRED UNDER SECTION 6166

CCA 200627023 (7/7/06). The IRS Chief Counsel's office has taken the position that the IRS can require a surety bond under Section 6165 or attach a special lien under Section 6324A to secure estate taxes deferred under Section 6166, at any time that the taxes remain unpaid. The Chief Counsel's office stated that neither the three-year limitations period on assessment of estate tax nor the issuance of a closing letter limits the ability of the IRS to require that an estate provide such security. The Chief Counsel's office noted, in part, that the estate tax closing letter is not a formal closing agreement under Section 7121, and so does not preclude reopening the audit if there is (1) evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of material fact; (2) a clearly defined substantial error based on an established IRS position; or (3) a serious administrative error.

DISTRIBUTING PARTNERSHIP INTEREST TO DECEDENT'S DAUGHTER DID NOT ACCELERATE
ESTATE TAXES DEFERRED UNDER SECTION 6166

PLR 200613020 (3/31/06). The decedent left part of his estate, including substantial partnership interests, in trust for his daughter. The trust allowed the daughter to withdraw one-half of the trust fund at one stated age, and the balance at a later stated age. The daughter proposed to exercise her power of withdrawal, having attained the first stated age.

The IRS stated that the trust's distribution of the partnership interests to the decedent's daughter pursuant to the terms of the trust, did not accelerate the estate taxes on the partnership interest, which had been deferred under Section 6166. The IRS noted that the contrary language in the regulations was inconsistent with the current statute, and that no acceleration of deferred estate tax occurs when property is transferred to a person who, under the trust, is entitled to receive the property.

GIFT TAXES

CODE SECTION 2503. GIFT TAX ANNUAL EXCLUSION

ANNUAL EXCLUSION ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/2706); Rev. Proc. 2005-70, 2005-47 I.R.B. 979 (11/21/05). The gift tax annual exclusion is increased to \$12,000 per donee per year, and the annual exclusion for gifts to a non-U.S. citizen spouse is raised to \$120,000 per year, both for transfers made in 2006 and 2007.

IRS APPROVES GIFT AND GST TAX EXCLUSION FOR PREPAID EDUCATIONAL COSTS

PLR 200602002 (1/13/06). The IRS approved the 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 an arrangement with the school to pay at one time an amount equal to the tuition for six grandchildren to attend through 12th grade. There were six separate agreements -- one for each grandchild. The payment was nonrefundable, and the donor would separately have to pay any increases in tuition during that term.

Note. See also similar ruling in PLR 199941013. This transaction involved a contractual arrangement with the school; a similar gift through a trust would not qualify for the unlimited gift or GST annual exclusion. Regs. Section 25.2503-6(c), Ex. 2. 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.

See sample agreement in Attachments. See also Matz, "Practical Strategies for Funding a Child's College Education," 33 Est. Plan. 22 (June

2006).

CODE SECTION 2511. TRANSFERS IN GENERAL

FIFTH CIRCUIT REVERSES TAX COURT AND APPROVES DEFINED VALUE GIFT

McCord v. Comr., 461 F.3d 614 (5th Cir. 8/22/06), rev'g and rem'g, 120 T.C. 358 (2003). Charles and Mary McCord formed a limited partnership to hold various investment assets, including stocks, bonds, real estate, and other limited partnership interests. Charles and Mary then gave partnership interests to their children and certain charities, under a formula clause that purported to give: (a) \$6,910,933 worth of partnership interest to Charles' and Mary's children and trusts for their benefit; (b) \$134,000 worth of partnership interests to the Shreveport Symphony (but not more than the difference between the value of the total gift and the amount allocated to the children and their trusts); and (c) the balance to a second charity. The donees were required to determine the value of the partnership interests, to allocate the gift among themselves, using gift tax valuation methods. The noncharitable donees agreed to be liable for all gift, estate and generation-skipping transfer taxes on the transfer, including any estate tax liability that would arise under Section 2035(c) if a donor died within three years of paying the gift taxes. The donees entered into a second agreement (the "Confirmation Agreement") two months later, allocating the gift among themselves, based on the values provided by an independent appraiser hired by the children, setting the value of the total partnership interests at \$7,369,278, and the value of the residuary gift to the second charity at \$324,345 (\$7,369,278 - \$6,910,933 - \$134,000). The IRS valued the total gift at \$12,426,086, and declined to recognize the validity of the defined value gift clause.

The Tax Court (Judge Halpern), in a reviewed decision with several dissents, held that (a) the donors had assigned only assignee interests, rather than partnership interests, because the partners had not elected the donees as partners; (b) the IRS was not bound by the donees' valuation, and that the formula clause might limit the amount given to the children and their trusts, but that it did not create a charitable deduction for the entire additional amount passing to the charity, because it relied on the valuation fixed by the donees, rather than one fixed by the courts; (c) the total value of the transferred interests was \$9,883,882 (\$120,046 per 1% interest), but the amount of the gift was based on the percentage units allocated by the donees under the Confirmation Agreement, limiting the donor's gift tax charitable deduction to the difference between the court's valuation of the total gift and the amount allocated to the children; and (d) that the gift could not take into account the liability of the donees for the additional estate taxes that would be due were the taxpayers to die within three years of the payment of the gift taxes, because those amounts were too uncertain, depending, as they do, on such changeable factors as the estate tax rates and exemption amounts, the continued existence of the estate tax itself.

Judge Foley, who had been the trial judge, and Judge Chiechi, wrote a separate opinion concurring in part and dissenting in part. They stated that the charitable deduction should be allowed for the entire excess of the value of the gift over the amount allocated to the children and their trusts, because there "is no material difference between fair market value 'as determined under Federal gift tax valuation principles' and fair market value as finally determined for Federal gift tax purposes." They also stated that the defined value clause did not violate public policy.

The Fifth Circuit reversed. The court stressed that there was absolutely no suggestion that the charities had agreed to value the partnership interests at anything other than their fair market value, even though the second charity had declined to hire its own appraiser. The court stated that the Tax Court's majority wrongly measured the gift based on donees' Confirmation Agreement, which occurred two months after the gift itself, and that they wrongly converted a fixed dollar gift into a gift of a fractional share of the total partnership interests. The court agreed with Judge Foley, that the law does not prevent a charitable deduction being based upon a gift of a specific dollar value, rather than a fractional share of an asset. The court also reversed the Tax Court on the net gift approach, holding that the value of the initial gift should take into account the liability of the donees for the additional estate taxes that would be due were the taxpayers to die within three years of the payment of the gift taxes. The court stressed that the Assignment Agreement merely created a present obligation to perform a future act (paying any estate taxes that might be engendered), and that the value of that obligation could be determined actuarially.

Note. Obviously, McCord reflects a difference of opinion between the Fifth Circuit (the Canal Zone, Louisiana, Mississippi and Texas) and the Tax Court over the use of formula clauses to avoid taxable gifts. The Fifth Circuit appears to view the defined value clause as effective, though one may note that the court stated that the IRS did not argue invalidity of the clause under public policy, based on the Proctor line of cases. Also, it should be noted, the Fifth Circuit stressed that in this case, there was absolutely no hint of any understanding between the donor and the donees regarding the valuation of the property and the charitable donees were independent entities. This might make it less appealing to use a marital gift, rather than a charitable gift, as the repository for excess values. Still, were the Fifth Circuit's rule adopted generally, defined value gifts would become the norm for transfers of hard-to-value assets, such as real estate, interests in partnerships or other closely-held businesses, antiques or artwork.

See also discussion of the Tax Court's opinion in Hood, "The Defined Value Gift Quagmire: Tax Court Dances a Lil Sidestep in McCord," 15 Prob. Pract. Rptr. 1 (July, 2003); and a critique of the Fifth Circuit opinion in Gerzog, "McCord and Post-Gift Events," 113 Tax Notes 349 (10/23/06).

SETTLEMENT OF FIGHT OVER MISADMINISTERED QPRT DOES NOT RESULT IN TAXABLE GIFT

PLR 200617002 (5/28/06). The decedent and the spouse each created an eight-year qualified personal residence trust, to which each conveyed a one-half undivided interest in their principal residence. The trust terms were identical, except that the decedent was the grantor, trustee and primary beneficiary of one trust, and the spouse was the grantor, trustee and primary beneficiary of the other. The remainders of both trusts were to be distributed to the couple's then-living daughters or, if neither daughter was then living, to the personal representatives of the estate of the latter daughter to die. The decedent informed one daughter that the couple had created the trusts, and that the daughter was alternate trustee, after the couple themselves. Thereafter, the spouse became distressed regarding the loss of the residence on the termination of the QPRTs, and eight months before the expiration date of the trusts, the decedent and the spouse deeded the residence to their revocable trusts. Neither daughter was consulted, advised of or aware of these deeds, and when they learned of them several years later, when the parties began the process of selling the residence, they hired a lawyer and made a demand against their parents for the sale proceeds, based on fraud, breach of fiduciary duties, and tortious interference with the daughters' interest in the residence. The sales proceeds were held in escrow pending the determination of the rights of the parties and resolution of this conflict. The decedent died and the decedent's estate and the spouse, to avoid the costs of litigation with the daughters, offered to settle the claims by delivering all of the sales proceeds the daughters, in equal shares. The daughters agreed to accept the sales proceeds in full settlement of all claims against the decedent's estate and the surviving spouse.

The IRS ruled that the payment of the sales proceeds of the residence to the daughters would not constitute a taxable gift by the spouse or the beneficiaries of the decedent's revocable trust or the beneficiaries of the decedent's estate. The IRS stated that, under *Comr. v. Bosch Est.*, 387 U.S. 456 (1967), an agreement settling a dispute is effective for transfer tax purposes, if the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. *Ahmanson Foundation v. U.S.*, 674 F.2d 761, 774775 (9th Cir. 1981). In this case, the daughters clearly had a right to the remainder interest in the residence, and the trust did not authorize distributions of the corpus to the decedent and the spouse. Further, each trust instrument stated that it was irrevocable and that the grantor had no right or power, whether alone or in conjunction with others, in whatever capacity, to alter, amend, revoke or terminate the trust. Thus, the decedent and the spouse acted without authority in withdrawing the residence from the QPRTs. The IRS also noted that nothing suggested that any of the daughters had consented to the actions of the decedent or the spouse, and thus had not relinquished or otherwise transferred their respective remainder interests in the corpus of the QPRTs to the revocable trusts, and they had not made taxable gifts when the residence was transferred from the QPRTs to the revocable trusts.

DONOR'S RESERVATION OF RIGHT TO CHANGE BENEFICIARIES CREATES INCOMPLETE GIFT,
BUT TRUST STILL SHIFTS TAXABLE INCOME

PLR 200637025 (9/15/06). The grantor created a trust with a corporate trustee, and directed that the trust income and principal would be distributed during the grantor's lifetime to and among a class that includes the grantor, the grantor's spouse (if and when the grantor marries), the grantor's parents and any descendant of the grantor's parents, including the grantor's own descendants, if any, and any "qualified charity" (defined as one to which contributions are deductible for income, gift and estate tax purposes). The distributions will be made in such proportions as directed by either the unanimous decision of the distributions committee (the "Committee"), or by the decision of the grantor and one or more members of the Committee. At the grantor's death, the remaining trust principal (including any undistributed income) will be distributed to the persons that the grantor names in the grantor's last will. The grantor may exercise this power of appointment in favor of anyone other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate. The trust included an alternate disposition in default of the valid exercise of this power of appointment, in favor of the grantor's siblings and their descendants, with a contingent remainder in certain private foundations. The Committee initially consists of the grantor's brother and sister, but at all times it must include at least two adult members of the class of potential beneficiaries. Neither the grantor nor the grantor's spouse may be a member of the Committee.

The IRS stated that the trust was not a grantor trust for income tax purposes, apparently because any distribution of income or principal to the grantor or the grantor's spouse could be made only with the consent of an adverse party. §§672(a), 674(b)(3), 677(a). The IRS also stated that the grantor's limited power of appointment gave the grantor the power to change the trust beneficiaries, and caused any gifts to the trust to be incomplete for gift tax purposes. Regs. Section 25.2511-2; *Stanford Est. v. Comr.*, 308 U.S. 39 (1939). Trust distributions are not taxable gifts from the distribution committee, because their power to distribute trust funds to themselves is exercisable only with the consent of an adverse party. Distributions of trust property to a beneficiary other than the grantor, however, or the grantor's lifetime release of the testamentary power of appointment, would constitute completed gifts by the grantor.

Note. See also PLRs 200502014 and 200612002. These rulings support the creation of a trust that will shift taxable income without a taxable gift of the underlying trust principal.

CODE SECTION 2512. GIFT TAX VALUATION

ANNUAL VALUATIONS FOR STOCK TRANSFER RESTRICTIONS SUSTAINED AS GIFT TAX VALUE OF CLOSELY-HELD STOCK

Huber v. Comr., T.C. Memo 2006-96 (5/9/06). Michael, Caroline, Tabitha,

Hans and Laurel owned shares of a closely-held corporation founded in the 19th century by J.M. Huber, a German immigrant. The corporation operated a diversified business with annual sales in excess of \$500 million. The corporation had approximately 250 shareholders, who were either Huber family members, the Huber Foundation, or other charities. The corporation's by-laws prevented the transfer of shares outside of the family unit. Shareholders could seek waivers from the board to transfer stock to nonprofit organizations, which were then allowed to hold the shares or to sell them to permitted shareholders. There were also 3,000 to 5,000 employees, most of whom were not related to the Huber family. Huber was governed by its board of directors, most of whom were not family members. The corporation's CEO, president and chairman is a great-grandson of the founder of the corporation. The corporation had no formal stock buyback program, but its bylaws: (a) authorize it to redeem stock from Huber shareholders; (b) provide it a right of first refusal to purchase shares offered outside the Huber family at a price specified in the bylaws; (c) provide that if any shareholder attempts to sell his shares to a buyer not authorized by the bylaws, Huber has the irrevocable option to purchase the shares at the lower of the offer price, the book value, or the formula price set by the bylaws; (d) authorize sale of Huber shares to Huber family members, including lineal descendants of J.M. Huber, their spouses, their children, trusts whose beneficiaries are such persons, and the Huber Foundation; and (e) authorize shareholders to sell to independent nonprofit organizations. The corporation retained Ernst & Young (E&Y), who were not its accountants for other purposes, to appraise its shares each year. E&Y uses a consistent methodology, comparing Huber to comparable publicly-traded companies, and applying a 50% discount for lack of marketability. The E&Y reports were used in valuing gifts of Huber shares to nonprofit organizations, valuing both the grant and exercise of stock options issued to Huber's CEO, fixing the compensation of Huber's board members, evaluating the performance of Huber as a whole, and valuing shares that are bought back by Huber from its shareholders. From 1996 to 2000, the board of directors authorized 14 redemptions of stock owned by Huber shareholders, and in each case set at the E&Y values, usually less 5%, after obtaining a waiver from the board. Also from 1994 to 2000, there were approximately 90 transactions of Huber shares between shareholders, all of which used the E&Y values, though none of which were required to use those values. The IRS argued that the E&Y values were too low for gift tax purposes.

The Tax Court (Judge Goeke) sustained the E&Y values for gift tax purposes. The court agreed with the taxpayer that two transactions were particularly good comparables. In one, the Brown estate transactions, the executors of the estate of a third-generation descendant of J.M. Huber, sold 52,796 shares to help pay estate taxes. The sales were made to purchasers including distant family members and trustees acting in their fiduciary capacity. One of the buyers, the husband of the executor's second cousin, held an M.B.A. from Stanford and runs a private equity firm, and he agreed to buy the shares at the E&Y values. In another, the Foster Trust transactions, a

testamentary trust created under the will of another third-generation Huber family member, for the benefit of her children and husband, sold some of the Huber shares to raise money to meet trust expenses and the estate taxes on the deceased's estate. Sales were made to, among others, one of the decedent's children who was a beneficiary of the trust and who understood the E&Y valuation methods and agreed to that price. The Tax Court stressed that there were over 90 transactions between 1994 and 2000, involving Huber shareholders in relationships both close and distant, and that all of them took place at the E&Y values. The IRS noted that there was little negotiation in the transactions, but the court did not find "that the lack of negotiation in the transactions at issue connotes the lack of an intent to realize the best price for the value of the shares." The Tax Court rejected this notion, finding that negotiation is not essential.

GIFT TAX PROCEDURES

NOTICE OF LARGE GIFTS FROM FOREIGN PERSONS

Rev. Proc. 2006-53, Section 3.36, 2005-48 I.R.B. 996. For taxable years beginning in 2007, recipients of gifts from certain foreign persons may be required to report these gifts under Section 6039F, if the aggregate value of gifts in the year exceeds \$13,258.

GENERATION-SKIPPINGTRANSFER TAXES

CODE SECTION 2601. EFFECTIVE DATE PROVISIONS

DIVIDED TAX COURT SUSTAINS VALIDITY OF GST EFFECTIVE DATE REGULATIONS

Gerson Est. v. Comr., 127 T.C. No. 11 (10/24/06). Eleanor died on October 20, 2000, leaving a will that, in applicable part, exercised a broad general power of appointment contained in the marital trust created by her late husband, Benjamin, who died in 1973. No additions were made to the corpus of the marital trust after September 25, 1985. Eleanor appointed the marital trust to a trust for the benefit of her grandchildren and more remote descendants.

The Tax Court (Judge Haines) held that the regulations that treat the exercise of a general power of appointment as a separate constructive addition to the pre-September 25, 1985 trust were a reasonable interpretation of the statutory effective date rules. The majority relied on its earlier holding in Peterson Marital Trust v. Comr., 102 T.C. 790 (1994), aff'd 78 F.3d 795 (2d Cir. 1996), which involved a lapse of a general power of appointment and an interpretation of the temporary regulations. The court noted that the effective date provisions sought to protect the "reliance interests" of settlors who established trusts before the new GST tax regime was introduced. The majority also noted that the Second Circuit, in affirming the Tax Court, had stressed the fact that a general power of appointment is generally treated

like outright ownership, and that one holding such a power had no reliance interest in the earlier trust terms, because the power-holder could vary them in the exercise of the power. The Eighth and Ninth Circuits, however, had disagreed in *Simpson v. U.S.*, 183 F.3d 812 (8th Cir. 1999), rev'g, 17 F. Supp.2d 972 (W.D. Mo. 1998), and *Bachler v. U.S.*, 281 F.3d 1078 (9th Cir. 2002), rev'g 126 F. Supp.2d 1279 (N.D. Cal. 2000), both of which involved the exercise of general powers of appointments under facts very like those in *Gerson*. The Eighth and Ninth Circuits had held that the plain language of the statute rendered the entire pre-September 25, 1985 trust exempt from the GST tax, including the exercise of powers of appointment created under that trust. The majority noted that these contrary holdings predated the final regulations, which, though only interpretative regulations, have the force of law and are valid reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). The court rejected the views of the Eighth and Ninth Circuits in *Simpson* and *Bachler*, and sustained the regulations as harmonious with the statutory effective date rules.

Note. There were three concurring opinions and two dissenting opinions. Judge Swift wrote a three-judge concurring opinion that stated that the decisions of the Eighth and Ninth circuits in *Simpson* and *Bachler* had confused which transfers were protected by the effective date rules and had improperly distinguished the opinions in *Peterson Marital Trust*. Judge Swift stated that the pre-September 25, 1985 creation of the trusts in each case that included powers of appointment made the later exercise of those powers possible, but the "possibility" of a later transfer that was created before the effective date was different from the actual transfer that occurred after that date. The relevant transfer of property that occurred "under" the trust was the one made to the surviving spouse, and not the one that she made when she exercised or permitted to lapse her general power of appointment.

Judge Thornton wrote a separate concurrence with which seven judges agreed (including four judges who signed the majority opinion). Judge Thornton stressed the need to "give effect, if possible, to every clause and word of" the statute, and criticized the Eighth and Ninth Circuits for failing to give effect to the phrase "generation-skipping" that immediately precedes "transfer under a trust." The *Simpson* analysis rendered the phrase "generation-skipping" irrelevant, because neither the GST tax nor the effective date rule apply to any type of transfer other than a generation-skipping transfer. Judge Thornton stated that the only way that the phrase "generation-skipping" used before the phrase "transfer under a trust" can have purpose and effect, is by limiting the effective date protection to a generation-skipping transfer that occurs pursuant to the terms of the trust instrument. A generation-skipping transfer that results from the exercise of a general power of appointment is not, therefore, a "generation-skipping transfer under a trust."

Judge Holmes wrote a third concurring opinion (in which Judge Swift joined), focusing on whether the effective date regulations are a reasonable

interpretation of the statute. Judge Holmes noted that the intent of Congress on this issue is not clear, leaving the Treasury to construe it. The variation in views in this case alone, Judge Holmes stated, shows that the statute is ambiguous. The only thing required of the regulations is reasonableness, and the regulations are reasonable because they merely extend the long-standing rule that a general power of appointment is taxed as the equivalent of ownership.

Judge Laro and Judge Vasquez both wrote separate dissenting opinions, though Judge Vasquez also joined on Judge Laro's dissent (together with three other judges.) Judge Laro deemed the regulation not to be "a reasonable and valid interpretation of the plain language" of the effective date rules. The Sixth Circuit, Judge Laro noted, has stated that "[w]here the statute is clear, the agency has nothing to interpret and the court has no agency interpretation to which it may be required to defer." *Dixie Fuel Co. v. Comr. of Soc. Sec.*, 171 F.3d 1052, 1064 (6th Cir. 1999), abrogated on other grounds by *Barnhart v. Peabody Coal Co.*, 537 U.S. 149 (2003). Judge Laro noted that *Peterson Marital Trust* was concerned only with the portion of the statute that follows the comma -- the exception that provides "only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985." The instant case, as well as the opinions of the Eighth and Ninth Circuits concerned the part of TRA 1986 Section 1433(b)(2)(A) preceding the comma; i.e., the general rule that provides "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985."

Judge Vasquez wrote a separate dissent to address the issue of the proper deference the Court should give to interpretive regulations. Judge Vasquez did not believe that interpretive regulations are subject to the deference described by the Supreme Court in *Natl. Muffler Dealers Ass'n*, in light of the opinion of the Court in *U.S. v. Mead Corp.*, 533 U.S. 218 (2001). In *Mead*, the Supreme Court clarified the limits of Chevron deference owed to an agency's interpretation of a statute it administers. The Supreme Court held that an agency's interpretation of a particular statutory provision qualifies for Chevron deference when (1) Congress delegated authority to the agency to make rules or regulations carrying the force of law, and (2) the agency interpretation claiming deference was promulgated in the exercise of that authority. An agency's interpretation that does not qualify for Chevron deference is "accorded respect proportional to its 'power to persuade'" *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). Judge Vasquez stated that regulations promulgated under Section 7805 do not have 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. Interpretative regulations are owed less deference than legislative regulations. Under *Mead*, the first question is whether Congress delegated authority to the agency to make rules or regulations carrying the force and effect of law. The second question is whether the agency invoked that authority. By promulgating a regulation pursuant to Section 7805, the regulation was not issued pursuant to a delegation of authority by Congress to

make rules or regulations carrying the force and effect of law. Therefore, Judge Vasquez stated that, under Mead, the regulations under the grantor trust effective date rules would not need merely to be a reasonable interpretation; they would need to be persuasive.

CHAPTER 14. SPECIAL VALUATION RULES

CODE SECTION 2702. SPECIAL VALUATION RULES IN CASE OF TRANSFERS OF INTERESTS IN TRUSTS

TAX COURT AGAIN STATES THAT REVOCABLE SPOUSAL ANNUITIES IN GRATS ARE NOT QUALIFIED INTERESTS

Focardi Est. v. Comr., T.C. Memo 2006-56 (3/27/06). Claude and Nina each created parallel GRATS. Each created two trusts, one for a two-year term and one for a four-year term. Each trust reserved to the grantor a substantial annuity for its term, increasing by 20% per year. In each case, the grantor retained the annuity interest, and gave the spouse a revocable right to the balance of the annuity interest if the grantor died during the reserved term of the trust. Each trust also directed that the reserved annuity and the spouse's annuity were intended to be qualified interests under Section 2702(b)(1) and the regulations thereunder, and that the trust instrument should be construed consistently with that intent. It also stated that no power, right or duty under the trust could be exercised in a manner contrary to that intent. After Claude's death, his gift tax return was examined and the IRS increased the value of the remainder interest gifts, to measure them without regard to Nina's contingent annuity interest.

The Tax Court (Judge Laro) held for the IRS, applying the law in existence before the 2005 regulations that expressly denied qualified interest status to most revocable spousal interests. T.D. 9181,70 Fed. Reg. 9222 (2/25/05). The court held that the spousal interests were not qualified interests because they were contingent on the grantor's failing to survive the applicable reserved annuity term, and so were not fixed and ascertainable, and because they were not payable for either the life of the annuity holder or a term of years (or the shorter of the two). The court rejected the taxpayer's arguments that the interests were "fixed and ascertainable interests existing for a specified term of years, for the life of the term holders, or for the shorter of the two." The taxpayer argued that the interests were "fixed and ascertainable interests existing for a specified term of years, for the life of the term holders, or for the shorter of the two," relying on Schott v. Comr., 319 F.3d 1203 (9th Cir. 2003), rev'g T.C. Memo 2001-110, and attempting to distinguish Cook v. Comr., 115 T.C. 15 (2000), aff'd 269 F.3d 854 (7th Cir. 2001). The taxpayer stated that the GRATS in Cook, unlike those in this case and in Schott, involved a further contingency that the grantor and spouse remain married. The Tax Court held that the lack of this additional contingency did not mean that the interest in this case was a qualified interest, and that the inclusion of the spousal annuity within a marital trust

made the facts of this case more similar to those of Cook than to those of Schott.

Note. The court also rejected the taxpayer's arguments that, under the trusts' savings clauses, the court's determination that the spousal interests were not qualified interests, necessarily converted the trusts into GRATs for a set term-of-years, rather than for the shorter of a term-of-years or the grantor's lifetime. The court stated that such clauses are ineffective for Federal transfer tax purposes. Citing *Comr. v. Procter*, 142 F.2d 824 (4th Cir. 1944); *Ward v. Comr.*, 87 T.C. 78 (1986); *Harwood v. Comr.*, 82 T.C. 239 (1984), aff'd without published opinion 786 F.2d 1174 (9th Cir. 1986); Rev. Rul. 65144, 19651 C.B. 442. This analysis seems unduly simplistic and harsh, because it ignores the importance of such clauses in construing ambiguous provisions of trust instruments. It would have been equally easy, however, for the court to construe the language of the specific savings clause as not eliminating the contingent reversionary interest in the grantor, merely because the spouse's interest was found not to be qualified. See also Gerzog, "Focardi: Cook-ed, Not Schott," 111 Tax Notes 1057 (5/29/06).

CODE SECTION 2703. SPECIAL VALUATION RULES FOR OPTIONS, AGREEMENTS, AND OTHER RIGHTS TO USE OR ACQUIRE PROPERTY

AMENDMENT TO BUY-SELL AGREEMENT IS NOT SUBSTANTIAL MODIFICATION

PLR 200625011 (6/23/06). The voting stock of an S corporation was owned by a married couple and the nonvoting stock by their children. The shareholders and the corporation signed a buy-sell agreement that restricted the ability of any shareholder to give, bequeath or otherwise transfer his or her shares, without first offering them to the corporation and the other shareholders for their book value (or, if less, the amount offered by the purchaser in a proposed sale). The parties stated that they had always intended that the parents have the unrestricted right to transfer their voting stock as they pleased. The parties proposed to amend the agreement to state that it applied only to the nonvoting shares.

The IRS stated that the modification was clarifying in nature, and that it did not affect the "quality, value or timing of any rights under the Agreement." Therefore, it was not a substantial modification, under Regs. Section 25.2703-1(c), and it did not impair the effective date protection afforded the agreement, which had been executed before October 8, 1990 and not otherwise substantially modified after that date.

INCOME TAXES

CODE SECTION 1. INCOME TAX RATES

TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 CHANGES KIDDIE TAX

P.L. 109-222, 109th Cong., 2d Sess. (5/17/06). The new law changes the maximum age at which the unearned income (i.e., passive income such as interest) of a minor child is taxed at the parent's marginal tax rate, from fourteen to eighteen years of age. The new law provides an exception for distributions from certain qualified disability trusts. See 42 U.S.C. §§1382c and 1396p.

Note. See discussion in Smith, "Revised Kiddie Tax Affects Family Gift and College Savings Plans," 77 Pract. Tax Strategies 68 (Aug. 2006).

INCOME TAX RATES ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/27/06); Rev. Proc. 2005-70, Section 3.01, 2005-47 I.R.B. 979 (11/21/05). The 2006 income tax rates for trusts and estates are:

Income	Rate
Not over \$2,050	15%
Over \$2,050 but not over \$4,850	\$307.50 + 25% on excess over \$2,050
Over \$4,850 but not over \$7,400	\$1,007.50 + 28% on excess over \$4,850
Over \$7,400 but not over \$10,050	\$1,721.50 + 33% on excess over \$7,400
Over \$10,050	\$2,596 plus 35% on excess over \$10,050

The 2007 income tax rates for trusts and estates are:

Income	Rate
Not over \$2,150	15%
Over \$2,050 but not over \$5,000	\$322 + 25% on excess over \$2,050
Over \$5,000 but not over \$7,650	\$1,035 + 28% on excess over \$4,850
Over \$7,650 but not over \$10,450	\$1,777 + 33% on excess over \$7,400
Over \$10,450	\$2,701 plus 35% on excess over \$10,450

Also, the kiddie tax applies to income over \$850 (standard deduction for a dependent under Section 63(c)(5)), and a parent may elect to include in gross income up to \$8,500 of a child's income. Section 1(g)(4)(A).

CODE SECTION 67. MISCELLANEOUS ITEMIZED DEDUCTIONS

SECOND CIRCUIT IMPOSES STRICT LIMITATION ON TRUST'S INCOME TAX DEDUCTION FOR INVESTMENT ADVICE

Rudkin Testamentary Trust v. Comr., ___ F.3d ___, 2006 WL 2972609 (2d Cir. 10/19/06), aff'g, 124 T.C. 304 (2005). William Rudkin created an irrevocable trust for the benefit of his family and funded it with the proceeds of the sale of his interest in Pepperidge Farm Corporation to Campbell Soup Company. The trustees were expressly authorized by the trust instrument to invest in any

type of investment that was suitable for fiduciary investment, and to employ such advisors as the trustees deemed appropriate. Applicable state (Connecticut) law imposed the prudent investor standard on the trustees, who were not themselves skilled investors. The trustees then hired an investment advisor to manage the trust assets. The trustees paid the advisor more than \$28,000, and deducted the payments as miscellaneous itemized deductions. The IRS stated that the deductions were subject to the 2% floor.

The Tax Court (Judge Wherry), in a reviewed opinion, held for the government. The court stated that the investment expenses paid by the trust were clearly paid or incurred in connection with the administration of a trust or estate, but that they were not incurred because the taxpayer was a trust. The court stated that Section 67(e) is designed to permit the trust to deduct without regard to the 2% floor, only "those costs which are unique to the administration of an estate or trust" and that individual investors routinely incur costs for investment advice as an part of their investment activities. Therefore, the court stated, such expenses could never be deemed unique to the administration of an estate or trust, even if the fiduciary feels compelled to incur such expenses in order to meet the prudent person standards imposed by state law.

The Second Circuit affirmed, stating that Congress could clearly have created a "but for" causal test, but that the language of the Code does not do so. The court stated that "the plain meaning of Section 67(e)(1)'s second clause" applies the 2% floor to any expenses of that type that could be incurred if the property were held individually. The statute, the court stated, demands an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are "incapable of incurring." The court expressly rejected the focus by the Federal and Fourth Circuits on whether the costs were "not customarily incurred outside of trusts."

Note. The Second Circuit's new "incapable of incurring" standard seems quite close to the standard of the Tax Court "unique to the administration of a trust or estate" standard. It differs materially, however, from the standard of the Fourth Circuit, that the 2% floor applies to "expenses commonly incurred by individual taxpayers." *Scott v. U.S.*, 328 F.3d 132 (4th Cir. 2003). It is vastly different from the only pro-taxpayer court, the Sixth Circuit, that stated in *O'Neill v. Comr.*, 98 T.C. 227 (1992), rev'd, 994 F.2d 302 (6th Cir. 1993), nonacq. 1994-2 C.B. 1, that the question was whether the expense was "caused by" the fiduciary duty of the trustee. The view of the Federal Circuit in *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001), is an almost impossibly ambiguous standard that "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." 265 F.2d at 1280-1281 (emphasis supplied.)

CODE SECTION 72. TAXATION OF ANNUITIES

PROP. REGS. WOULD ELIMINATE DEFERRAL OF GAIN ON SALES OF APPRECIATED PROPERTY FOR AN ANNUITY

Prop. Regs. §§1.72-6(e)1), 1.1001-1(j)(1), 71 Fed. Reg. 61441 (10/18/06). Noncharitable Annuities. Under the proposed regulations, an annuity contract is received in exchange for property (other than money), three results occur: (i) the amount realized attributable to the annuity contract is its fair market value determined under Section 7520 contract at the time of the exchange, two results occur; (ii) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (iii) for purposes of determining 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), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the fair market value of the annuity contract). Thus, if an unsecured private annuity promise or a commercial annuity contract is received by the transferor in exchange for property other than cash, the entire amount of the seller's realized gain or loss (if any) must be recognized at the time of the exchange, rather than recognized ratably over the seller's life expectancy. This rule will apply regardless of the method of accounting used by the taxpayer, and regardless of whether the annuity is created in the exchange or is a pre-existing contract.

Charitable Gift Annuities. The proposed regulations would not change the taxation of charitable gift annuities. Rather, they would leave this class of annuities subject to the deferral rules of Regs. Section 1.1011-2, which governs the tax treatment of an exchange of property that constitutes a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity).

Effective Date. The proposed regulations generally apply to exchanges of property for an annuity contract after October 18, 2006 (the publication date of the proposed regulations.) The new regulations would not apply 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 for six months (until April 18, 2006) for transactions in which: (i) the issuer of the annuity contract must be an individual, rather than a corporation, partnership, trust or other legal entity; (ii) the obligations under the annuity contract cannot be secured, either directly or indirectly; and (iii) the property transferred in the exchange cannot be sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

Note. The proposed regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company and those issued by a taxpayer who is not an insurance company. The same set of rules will apply to leave the transferor and transferee in the same position before tax, as if the transferor had sold the property for cash and used the proceeds to buy the annuity contract.

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. Obviously, this is relevant only with respect to the exchange of substantially appreciated assets for an annuity. Exchanges of assets with little or no appreciation will generate very little taxable gain and, therefore, remain useful estate planning devices, and purchases of a private annuity for cash will generate no taxable gain and are expressly excluded from the operation of the proposed regulations.

CODE SECTION 101. TAXATION OF LIFE INSURANCE PROCEEDS

NEW LAW TAXING COMPANY-OWNED LIFE INSURANCE (COLI) CASTS WIDE NET

Pension Protection Act of 2006, P. L. 109-280, Section 863, 109th Cong., 2d Sess. (8/17/06). The Pension Protection Act includes new rules taxing as ordinary income certain life insurance proceeds received by a company on insurance policies owned on the lives of certain of its employees. Section 101(j). The new rule applies to any policy issued after the date of enactment, that is owned by and names as beneficiary (directly or indirectly) a person engaged in a trade or business, and that insures the life of an employee, officer, or director of the business. Section 101(j)(3)(A). The new law makes two significant exceptions to new rule taxing the proceeds of a company-owned life insurance policy. First, the new law also excludes from gross income any amount received because of the death of an insured, that is paid to a member of the family of the insured, to an individual designated beneficiary of the insured under the contract (other than the applicable policyholder, of course), or to a trust created for the benefit of any member of the family of the insured or any individual who is the designated beneficiary under the contract (other than the applicable policyholder). Section 101(j)(2)(B)(i). The new rules also exclude from gross income any amount received because of the death of an insured, if the insured was employed by the policyholder within the year ending on the date of death, or was, when the contract was issued, a director, highly-compensated employee, or highly-compensated individual with respect to the policyholder. Section 101(j)(4). This second exception, however, applies only, before the contract is issued, the insured: (a) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured; (b) is notified in writing that an applicable policyholder will be the beneficiary of the death benefits; and (c) consents in writing to being insured on such terms and that such coverage may continue after the insured's employment terminates. Section 101(j)(4).

Note. This new rule is designed to discourage corporations from buying a large number of policies of insurance on the lives of rank-and-file employees, without their notice, and retaining these policies after the employment relationship had terminated. It may, however, create serious problems for certain insurance-funded corporate buy-sell agreements. A

corporate redemption buy-sell agreement is often funded by having the corporation buy insurance on the lives of the stockholders to whom the agreement applies, to provide cash with which the corporation can purchase the stock of a deceased stockholder. The business owners are most often also employees, officers or directors of the corporation. The policies on their lives will produce ordinary income under this rule, however, unless the notice and consent requirements have also been met. It is unsettling that very few corporations whose insurance is used to fund a redemption buy-sell agreement will be able to meet these rules. The business owners are likely to know before the policy is bought that the policy will be purchased, that it will insure their lives, and that it will be payable to the corporation. They may even have this information in writing, though often they do not receive a formal notice and sometimes the documents that provide that notice are executed after the policies have been bought. It is rare, however, that the employee-business owner will know the maximum face amount for which his or her life can be insured, because there is often no such maximum. The insurance coverage is often periodically adjusted to reflect the increased values of the stockholdings of the insureds. Also, it is unlikely that most of the insureds will have consented in writing to being insured on these terms and that the coverage may continue after the insured's employment terminates. Practitioners should now include such notice and consent provisions as part of their buy-sell agreement forms. Such a buy-sell clause could resemble the following:

Section 5. Life Insurance

5.1. Required Policies. The Corporation shall apply for, own, maintain and be the beneficiary of life insurance policies on the life of each Shareholder, in amounts listed on Schedule.

5.2. Added Policies. The Corporation may acquire any additional policies of life insurance that it deems appropriate to carry out this Agreement, and each Shareholder shall cooperate fully in any such acquisitions, including submitting to any physical examinations and providing any medical information required by the insurer. All additional policies shall be listed on Schedule.

5.3. Premiums. The Corporation shall pay every premium on any life insurance policies that it is required or permitted to maintain under this Section, and give each Shareholder proof of such payment within fifteen (15) days of the date the premium was due. If the Corporation fails to supply such proof, any Shareholder may pay the premium and be reimbursed for his or her payment by the Corporation. All dividends on any such policies shall be applied to the payment of premiums.

5.4. Notice and Consent. This Section 5 shall constitute written notice to each Shareholder that the Corporation intends to insure the Shareholder's life and the maximum face amount for which the Shareholder could be insured, and that the Corporation shall be the beneficiary of the death benefits under all such insurance policies. The signature of each Shareholder

to this Agreement shall constitute a written consent to being insured on such terms and that such coverage may continue even if any employment of the Shareholder with the Corporation shall have hereafter been terminated, regardless of cause and regardless of whether the termination shall have been by the unilateral decision of the Corporation, the unilateral decision of the Shareholder, or by mutual consent of the Corporation and the Shareholder.

See also *Magner & Leimberg*, "Pension Protection Act Adopts Far-Reaching Rules for COLI," 33 *Est. Plan.* 3 (Oct. 2006); and *Zaritsky*, "What Estate Planners Need to Know About the Pension Protection Act of 2006," 18 *Prob. Pract. Rptr.* 1 (Sept. 2006).

SALE OF LIFE INSURANCE POLICY TO GRANTOR TRUST IS NOT A TRANSFER FOR VALUE

PLR 200636086 (Sept. 8, 2006). The insured proposed to sell a policy of insurance on his life to his wife, as trustee of an irrevocable life insurance trust that he had created for the benefit of their children. The insured represented that the trust was a grantor trust for income tax purposes. The insured was the original purchaser of the policy and paid all of its premiums. The IRS stated that, although the transfer would be for valuable consideration, it would be treated as a transfer to the insured, who was deemed to own the trust under the grantor trust rules, and that the proceeds would not, therefore, be includible in the beneficiary's gross income.

Note. The IRS did not rule on whether the trust was a grantor trust; it merely accepted the representation of the taxpayer that the trust was a grantor trust. The IRS also did not raise the arguments it had made unsuccessfully in *Swanson, Jr. Trust v. Comr.*, 518 F.2d 59 (8th Cir. 1975), that the grantor trust rules should not be permitted to create an exception to the transfer for value rules. In the action on decision by which the IRS explained why it recommended not asking for certiorari in *Swanson, Jr. Trust*, the IRS stated that it still did not agree with the reasoning or holding of the Tax Court or the Eighth Circuit. The IRS stated:

The Eighth Circuit erred in holding that the trusts as grantor-trusts did not retain their identity as separate tax entities under section 101(a)(2)(B).

The fact that the grantor by virtue of powers to control the beneficial enjoyment is taxed on the income of the trusts under section 674 merely provides that a grantor who retains powers to control beneficial enjoyment is taxed on income. A contrary holding of the Eighth Circuit by looking to a statute whose only function is to prevent tax avoidance (section 674) in effect broadens the scope of the second statute (section 101) whose only function is to exclude from income what would be taxable under ordinary principles. It views a statute designed to affect the liability of a particular taxpayer during his lifetime (section 674) as a gloss on another statute (section 101) which by its term goes into play only after the death of that same taxpayer.

AOD 38042 (7/23/75). This seems no longer to represent the position of the IRS. Also see discussion in Zaritsky & Leimberg, *Tax Planning with Life Insurance*, ¶2.07[3][b] (WG&L/RIA Group).

WHEN AN IRREVOCABLE INSURANCE TRUST BEGINS TO BIND -- IRS AGAIN APPROVES USE OF TRUST-TO-TRUST TRANSFER OF INSURANCE POLICIES

PLR 200606027 (2/10/06). Trust 1 owns two life insurance policies, one insuring the life of the grantor and the other insuring the joint lives of the grantor and the grantor's spouse, which it holds for the benefit of certain of the couple's children. Trust 2 owns other policies on the life of the grantor and the joint lives of the grantor and the spouse, which it holds benefit of certain of the couple's grandchildren. The spouse predeceased the grantor. The trustee of Trust 1 proposes to transfer its policies to the trustee of Trust 2 in exchange for the policies held by Trust 2. The policies to be exchanged will be valued using their interpolated terminal reserve value (including any unused premiums), and any excess value will be offset by a promissory note bearing interest at the applicable Federal rate. Both trusts are grantor trusts deemed owned by the grantor.

The IRS ruled that the transfer of two policies from Trust 1 to Trust 2, in exchange for two different policies and other consideration, will not be a taxable event for Federal income tax purposes, because the trusts are both grantor trusts. The IRS also ruled that the transfer-for-value rule of Section 101(a)(2) will not apply to prevent full exclusion from gross income under Section 101(a)(1) of the proceeds of the four policies. The IRS applied its traditional analysis on both issues. It stated that gain would normally be recognized on the exchange of one valuable asset for another, but that grantor trusts are generally disregarded for income tax purposes. The assets of the trust are deemed owned directly by the grantor for these purposes. Rev. Rul. 85-13, 1985-1 C.B. 184. Therefore, the transfer of two life insurance policies owned by the grantor for two other policies owned by the grantor cannot be an event in which gain or loss is recognized, because no change of ownership has occurred. The IRS also noted that the transfer for value rule applies to any transfer of a life insurance policy by the owner to someone else, for valuable consideration. It applies, however, only if there is a transfer. The IRS stated that the transaction in question is ignored for all income tax purposes, because both trusts are deemed owned by the grantor. Therefore, without a transfer, there cannot be a transfer for valuable consideration.

Note. The result is the same whether the transaction involves an exchange of life insurance policies or a transfer of policies in exchange for cash or a promissory note. Thus, this technique may be useful to change the terms under which an irrevocable life insurance trust holds life insurance policies. See also PLRs 9413045, 9843028, 200228019, 200247006, 2005 and 200514002; and also in Zaritsky & Leimberg, *Tax Planning with Life Insurance*, ¶5.03[11] (WG&L/RIA Group).

CODE §§170, 642, 4940-4947. CHARITABLE GIFTS AND DISTRIBUTIONS

CHARITABLE GIVING TAX REVISIONS PASS HOUSE AND SENATE AS PART OF PENSION PROTECTION ACT OF 2006

P.L. 109-280, 109th Cong., 2d Sess. (8/17/06). The Pension Protection Act of 2006 includes several reforms in the rules for charitable gifts. These proposals include the following changes, several of which are scaled-back from their previous versions:

Charitable IRA Distributions. The Pension Protection Act permits a participant to distribute up to \$100,000 annually from a regular or Roth IRA to a qualified charity, without first taking the distribution into income. This rule applies to distributions made in taxable years beginning in 2006 or 2007, and does not apply either to distributions from a simplified employee pension (SEP), a simplified retirement account (SIMPLE) or any qualified pension or profit-sharing plan, or to distributions made before the individual for whose benefit the plan is maintained reaches 70 1/2 years of age. §§408(d)(8)(A), 408(d)(8)(B), 408(d)(8)(F). This rule applies only to distributions made directly to charities to which the 50% of adjusted gross income limitation applies. Generally, this includes all public charities, and excludes most private foundations. The new rules also expressly exclude distributions to certain donor advised funds and supporting organizations. Section 408(d)(8)(B). The new rules state that the exclusion is allowed only if an income tax deduction would have been allowed under Section 170 for the "entire distribution." This precludes an exclusion for contributions to split-interest charitable trusts, such as charitable remainder trusts. Section 408(d)(8)(C). Qualified charitable distributions from an IRA count towards the minimum distribution requirements. Thus, a participant who, in 2006, was required to withdraw 4% of the plan assets to continue a plan of substantially equal periodic payments over the participant's life, could instead distribute 3% of the plan assets to a qualifying charity and withdraw an additional 1% personally. Section 408(d)(8)(D).

Note. Estate planners have long focused on retirement plan benefits as a source for testamentary charitable gifts, because the charitable application of these funds reduces both income and estate taxes. Now, charitably-minded clients can satisfy up to \$100,000 per year of their lifetime charitable objectives with retirement plan benefits, and both avoid income taxes and reduce potential estate (and gift) taxes.

The new rule creates an exclusion from income, rather than a deduction. This makes the charitable distribution from an IRA particularly useful to donors who do not itemize income tax deductions, who live in states that do not provide an income tax deduction for charitable gifts (such as Indiana, Michigan, New Jersey, Ohio, or Massachusetts), whose other gifts already run up against the 50% of contribution base (modified adjusted gross income) limit on annual income tax deductions for charitable contributions, and those whose

itemized deductions are lost because of the phase-out rules as the taxpayer's income increases above \$150,000.

The new law requires that the IRA distribution be made directly to the charity. The new law will not apply if the IRA custodian distributes funds to a beneficiary, who then contributes the money to charity. Even writing a check to the participant that is endorsed over to the charity may not qualify under these rules. Thus, the IRA custodian should make out a check or document of assignment directly to the charity.

The new charitable exclusion applies only to distributions made after the donor actually reaches age 70 1/2. This should be distinguished from the rule that credits as minimum distributions any IRA distribution made at any time during the year in which the participant reaches age 70 1/2.

Partial Interests in Tangible Personal Property. The Act denies an income, estate or gift tax charitable deduction for a second or later contribution of a partial interest in tangible property unless, immediately before the gift, all of the interests in the property are owned by the donor, the charity or both. The Act also calculates the income, estate and gift tax deduction for charitable contributions of partial interests in tangible personal property, where the donor has already made one contribution of interests in the same property, at the lesser of the value used for the first contribution or the value of the later contributed interest. The Act also recaptures these deductions unless the donor contributes all of his or her interests in the property to the same charity within ten years after the first contribution. The Act treats the first contribution after the date of enactment as the initial contribution. These changes are effective for all transfers after the date of enactment.

Note. Gifts of tenancy-in-common interests can provide a useful way to schedule charitable gifts of tangible assets, to permit use of the income tax deductions over a longer period of time, and to make gifts of interests in tangible property that the donor does not use during the entire year. The planning appeal of such gifts was increased by the decision of the Tax Court in *Winokur v. Comr.*, 90 T.C. 733 (1988), acq. 1989-1 C.B. 2, which involved a donor's gift to the Carnegie Institute of a 10% undivided interest in his art collection. The donor's agreement allowed the Institute to possess and display the artworks for one tenth of each year. The Tax Court stated that nothing precluded fractionalization based on the number of days in a year, rather than on the number of items in the collection, and allowed the deduction. The IRS acquiesced.

Qualified Conservation Contributions. The Act raises the deduction limit from 30% of adjusted gross income to 50% of adjusted gross income, for qualified conservation contributions, and allowing a 15-year carryover of unused deductions. This provision is applicable only for distributions made in taxable years beginning in 2006 or 2007.

Split Purchases of Life Insurance. The Act imposes a temporary reporting requirement for certain exempt organizations with respect to the acquisition of interests in certain life insurance policies (where interests are acquired by both charitable and noncharitable persons), and requires the Secretary of Treasury to issue a report within 30 months after the date of enactment, examining whether acquisitions of applicable insurance contracts is consistent with tax-exempt purposes of charitable organizations. This provision applies to contracts acquired after the date of enactment.

Historic Facade Easements. The Act tightens the rules relating to charitable contributions of historic easements on buildings, allowing the deduction only if the easement relating to the exterior of the building preserves the entire exterior, including the space above and to all of the sides of the building, from changes that are inconsistent with the historical character of the building, requiring a qualified appraisal (including certain specified data) to be attached to the tax return claiming the deduction, and reducing the deduction to take into account any federal rehabilitation credit. This change is effective for contributions made after July 25, 2006.

Taxidermy (Really!). The Act limits the charitable contribution deduction for appreciated taxidermy items contributed by the person who did the taxidermy or incurred the cost of the taxidermy, to the lesser of the taxpayer's basis in the property or its fair market value, effective for contributions made after July 25, 2006.

Tangible Personal Property Used for Exempt Function. The Act recaptures the tax benefit for charitable contributions of tangible personal property that were deducted based on the use of the property by the charity in conjunction with its exempt function, when the charity did not so use the property, effective for contributions made and returns filed after September 1, 2006.

Clothing and Household Items. The Act denies the deduction for contributions of clothing or household items that were not in good or better condition or that had minimal monetary value (such as socks and underwear), with exceptions for items valued at more than \$500 where the taxpayer provides a qualified appraisal. This change applies to contributions made after July 25, 2006.

Tightening the Rules on Appraisals. The Act lowers the threshold for imposing accuracy-related penalties on a taxpayer relating to valuation misstatements, imposing civil penalties on appraisers who prepare an appraisal that is deemed to have resulted in a substantial or gross valuation misstatement. This change applies to returns filed after the date of enactment.

Private Foundation Net Investment Income Tax. The Act expands the base of the tax on private foundation net investment income, so that it includes income of a time similar to the items enumerated in the Code, such as income from notional principal contracts (derivatives), annuities, and other substantially

similar income, but not capital gains from property held for more than one year for the charity's exempt function. This change applies to taxable years beginning after the date of enactment.

Donor Advised Funds. The Act includes specific rules on donor advised funds, including the first definition of a "donor advised fund," imposing new substantiation requirements for gifts to donor advised funds applying the excess business holdings rules of Section 4943 to donor advised funds, imposing the excess benefit excise tax under Section 4958 on certain distributions from donor advised funds to disqualified persons and on distributions with more than an incidental benefit to disqualified persons. The Act also requires the Secretary to study the organization and operation of donor advised funds and supporting organizations, and applies an excess benefits transaction tax on any grant, loan, compensation or similar payment from a donor-advised fund to a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person. These changes apply to taxable years beginning after the date of enactment.

Supporting Organizations. The Act increases the reporting requirements for supporting organizations. This change applies to taxable years beginning after the date of enactment.

See also Zeydel, Gans & Blattmachr, "What Estate Planners Need to Know About the New Pension Protection Act," 105 J. Tax'n 109 (Oct. 2006); Zaritsky, "What Estate Planners Need to Know About the Pension Protection Act of 2006," 18 Prob. Pract. Rptr. 1 (Sept. 2006).

NO INCOME TAX DEDUCTION FOR CHARITABLE DISTRIBUTION MADE PURSUANT TO EXERCISE OF GENERAL POWER OF APPOINTMENT

Brownstone v. U.S., 465 F.3d 525 (2d Cir. 9/27/06). Lucien's will created a marital deduction trust for his wife, Ethel, in which gave Ethel the testamentary power to appoint the remaining trust principal to whomever she wished. The taker in default of the exercise of this power of appointment was a charitable foundation created by Lucien and Ethel. Ethel survived Lucien, and at her death directed that the trust funds be paid to her estate, that the executor of her estate should pay her debts and estate expenses, and satisfy 48 cash bequests to various friends and family members. Ethel left the residue of her estate to be divided among eight charitable institutions. The trustee of the marital trust distributed \$1 million to the executor of Ethel's estate. The trustee of the marital trust then amended its income tax return to claim this distribution as a charitable contribution under Section 642(c)(1). The trustee argued that the \$1 million was distributed from gross income and pursuant to the terms of the governing instrument, and that it would be distributed by Ethel's estate to eight qualified charities. The IRS denied the claim for refund, the trustee sued for a refund and the district court granted summary judgment for the government. The trustee appealed.

The Second Circuit affirmed, holding that the distribution was not made by

the trustee pursuant to the governing instrument, but rather by Ethel pursuant to the power of appointment. The trustee argued that the "governing instrument" referred to in Section 642(c)(1) was the combination of Lucien's will and the power of appointment, but the court, relying on *Old Colony Trust Co. v. Comr.*, 301 U.S. 379 (1937), and *Ernest and Mary Hayward Weir Foundation v. U.S.*, 508 F.2d 894 (2d Cir. 1974), held that the "governing instrument" was the instrument that created the trust fund, and not the power of appointment. Thus, the distribution was not made pursuant to the governing instrument. The trustee also argued that the \$1 million distribution was made pursuant to Lucien's will, but the court stated that Lucien's will had not express charitable intent, and that the charitable payment was not "pursuant to" the will.

DEVELOPER CANNOT DEDUCT CHARITABLE CONTRIBUTION OF CONSERVATION EASEMENT,
BECAUSE IT DID NOT SATISFY REQUIRED PUBLIC PURPOSES

Turner v. Comr., 126 T.C. 299 (5/16/06). James, an attorney and real estate developer, claimed that he could develop 62 residences on certain acreage, where current zoning and land use laws permitted only 30 residences. He assigned to the county government an easement stating that he could construct only 30 residences. James claimed an income tax deduction for this as a grant of a conservation easement, under Section 170(h)(1).

The Tax Court (Chief Judge Gerber) held that no deduction was allowed, because the purported grant did not satisfy the conservation purposes required under Section 170(h)(4)(A). The court noted that the property was located in a historic overlay district, but that the local zoning regulations were already more restrictive than those for the district. The court noted that the restriction in the number of houses, even if it were more limited than required by local regulations, would not preserve open space; it would merely develop it less. The court also noted that the gift did not preserve an historic structure, because there was none on that property to be preserved, and that the restricted development near other historic structures produced only a very ancillary benefit. Therefore, the transfer was not deductible, and a 20% negligence penalty under Section 6662 was allowed.

Note. See also Gerzog, "Conservation Easements Under Turner and Glass," 112 Tax Notes 179 (7/10/06).

TAX COURT AGGREGATES GIFTS IN DETERMINING MINORITY DISCOUNT ON CHARITABLE GIFT

Koblick v. Comr., T.C. Memo 2006-63 (4/3/06). Ian sold to the Maine Resources Development Foundation his 45% interest in the stock of Sealodge International, Inc., a closely-held corporation that operated an underwater lodge/hotel. The foundation paid Ian \$90,000 for the shares, which Ian valued at \$810,000. At the same time, the other two shareholders also sold their shares to the same foundation for a similar price per share. The IRS contended that the taxpayer had overvalued the shares (based on the value of

the underlying corporate assets), and that there should have been a 22% discount for lack of control applied to the 45% gift.

The Tax Court (Judge Goeke) agreed with the IRS that the underlying assets were not worth as much as the taxpayer and his appraiser claimed, based largely on the fact that the comparable properties used by the taxpayer's appraiser were all American Board of Shipping certified, whereas the property owned by Sealodge International was not. The court also held, however, that the minority discount should be limited to 10%, because the three shareholders all acted in concert in making their gifts, and the charity received a controlling interest from the joint transfers. Citing *Northern Trust Co. v. Comr.*, 87 T.C. 349 (1986), *aff'd sub nom. Citizens Bank & Trust Co. v. Comr.*, 839 F.2d 1249 (7th Cir. 1988).

IRS PROVIDES TRANSITIONAL GUIDELINES FOR PENSION PROTECTION ACT OF 2006 CHANGES IN RULES FOR QUALIFIED APPRAISALS OF NONCASH CHARITABLE CONTRIBUTIONS

Notice 2006-96, 2006-46 I.R.B. 902 (11/13/06). The IRS provided transitional guidance on the definition of "qualified appraisal" and "qualified appraiser." The Pension Protection Act of 2006 provides that, with respect to noncash charitable contributions reported on tax returns filed after August 17, 2006, provides new statutory definitions of "qualified appraisal" and "qualified appraiser," and adds new penalties on an appraiser for a substantial or gross valuation misstatement that the appraiser knows or should have known would be used in connection with a tax return or claim for refund. For contributions of property (other than readily valued property) valued at more than \$5,000 on returns filed after August 17, 2006 and before the effective date of regulations not yet promulgated, an appraisal is qualified if: it complies with the prior rules, except as expressly contradicted by the new statute, and it complies with generally accepted appraisal standards, such as the Standards of Professional Appraisal Practice. A "qualified appraiser," for such transfers, includes (but is not necessarily limited to) an appraiser who has earned an appraisal designation from a recognized professional appraisal organization on the basis of demonstrated competency in valuing the type of property now being valued, or has certain minimum levels of verifiable education and experience.

CODE SECTION 664. CHARITABLE REMAINDER TRUSTS

IRS EXPLAINS TREATMENT OF REAL ESTATE MORTGAGE INVESTMENT CONDUITS HELD INDIRECTLY BY A CHARITABLE REMAINDER TRUST THROUGH A REIT OR PARTNERSHIP

Rev. Rul. 2006-58, 2006-46 I.R.B. 896 (11/13/06). Real estate mortgage investment companies (REMICs) are real estate mortgage pools that are generally exempt from tax, but the income of which is allocated among, and currently taxed to, holders of its interests. REMICs have both one or more classes of regular interests and one class of residual interest. The holder of a REMIC regular interest is entitled to a fixed principal amount payable, with or without interest, and is treated for tax purposes as a debt interest. The

holder of a REMIC residual interest is treated as holding an equity interest, and shares ratably in all distributions to the residual class. The ruling involved a charitable remainder trust (TR1) that held holding a 10% equity interest in a partnership that itself held a residual interest in a REMIC, and another charitable remainder trust (TR2) that held a 10% interest in a corporation that elected to be taxed as a real estate investment trust (REIT). The REIT held an interest in a REMIC. The REMIC tax rules (Section 860C(a)) requires that the REIT or partnership take into account its daily portion of the REMIC's net income or net loss. For 2004, a portion of the REMIC net income taken into account by the REIT or partnership was an excess inclusion, as defined in Section 860E(c). The REIT's taxable income was zero.

The IRS ruled that a charitable remainder trust that is a partner in a partnership or a shareholder in a REIT, that has excess inclusion income from holding a residual interest in a REMIC does not have unrelated business taxable income, but that it is a disqualified organization for REMIC purposes and that the partnership or REIT is subject to the pass-thru entity tax under Section 860E(e)(6).

IRS ISSUES GUIDANCE ON SPOUSAL ELECTION RIGHTS AND CHARITABLE REMAINDER TRUSTS

Notice 2006-15, 2006-8 I.R.B. 501 (2/21/06), modifying Rev. Proc. 2005-24, 2005-16 I.R.B. 909 (4/18/05). Rev. Proc. 2005-24. The IRS noted that some states, including those which have adopted the Uniform Probate Code (UPC) concept of the augmented estate, give a surviving spouse a right to renounce the provisions of a deceased spouse's will and to claim, instead, a share of various assets, including both the probate estate and certain assets transferred by the deceased spouse during his or her lifetime. The assets of a charitable remainder trust may be included in the augmented estate and, therefore, used to determine and satisfy the elective share amount. UPC Section 2209. In some states, the charitable remainder trust assets may be used to satisfy the elective share only after other property in the augmented estate first has been exhausted. In either case, the spouse's right to a share of the trust assets, even if other assets must first be exhausted, would constitute a disqualifying distribution of trust assets to someone other than the charity and the noncharitable distribution of the unitrust or annuity amount. §§664(d)(1)(B), 664(d)(2)(B). The trust would be disqualified merely because the elective share right exists, even if the spouse does not exercise that right. To avoid this disqualification, the IRS stated that charitable remainder trusts created on or after June 28, 2005, will not be disqualified if the surviving spouse irrevocably waives the right of election against trust assets. The waiver must be made within six months of the due date (including extensions actually granted) of Form 5227 (Split-Interest Trust Information Return), for the year in which the latest of the following occurs: (a) the trust is created, (b) the grantor marries the spouse; (c) the grantor first is domiciled or resident in a jurisdiction in which the spouse has an elective share right that extends to the trust assets; and (d) the effective date of the state law granting the spouse the elective share right. Trusts created before

June 28, 2005, are protected from disqualification, unless the spousal right of election is actually exercised.

Notice 2006-15. The IRS states in Notice 2006-15, that until further guidance may be issued, the rule applicable to charitable remainder trusts in existence on June 28, 2005 will apply to all charitable remainder trusts, and the mere existence of unexercised elective share rights against the trust will not disqualify the trust. Notice 2006-15 does not hint at what the future IRS guidance will be, or when it will occur, but it does presently eliminate this potential tax trap.

Note. The problem raised by Rev. Proc. 2005-24 occurs only if state law gives the surviving spouse an elective share right that extends to the charitable remainder trust assets, as under the UPC's augmented estate. This can be a serious problem even if the trust is qualified when created, because the waiver will be required if: (a) the grantor marries someone in a state in which the new spouse would have elective rights over the trust; (b) the grantor, who is already married, moves from a state that does not give such elective rights, to one that does; or (c) state law changes to extend the spouse's elective rights to the trust.

It is also odd that the IRS did not discuss the decision of the Tax Court in *Longue Vue Foundation v. Comr.*, 90 T.C. 150 (1988), acq., 1989-1 C.B. 1, in which the court held that a charitable bequest that was voidable, but not void, due to the local law doctrine of legitime (elective share rights of a child of the decedent), was not a nondeductible conditional charitable bequest. The decedent's children could have exercised their legitime interest and voided the charitable bequest, but none of them chose to do so. The court held that the children did not need to disclaim their legitime interest in order for the estate to claim a charitable deduction, because the voidable bequest was not so uncertain or conditional as to violate the estate tax charitable deduction rules. Practitioners have long believed that the analysis in *Longue Vue Foundation* would also protect a charitable remainder trust over which a spouse had an elective share right, but the IRS and Treasury apparently do not concur.

See also Colliton, *Charitable Gifts*, ¶6.05A (WG&L/RIA Group); Gerzog, "The Collision Between CRTs and the UPC Elective Share," 111 *Tax Notes* 583 (5/1/06); Schlesinger & Goodman, "IRS Delays Application of Rules Affecting CRTs," 33 *Estate Planning* 35 (June 2006); Teitell, "Pandora's Box Opened on Spousal 'Right of Election'," 231 *N.Y.L.J.* 3 (6/27/05); Wallenfelsz & Jenson, "CRTs in the Wake of Rev. Proc 2005-24 and Notice 2006-15," 17 *Tax'n of Exempts* 269 (May/June 2006).

BAD ADMINISTRATION DISQUALIFIES CHARITABLE REMAINDER UNITRUST

CCA 200628026 (7/14/06). The grantor created a charitable remainder unitrust, reserving the unitrust interest and transferring to the trust real property encumbered by a mortgage. The grantor (as trustee) sold the real property and paid off the mortgage, holding the net proceeds as part of the

trust corpus. In addition, the grantor made distributions to himself, his wife, and third parties "on an apparently random, ongoing basis," including making installment payments on the grantor's pickup truck for two years, allowing the grantor to use certain real estate held by the trust rent-free, and prepaying ten-years rent for the grantor on a building owned by a third-party. The IRS noted that the payment of the debt on which the grantor remained personally liable was a constructive distribution to the grantor under Section 677(a), causing the grantor to be deemed to own the entire trust under the grantor trust rules. Regs. Section 1.677(a)-1(d). Furthermore, the trust distributions to the grantor and other persons beyond the making of the specified unitrust amount also disqualified the trust.

Note. Good drafting of a charitable remainder trust is only the start. One must also carefully administer the trust in accordance with the terms of the instrument and applicable state and tax laws. See, e.g., *Atkinson Est. v. Comr.*, 115 T.C. 26 (2002), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). One should also be careful about making the grantor or a family member the trustee of such a trust, unless one is very confident that they will meticulously follow the terms of the instrument. See also Langstraat & Cagle, "Charitable Remainder Trusts Require More Than Good Drafting," 66 *Practical Tax Strategies* 94 (Feb. 2001).

CODE SECTION 685. FUNERAL TRUSTS

CONTRIBUTIONS TO QUALIFIED FUNERAL TRUSTS ADJUSTED FOR INFLATION

Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11/27/06); Rev. Proc. 2005-70, Section 3.25, 2005-47 I.R.B. 979 (11/21/05). A qualified funeral trust can accept no more than \$8,500 in contributions by or for the benefit of an individual, if the contract is entered into during 2006, or \$8,800 in contributions for contracts entered into in 2007.

CODE SECTION 691. INCOME IN RESPECT OF A DECEDENT

WHY YOU SHOULD NOT USE IRD TO SATISFY A PECUNIARY CHARITABLE BEQUEST

CCA 200644020 (11/3/06). The revocable trust in the ruling satisfied the right of a charitable beneficiary to a \$100,000 bequest by distributing to it the right to receive a portion of the trust's beneficial interest in an individual retirement account (IRA).

The Chief Counsel's Office stated that a trust or estate recognizes an item of IRD that it distributes in satisfaction of a pecuniary obligation, under the general rule of *Kenan v. Comr.*, 147 F.2d 417 (2d Cir. 1940). No income tax deduction is allowed, the IRS stated, because the trust does not require that pecuniary gifts be satisfied from trust income. The Chief Counsel's Office also rejected the argument of the taxpayer that the result should change because Section 408(d)(1) states that "any amount paid or distributed out of an IRA shall be included in gross income by the payee or

distributee." The IRS stated that the trust, rather than the charity, was the "payee or distributee" because it received an immediate economic benefit from the distribution of the right to the IRA in satisfaction of a pecuniary obligation.

Note. CCA 200644020 basically means that one should avoid using items of IRD to satisfy a pecuniary charitable gift, and perhaps that one should favor drafting pecuniary charitable gifts as fractional shares of the residue, the numerator of which is the desired dollar amount and the denominator of which is the value of the residue. Also see Danforth, Lane & Zaritsky, *Federal Income Taxation of Estates & Trusts*, ¶¶4.11[1][b], 15.07 (WG&L/RIA Group).

Also note that the taxpayer in CCM 200644020 had submitted a private ruling request, and withdrawn this particular issue when told that the IRS would rule adversely. The Office of Chief Counsel issued this memorandum to advise the various district directors and agents that this was its position, so that they would be aware of the difference of opinion when this taxpayer (or other similarly situated taxpayers) filed their returns. The practice of issuing notice to the local offices of differences of opinion that materialized in withdrawn ruling requests may be new, or it may only be new that we now see the memoranda filed with the local IRS offices. It now appears, however, that a request for a private ruling on an uncertain point of law may not be entirely free of risk. The taxpayer may withdraw a request upon learning that the IRS will rule adversely, but the office with whom the taxpayer files his or her tax return will now be informed of the problem, making it far more likely that the return will be audited and the issue taken to litigation.

ESTATE OR TRUST NOT TAXED ON IRD RECEIVED AND DISTRIBUTED IN ONE TAXABLE YEAR

CCA 200644016 (11/3/06). The IRS Chief Counsel received the same inquiry from several different examiners, each reporting on an estate or trust that received a cash payment of an item of IRD, and distributed the cash to the noncharitable beneficiaries in the same year as the estate or trust had received it. The Chief Counsel sought to provide guidance on this issue.

The Chief Counsel stated that an item of IRD received by an estate or trust is generally includible in its gross income. Taxable income begins with gross income, and distributable net income (DNI) begins with taxable income. Therefore, the Chief Counsel's Office stated, such items of IRD are generally includible in DNI under Section 643(a). A trust or estate may deduct under Section 661(a), the amounts properly distributed to beneficiaries, to the extent of the entity's DNI. The distribution of the IRD to the beneficiaries in the year in which they were received by the trust or estate, therefore, produces an income tax deduction for the trust or estate, under Section 661(a). The Chief Counsel's Office stated that taxpayers have frequently cited *Rollert Residuary Trust v. Comr.*, 752 F.2d 1128 (6th Cir. 1985), *aff'g*, 80 T.C. 619 (1983), for the proposition that a distribution of an item of IRD does not produce an income tax deduction. The Chief Counsel's Office noted, however,

that Rollert involved a distribution of the right to receive an item of IRD, rather than a distribution of the cash itself. The IRS noted that the estate in that case could not have taken the item of IRD into income, because it did not receive the actual payment.

Note. CCA 200644016 basically means that an estate or trust that receives DNI will be taxed on that item of income, unless it properly distributes it to a noncharitable beneficiary in the year in which the item was received. A trust or estate is taxed on a very highly-compressed income tax rate schedule, so total taxes are usually reduced by distributing such items of IRD as soon as they are received. Also see Danforth, Lane & Zaritsky, Federal Income Taxation of Estates & Trusts, ¶¶4.11[1][d], 15.05[1] (WG&L/RIA Group).

ESTATE'S CHARITABLE DISTRIBUTION OF RIGHT TO IRD DOES NOT ACCELERATE TAX

PLR 200633009 (8/18/06). The decedent's will named a specific charity as the residuary beneficiary. The decedent's executor proposes to assign to the charity all rights to the decedent's individual retirement account (IRA), of which the estate was the beneficiary. The will gave the executors the power to make divisions and distributions in cash or in kind, "either pro-rata or otherwise."

The IRS explained that the IRA was an item of income in respect of a decedent (IRD), because it was a right to income that was not properly includible in the decedent's gross income before the date of his death. Section 691(a)(1). The IRS stated that the estate did not accelerate the income tax when it distributed the right to an item of IRD (the IRA) to the charitable remainder beneficiary in partial satisfaction of its right to the residuary estate. The IRS explained that a distribution of IRD to a specific legatee or residuary beneficiary does not accelerate the incidence of income taxation. Regs. Section 1.691(a)-4(b)(2); Rev. Rul. 92-47, 1992-1 C.B. 198. Thus, only the charity was required to include the IRA in income, and it is a tax-exempt entity.

Note. See also PLR 200617020 (4/28/06) (same result on virtually identical facts) and PLR 200618023 (5/4/06) (same result for distribution of nonqualified deferred annuity to charities in partial satisfaction of residuary gift, when state law, but not will, authorized non-pro rata in kind distributions). Also see Danforth, Lane & Zaritsky, Federal Income Taxation of Estates & Trusts, ¶15.02[1] (WG&L/RIA Group).

CODE SECTION 871. FIXED AND DETERMINABLE U.S. SOURCE PERIODIC INCOME

PROPOSED REGULATIONS FINE TUNE EXCEPTION TO THE INCOME TAX EXCLUSION FOR U.S. INVESTMENT INTEREST RECEIVED BY A SIMPLE TRUST OR A GRANTOR TRUST

Prop. Regs. §§1.871-14(g), 1.881-2(a)(6), 71 Fed. Reg. 34047 (6/13/06). The 30% withholding tax on U.S. source fixed or determinable annual or periodic income received by a nonresident alien individual or foreign corporation, is

not imposed on portfolio interest. §§871(h)(2) and 881(c)(2). Excludible portfolio interest, however, does not include paid by a corporation to a 10% shareholder or by a partnership to a 10% partner. The 10% rules refer to a percentage of the total voting power of a corporation's stock or the total capital or profits interests of a partnership, and they are determined by applying the attribution rules of Section 318 (with certain modifications.) §§871(h)(3)(A), 881(c)(3)(B).

Under new proposed regulations, interest paid to a simple trust or a grantor trust by a corporation may be subject to the 10% test, and that this test should be applied at the beneficiary level, rather than the trust level. Specifically, the U.S. withholding agent for any interest paid to a simple trust and distributed to a nonresident alien individual or foreign corporation, or paid to a grantor trust and included in the gross income of a nonresident alien individual or foreign corporation, must determine whether the beneficiary or grantor, as the case may be, is a 10% shareholder. Prop. Regs. §§1.871-14(g), 1.881-2(a)(6) (6/13/06). These proposed regulations apply to interest paid on obligations issued on or after the date that the regulations are issued as final regulations. Prop. Regs. §§1.871-14(g)(5) (6/13/06).

CODE SECTION 1014. BASIS IN INHERITED PROPERTY

BENEFICIARIES BOUND FOR INCOME TAX PURPOSES BY DISCOUNTED VALUE OF ARTWORK USED BY DECEDENT'S ESTATE FOR ESTATE TAX PURPOSES

Janis v. Comr., T.C. Memo 2004-117, aff'd, 461 F.3d 1080 (9th Cir. 8/21/06) and ___ F.3d ___, 2006 WL 3316861 (2d Cir. 11/15/06). Sidney owned and operated an art gallery through an irrevocable trust in which he held a lifetime right to receive and control the beneficial enjoyment. Sidney's will left his entire estate to his two children, Conrad and Carroll, whom he named co-executors. Sidney's estate tax return was audited, and the estate agreed to an adjustment based on an opinion of the IRS Art Advisory Panel, which first determined that the undiscounted value of the individual works of art ranging from Mondrian to Grandma Moses was approximately \$36.6 million. The Panel allowed a blockage discount of approximately \$13.6 million, to reflect the depressing effect of selling the entire collection at one time. The Panel also considered discounts based on the gallery's annual gross and net receipts of the inventory, and allowed an overall weighted discount of 37%. The value of the collection was subsequently further discounted to \$14.5 million (a total discount of approximately 60.42%). Accordingly, the IRS determined that the value of the gallery was \$21,630,543. The estate agreed to this valuation. The beneficiaries used the undiscounted \$36.6 million value, allocated among the individual works, to determine the gallery's cost of goods sold, in calculating their taxable income.

The Tax Court (Judge Cohen) held that the discounted value of the entire business, allocated among the inventory, should be used to establish the

cost of goods sold. The taxpayers argued that the discounts should be ignored, citing *Augustus v. Comr.*, 40 B.T.A. 1201 (1939), *aff'd* 118 F. 2d 38 (6th Cir. 1941), but the court explained that *Augustus* involved a taxpayer who proved that there had been no evidence adduced to support allowing a blockage discount in determining the estate tax valuation of stock of F. W. Woolworth Co. The court noted that Section 1014 requires that the beneficiaries use as the basis of the stock the fair market value of the inherited property, as appraised for estate tax purposes. Regs. Section 1.1014-3(a). Generally, the value finally used for estate tax purposes is *prima facie* evidence of the correct estate tax value. The Tax Court also held that the beneficiaries of the estate were bound to use the same valuation adopted by the fiduciaries of the decedent's estate, under the "duty of consistency." The court noted that the duty of consistency imposes upon a taxpayer a duty to be consistent in the tax treatment of items and will not permit the taxpayer to benefit from his or her own prior error or omission. The duty of consistency applies if: (1) the taxpayer makes a representation of fact or reports an item for tax purposes in one tax year; (2) the IRS acquiesces in or relied on that fact for that year; and (3) the taxpayer wishes to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations. These requirements were satisfied in this case.

Conrad and his wife appealed to the Ninth Circuit, which affirmed, noting that the taxpayers had stipulated to the Panel's recommendation of the value of the collection for estate tax purposes, and that this valuation flowed through to them as the heirs of the estate. The court stated that the duty of consistency:

not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law. The law should not be such a idiot that it cannot prevent a taxpayer from changing the historical facts from year to year in order to escape a fair share of the burdens of maintaining our government.

The court also held that all three of the elements required by the duty of consistency existed in this case: (1) a representation or report by the taxpayer (the agreement to the decision of the Panel regarding the estate tax value of the artwork); (2) on which the Commissioner has relied (in this case, permitting the statute of limitations on any estate tax deficiency to run); and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner.

Carroll and his wife appealed to the Second Circuit, which also affirmed the Tax Court's holding. The court noted that the brothers may have obtained an unreasonably low valuation in the audit, but that to permit them to claim a higher income tax basis would encourage efforts by estates to secure unreasonably low valuations and discourage the IRS from seeking to obtain an

agreed, albeit low, value.

CODE §§1361-1367. S CORPORATIONS

IRS PROVIDES FIRST GUIDANCE ON S CORPORATION FAMILY SHAREHOLDER ELECTION

Notice 2005-91, 2005-51 I.R.B. 1164 (12/19/05). The IRS states that it will, in the future, provide guidance regarding the election under Section 1361(c)(1)(D), to treat members of a family as a single S corporation shareholder, for purposes of determining whether the corporation has more than 100 shareholders. The Notice establishes several important rules for making this election.

Required Notice of Election. A member of the family may make the election by notifying the corporation to which the election applies, identifying by name the member of the family making the election, the "common ancestor" of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective.

Identifying the Common Ancestor. For purposes of identifying the common ancestor (who does not have to be alive at the time the election is made) any spouse or former spouse of the common ancestor will be treated as being in the same generation as the common ancestor, and any spouse or former spouse of a lineal descendant of the common ancestor will be treated as being in the same generation as the lineal descendant to whom that spouse is or was married.

Decedent, Decedent's Estate and Decedent's Testamentary Trust All Treated the Same. The estate of a deceased family member is considered a member of the family during the period in which the estate, or a testamentary trust described in Section 1361(c)(2)(A)(iii), holds stock in the S corporation.

Members of the Family Includes Certain Trust Beneficiaries. For purposes of this election, the "members of the family" also include: (i) each potential current beneficiary of an ESBT who is a member of the family; (ii) the income beneficiary of a electing QSST, if that income beneficiary is a member of the family; (iii) each beneficiary of a trust who is a member of the family, if the trust was created primarily to exercise the voting power of stock transferred to it; (iv) the member of the family for whose benefit an IRA described in Section 1361(c)(2)(A)(vi) was created; (v) the deemed owner of a wholly-owned grantor trust; and (vi) the owner of a disregarded entity.

Overlapping Electing Families. Where an S corporation has two or more family shareholder elections in effect and the members of one electing family (the inclusive family) include all the members of another electing family (the subsumed family), then the members of the inclusive family will be counted as one shareholder as long as its election is in effect, and the members of the subsumed family will not be counted as a separate and additional shareholder.

When Election Is Effective. The election will be effective as of the

first day of the corporation's taxable year designated by the shareholder making the election. Any election will remain in effect until terminated as provided in regulations.

Correcting Prior Elections. Taxpayers who have already made their elections in a manner that does not conform with this notice must, for the election to be effective for taxable years beginning after December 31, 2004, provide the information described in this notice to the corporation (to the extent not already provided to the corporation).

Required Corporate Records. The corporation is required to keep records in accordance with Section 6001 and the regulations thereunder.

BUY-SELL AGREEMENT CREATES SECOND CLASS OF STOCK

PLR 200632004 (8/11/06). A bank holding company that had five wholly-owned subsidiaries sold shares of its stock to the directors of the subsidiaries, in compliance with Federal banking laws. The directors signed buy-sell agreements regarding their subsidiary shares. The buy-sell agreements provided that the directors could transfer their shares only to the holding company, and that the directors would have to sell their shares back to the holding company at a set purchase price, when their directorships terminated for any reason. The distribution and liquidation rights of the directors with respect to their shares were not otherwise affected by the agreement. The majority shareholder of the holding company died, and the decedent's estate and another major shareholder decided to sell the subsidiaries and liquidate the holding company. Upon the sale of the subsidiaries, the buy-sell agreements required the holding company to repurchase the shares of the directors for the set dollar amount. The holding company hired an accountant who specializes in S corporation banks to assist in the transfers, and the accountant questioned whether the buy-sell agreements might have caused the holding company to have a second class of stock.

The IRS stated that the buy-sell agreements did not create a second class of stock, despite their fixed purchase price for the shares in certain situations. The IRS discussed the application of the second-class-of-stock rules to shareholder agreements, noting in particular that such agreements restricting the transferability of stock are generally disregarded in determining whether a second class of stock is created, unless a principal purpose of the agreement is to circumvent the one-class-of-stock requirements, and unless the agreement establishes a purchase price that, when the agreement is entered into, differs significantly from the fair market value of the stock. Regs. Section 1.1361-1(1)(2)(iii)(A). The IRS also noted that bona fide buy-sell agreements to redeem or purchase stock at death, divorce, disability or termination of employment, are generally disregarded in determining whether a second class of stock has been created. Regs. Section 1.1361-1(1)(2)(iii)(B). The IRS considered the application of these rules to the facts of the ruling, and concluded that the holding company's S election

was not effective because the buy-sell agreement created a second class of stock. The IRS did not explain specifically why the agreement created a second class of stock, but the facts reveal only one problem with the agreements - that they used a fixed purchase price that does not appear to have reflected the fair market value of the stock on the date the agreement was entered into.

The IRS also stated, however, that the breach of the S election was inadvertent, and that Section 1362(f) provides that inadvertently ineffective S elections made before January 1, 2005 can be cured, where the taxpayer, within a reasonable period of time after discovering the circumstances that resulted in the ineffectiveness of the election, takes steps to correct the flaw, and agrees to make the adjustments required by the Treasury Secretary. The IRS required that the corporation, in this case, amend the agreements to provide for payment of the fair market value of the stock to the directors who are required to sell their shares, and that the holding company and its shareholders treat the holding company as an S corporation for all taxable years beginning with the first year to which it had intended the election apply.

INCOME TAX PROCEDURES

THREE-YEAR STATUTE OF LIMITATIONS APPLIES TO CHARITABLE REMAINDER TRUST CLAIM FOR REFUND OF ERRONEOUSLY-PAID TAXES

Wachovia Bank N.A. v. U.S., 455 F.3d 1261 (11th Cir. 7/13/06), rev'g, 2005 WL 1155078, 95 AFTR2d 20051939 (M.D. Fla. 2005). The trustee of the George C. Nunamann Trust, a charitable remainder trust, did not realize that the trust was not required to file a conventional income tax return, and for two years filed IRS Form 1041 and paid taxes. The trustee then filed a \$111,823 claim for refund of the erroneously-paid taxes. The claim was filed more than three years after, but less than six years after the return for the years in question.

The district court allowed the refund claim, noting that the three-year statute of limitations on claims for refund under Section 6511(a), did not apply to a charitable remainder trust. Rather, the court held, the general six-year statute of limitations on general claims against the government applied.²⁸ U.S.C. Section 2401. The court noted that Section 6511(a) applies to years "in respect of which tax the taxpayer is required to file a return " (emphasis supplied), and that a charitable remainder trust is not required to file a tax return or pay taxes.

The Court of Appeals for the Eleventh Circuit reversed. The court noted that Section 6401(c) states that an overpayment can exist where no liability exists, on the theory that "because anything is more than nothing, any payment is an overpayment when no payment was due." The court noted that Regs. Section 301.6511(a)-1 divides all taxes into those payable by stamp and those payable by return, and that it applies the three-year statute of limitations to the latter category. The quoted reference to "the taxpayer" in Section 6511(a), the

court agreed, refers to taxpayers in general, rather than to the individual taxpayer in a particular case. The court relied on *Little People's School Inc. v. U.S.*, 842 F.2d 570 (1st Cir. 1988), in which the three-year statute of limitations was applied to refund claims filed by a non-profit tax-exempt school that had mistakenly filed income and employment tax returns. The First Circuit there held that Section 7422(a), which makes the proper filing of an administrative refund claim a condition precedent to bringing a lawsuit for a refund, would be irrelevant were the taxpayer's reading of Section 6511.

LIFETIME CREATION OF SURVIVORSHIP RIGHTS DEPRIVES IRS OF TAX LIEN

U.S. v. Vittaly, 2006 WL 1883330, 98 AFTR2d 2006-5562 (N.D. Cal. 7/7/06) (slip opinion). Ada owned certain real property in Lafayette, California. The IRS assessed a \$243,964.69 income tax deficiency against Ada, after which she borrowed \$200,000 from a bank, mortgaging the real property to secure the loan. Ada defaulted on the loan, after which the bank's successor sought to foreclose on the property. Ada then deeded the property to herself and Alex Villasenor, the buyer, as joint tenants with a right of survivorship, in exchange for the buyer's payment of \$100,000, including satisfaction of the loan default. The IRS recorded a lien on the property before the bank had issued its a notice of default; the buyer was unaware of the Notice of Tax Lien at the time he acquired his interest in the property. Alex stated that he spent more than \$200,000 in property taxes, payments, mortgage payments and substantial repair work, and that he later agreed to buy the decedent's entire interest in the property for \$300,000 (\$100,000 in cash and an assumption of the \$200,000 debt). The property was then appraised for \$500,000. Ada died during litigation in which the IRS sought to reduce the tax lien to judgment and to foreclose upon it, and Alex demanded that Ada's personal representative convey the property to him, although by the deed, he automatically succeeded to its ownership.

The U.S. District Court for the Northern District of California held that the IRS could not enforce its lien against Ada's estate, because the estate had no interest in the property after Ada's death. The Federal tax lien attaches when the assessment is made, rather than when the lien is recorded and it attaches to all property and rights to property, whether real or personal, belonging to the taxpayer at the time of assessment. Section 6321; see also *Miller v. U.S.*, 763 F. Supp. 1534, 1539 n.8 (N.D. Cal. 1991); *TKB Int'l Inc. v. U.S.*, 995 F.2d 1460, 1463 (9th Cir. 1993). Ada held full legal and equitable title to the subject real property on the date of the assessment, but her death passed full title to Alex, as the surviving joint tenant, and Ada's estate had no remaining interest in the joint tenancy.

ESTATE'S REFUND OF INCOME TAXES ATTRIBUTABLE TO INCREASE IN VALUE OF ASSETS ON ESTATE TAX AUDIT BARRED BY STATUTE OF LIMITATIONS -- MITIGATION RULES DO NOT APPLY

Malm v. U.S., 420 F. Supp.2d 1040 (D.N.D. 11/30/05). Harry's estate

included a substantial block of the stock of Medtronic, Inc. The estate sold the stock while the value was still in dispute, and reported the gain based on a basis equal to the fair market value reported on the estate tax return. Ultimately, the courts upheld an estate tax deficiency based on a higher valuation, and the estate claimed a refund of the capital gains taxes.

The district court granted the government's motion to dismiss, rejecting the claim for refund as barred by the statute of limitations, because it was not filed within three years of the date of the return that contained the overpayment. Section 6511(a). The court refused to apply the mitigation provisions of §§13111314, which require that: (1) there be a "determination" of tax; (2) that is a specified circumstance of adjustment listed in Section 1312; and (3) the "party against whom the mitigation provisions are being invoked has maintained a position inconsistent with the challenged erroneous inclusion, exclusion, recognition or nonrecognition of income." The court held that an estate tax decision cannot be a "determination" under Section 1312, following the analysis of the Court of Claims and another district court, and rejecting that of the Fourth Circuit. See *Evans Trust v. U.S.*, 462 F.2d 521, 524 (Ct. Cl. 1972); *Provident Nat'l Bank v. U.S.*, 507 F. Supp. 1197, 1200 (E.D. Pa. 1981); and *Chertkof v. U.S.*, 676 F.2d 984, 989 (4th Cir. 1982). The court also held that the third requirement was not met, because mitigation requires that the error listed in Section 1312 be attributed to the transaction that created the basis valuation. *Koss v. U.S.*, 69 F.3d 705, 710 (3d Cir. 1995). Here, the sale of the Medtronic stock was not the transaction that determined the basis of this stock. The basis-determining transaction was the decedent's death, and the gain recognition event was the sale of the stock.

OTHER INCOME TAX ISSUES

FAVORABLE INCOME TAX TREATMENT DENIED PRIVATE ANNUITY SALE TO FOREIGN CORPORATION OWNED BY TRUST

Melnik v. Comr., T.C. Memo 2006-25 (2/15/06). In his divorce, Moshe had fought with his ex-wife over the value of his interest in his closely-held business. Their property settlement listed the value of his stock at \$1,970,000, but shortly after the divorce, Moshe was offered more than \$4 million for his stock (as part of the sale of the entire business.) Moshe sought to protect his assets from further claims by his ex-wife, by selling a portion of the stock to a foreign corporation owned by certain foreign trusts, in exchange for private annuities. An Israeli friend of the taxpayer and his brother established two foreign trusts, funding each with an initial contribution of \$10,000. One trust was established for the benefit of Moshe, his descendants and his friend. (The other was established for the benefit of Moshe's brother, who owned one-half of the stock of the business, his descendants and the friend.) Moshe and his brother were named trust protectors and given a limited testamentary power to appoint the trust fund to and among a broad class of beneficiaries, but excluding their own estates and the creditors of those estates. Each trust thereafter acquired an interest in a foreign

corporation that was formed the prior year, but that had no prior business activity. The corporation then bought the stock in exchange for a deferred private annuity. The stock purchase agreements were signed by Moshe and his brother and the director of the foreign corporation "to be effective as of" November 8, 1996, though on that date the corporation had not yet held its first shareholders' or directors' meeting nor appointed its director, and the corporation had no assets with which to pay for the stock. The corporation did not participate in any negotiations regarding the sale. Moshe used the corporation's assets to facilitate his own real estate investments at least twice. In one case, the corporation bought certain Texas investment property, and in another, it lent money to Moshe so that he could buy certain real estate. The loan bore adequate interest, but Moshe did not repay it when due.

The Tax Court (Judge Marvel) agreed with the IRS that the private annuity sales were sham transactions lacking economic substance. The Tax Court adopted the position of the Fourth Circuit, that the economic substance doctrine sustains a transaction as not being a sham, unless both (a) the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and (b) the transaction has no economic substance because no reasonable possibility of a profit exists. *Rice's Toyota World, Inc. v. Comr.*, 752 F.2d 89 (4th Cir. 1985), *aff'g in part, rev'g in part and rem'g* 81 T.C. 184 (1983). The court did not adopt the disjunctive analysis adopted by the Third Circuit, in which a transaction will be deemed a sham unless either a business purpose or a potential of profit are shown. *ACM Partnership v. Comr.*, 157 F.3d 231 (3d Cir. 1998). The court found that there was no legitimate business purpose, rejecting the arguments that the transaction was intended as retirement planning, and to protect the assets from the taxpayer's ex-wife. The Tax Court faulted the taxpayer because the records were inconsistent regarding the time line of the transaction, there was no evidence of negotiation on the part of the buyer, and the trustee and foreign corporation did not manage their investments as one would have expected in a typical annuity arrangement, taking great risks and, basically, functioning as the taxpayer's personal account.

Note. In what may have been dictum, because the transaction was not strictly a private annuity sale to a trust, the court also stated that a private annuity sale to a trust may not be respected by the court in cases not appealable to the Ninth Circuit.

IRS CAUTIONS AGAINST USE OF BOGUS TRUSTS TO AVOID TAXES

Rev. Rul. 2006-19, 2006-15 I.R.B. 749 (4/10/06). The IRS reviewed and cautioned against filing a Form 1041 and listing income in the amount stated on their W2, but claiming a deduction on the return for a "fiduciary fee" in the exact amount of that income, to produce a zero-tax return. The IRS explained that many other frivolous trust schemes involve the purported transfer of income and expenses to a trust, on the theory that the income and expenses then become that of the trust. Such schemes are ignored for federal tax purposes

because taxpayers cannot assign personal income to a trust in order to avoid tax, because such trusts are shams for federal tax purposes, and because the grantor trust rules tax the income to the individual grantor and not to the trust. See, e.g., *U.S. v. Krall*, 835 F.2d 711, 714 (8th Cir. 1987); *U.S. v. Buttorff*, 761 F.2d 1056, 106061 (5th Cir. 1985). Even if the taxpayer created a valid trust under state law, such a trust would be ignored for federal tax purposes because it is a sham, or under the grantor trust rules. See *Markosian v. Comr.*, 73 T.C. 1235 (1980) (sham transaction); and *Vnuk v. Comr.*, 621 F.2d 1318 (8th Cir. 1980); and Rev. Rul. 75-257, 1975-2 C.B. 251 (grantor trust status.) As no trust is deemed to exist for federal tax purposes, there is no fiduciary relationship upon which trustees' fees could be predicated and there is no ordinary and necessary business expense which could validly be claimed for such amounts. The IRS also stated that civil and criminal penalties, of various forms and amounts, would also be asserted.

OTHER IMPORTANT DEVELOPMENTS

IRREVOCABLE LIFE INSURANCE TRUST LACKS INSURABLE INTEREST

Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co., 2005 WL 405405 (E.D. Va. 2005), aff'd in part, vac'd in part, 440 F.3d 639 (4th Cir. 3/7/06). Harald Geisinger applied for a \$1 million life insurance policy from Transamerica, to be owned by and payable to Vera Chalwa, a good friend and business associate of Harald. Transamerica refused to issue the policy, because Vera lacked an insurable interest in Harald, under applicable state law (Maryland). Harald, apparently at the suggestion of the insurance agent, then submitted a new application naming the Harald Geisinger Special Trust as the owner and beneficiary of the policy. Harald and Vera were co-trustees of the trust, which held title to Harald's residence. The trust gave Harald the right to all of the trust income and to the use of the residence for the remainder of his life. At Harald's death, the trust assets were distributed to Vera. The trust did not expressly empower the trustee to buy or hold insurance policies on Harald's life. Harald made extensive omissions on his applications for the \$1 million life insurance policy and for an increase in the face amount to \$2.45 million. When asked about existing medical conditions and treatments, Harald forgot to mention that he had, within the past five years: (a) undergone brain surgery in Austria for the partial removal of a tumor; (b) suffered a series of neurological problems, for which he had be treated with several spinal taps; (c) developed motor dysfunction in his right hand, for which he had received radiation therapy; (d) undergone additional surgery in the U.S., including the insertion of a shunt in his head to drain excess fluid from his brain; and (e) been hospitalized repeatedly for alcohol abuse and related problems, including "episodes of unconsciousness" and "suspected psycho motor seizures." Harald died in 2001, and Vera, as the surviving trustee, sold the residence held by the trust and distributed to herself the trust assets remaining after payment of the mortgage. Vera also applied for the death benefits under the life insurance policy. Transamerica refused to pay, and instead rescinded the policy, refunding the premiums. Vera sued to obtain the

death benefits.

The U.S. District Court for the Eastern District of Virginia held for Transamerica, finding both that Harald had breached the contract by lying on the applications, and that the trust had no insurable interest in Harald's life. The court applied Maryland law, because the contract between the trust and Transamerica was completed when the policy was delivered to Vera in Maryland. The court first held that Transamerica did not have to pay the death benefits because, under Maryland law, a "material misrepresentation in the form of an incorrect statement in an application invalidates a policy issued on the basis of such application." The court rejected Vera's argument that Transamerica was barred from relying on these omissions because it had not questioned Harald about two rather obvious surgical scars that were noted in his physical. The court also stated that the trust lacked an insurable interest in Harald's life, and that this fact alone would have allowed Transamerica to avoid paying the death benefits. The court noted that Maryland law states that death benefits may be paid only to the insured, the insured's personal representative or "a person with an insurable interest" in the insured when the policy is issued. (Some states impose a constructive trust on the proceeds, in favor of the decedent's estate, rather than permitting the insurer to void the policy.) Maryland law also states that an insurable interest exists in one who is "related closely by blood or law" and that it includes "a substantial economic interest in the continuation of the life, health, bodily safety" of the insured. The law states that an insurable interest expressly does not include "an interest that arises only by, or would be enhanced in value by, the death, disablement or injury of the individual" The court noted that the trust "promised to gain more assets upon [Harald's] death ... than it would have in the event that [he] had lived" and that it "suffered no detriment, pecuniary or otherwise, upon the death of the decedent." Thus, it held, the trust lacked an insurable interest in Harald.

The Court of Appeals for the Fourth Circuit affirmed the district court holding regarding the misrepresentation, but vacated the portion of the district court order addressing the insurable interest issue. The court stated that the district court did not need to reach that issue, and should not unnecessarily address unique issues.

Note. The appellate decision in Chawla leaves unresolved issues faced by estate planners whenever they create an irrevocable trust that may hold life insurance policies.

Insurable Interest Generally. The Maryland statute is quite similar to the laws in other states. All 50 states (and the District of Columbia), either by statute or case law, require that one who buys an insurance policy on the life of an other must have an insurable interest in the insured's life. (Some states require that the beneficiary have an insurable interest; some require that both the owner and beneficiary have an insurable interest.)

A person usually has an insurable interest in the insured's life if that person can reasonably expect to receive a pecuniary benefit from the insured's continued longevity, or suffer a loss from the insured's death. Thus, a creditor of or surety for the insured would have an insurable interest. Similarly, close family members of the insured are deemed to have an insurable interest in the insured's life. The insurable interest requirement must be met when the policy is acquired from the insurer; the insured can buy a policy and then assign it to someone who does not have an insurable interest, as long as the insured is not just acting as the agent for the assignee when the insured buys the policy.

Scarcity of Law. Many practitioners had hoped that the Fourth Circuit would reverse the district court and hold that a trust had an insurable interest in the life of an insured if the then-current beneficiaries of the trust had insurable interests. Merely vacating of the district court holding regarding insurable interest is insignificant for estate planners. One arguing against the existence of an insurable interest in an ILIT could still cite the district court opinion in *Chawla*, because even if it was unnecessary, it still represented the views of the district court judge. The Fourth Circuit vacating of that part of the district court opinion expresses no view on the substantive law.

Most practitioners would agree that an insured should be able to create an ILIT with an insurable interest, because the insured consents to the acquisition of the policy (either explicitly or implicitly), and because the insured's family members are usually the current beneficiaries. There are, however, only a few state courts that seem to have adopted this view. See *Butterworth v. Mississippi Valley Trust Co.*, 362 Mo. 133,240 S.W. 2d 676 (1951); *Mickelberry's Food Products Co. v. Haeussermann*, 247 S.W. 2d 731 (Sup. Ct. Mo. 1952); and *In re LeBlanc*, 217 B.R. 365 (D. Mass. 1998). Both the district court in *Chawla* and a California court of appeals take the contrary view. See *Caso v. First Colony Life Ins. Co.*, 2003 WL 21019625 (Cal.App. 4 Dist., 2003).

Same Problem, Different Remedy. In some states and situations, a court will require that the proceeds of a policy held by a trust that lacks an insurable interest must still be paid to the named beneficiary, but held in constructive trust for the decedent's estate. These proceeds would, of course, be an asset of the decedent's estate, under Section 2042(1), because they would be receivable by the executor.

Income Taxation. In addition, proceeds paid with respect to a policy issued without an insurable interest do not qualify for exclusion from the beneficiary's gross income under Section 101(a), because they are really payments in the nature of insurance proceeds. *Atlantic Oil Co. v. Patterson*, 331 F.2d 516 (5th Cir. 1964). Thus, even if the insurer pays the proceeds, the IRS could argue against the existence of an insurable interest.

Planning for New ILITs. The best approach to avoid this problem with new ILITs is to create the trust and buy the insurance in a state that has enacted a statute giving a trust an insurable interest. See, e.g., Del. Code Ann. Tit. 18, Section 2704(c)(5); Va. Code Section 38.2-301(b)(5); 2006 South Dakota Laws Ch. 251 (SB 69); and Wash. Rev. Code Ann. Section 48.18.030(3)(c). See also Md. Ins. Code Section 12-201(b)(6), enacted by Maryland House Bill No. 271, Maryland 421st Session of the General Assembly (2006). The state whose law governs insurable interest issues is the state in which the policy is issued, which usually is determined by where the policy is delivered and where the first premium is paid. Thus, if the trust is created in one of these five states and the trustee in that state both receives the policy and pays the first premium, the state law should control. It is also very helpful if the policy states that this is the law that will be applied.

If this option is not practical, because the client does not want to create a trust or buy the policy in another state, the insured, rather than the ILIT, should be the first owner of the life insurance policy. The insured should buy the policy, and thereafter create the trust and assign the policy to the trustee. Obtaining the policy before the trust is even created will assure that the initial owner is the insured, who always has an insurable interest in his or her own life. It will also make it difficult for the insurer (or the IRS) to assert that the insured acted solely as the agent for the trustee in acquiring the policy. Generally, the insured can assign the policy to anyone he or she wishes, whether or not the assignee otherwise has an insurable interest. A court may, however, view a purchase of the policy and an immediate assignment to an ILIT as a purchase of the policy by the ILIT, acting through the insured, as an agent. If the ILIT does not exist when the insured buys the policy, it is very difficult to view the insured as its agent.

Obviously, this approach exposes the insured to estate taxation on the proceeds of the insurance payable to the trust, if the insured died within three years after the assignment. This is certainly a problem, but most insurance policies include (sometimes at a slight additional charge) a rider that doubles the payment if the insured dies within three years of the acquisition. This provides additional liquidity to pay the estate taxes on the insurance proceeds.

Also, the ILIT should include a contingent marital deduction provision, if the insured is married. Under such a clause, any proceeds that are included in the insured's gross estate are held in a format that qualifies for the estate tax marital deduction, deferring the taxes until the surviving spouse's death. Such a contingent marital clause could require that the includible proceeds be distributed outright to the spouse, or held in a power of appointment, estate, or QTIP marital trust (or a QDOT, if the spouse is not a U.S. citizen).

Existing ILITs. The problem with existing ILITs is far more serious, because the defect of the lack of an insurable interest does not disappear with age or length of time that the policy is held. Furthermore, the

policy against allowing a policy to be acquired by someone who lacks an insurable interest is so strong, that a court may decline to bar the insurer from raising this defense merely because it has accepted the premiums, or even expressly acknowledged the lack of an the insurable interest. Obviously, the law on such issues will vary from state-to-state. See Carter, "Estoppel of, or waiver by, issuer of life insurance policy to assert defense of lack of insurable interest," 86 ALR 4th 828.

There are very few things that can be done to cure the problems of an ILIT that lacks an insurable interest. The existing policy can be cancelled and a new policy obtained by the insured, and then assigned to the trust, if the insured remains in good health and the cost of a new policy is not unacceptable. The trust situs can be moved to a state with more favorable statutory rules, and the existing policy then exchanged for a new one issued under the more favorable state law. The exchange is likely to be tax-free under Section 1035.

A practitioner with a filing cabinet full of old ILITs in which the trustee had been the initial purchaser of the policies should also urge the state legislature to enact a clarifying amendment to the state insurable interest law. Such an amendment might declare that the existence of a trust's insurable interest is determined by whether the trust beneficiaries have an insurable interest. Such an amendment would not necessarily alter the existing statute, but merely interpret how it was intended to apply to trusts. Such legislation could arguably be retroactive in its effect.

TECHNICAL ADVICE MEMORANDUM STRIKES DOWN INSURANCE SUBTRUST IN DEFINED BENEFIT PLAN

A technical advice memorandum that has not yet been released arose out of an audit of a corporation's defined benefit pension plan. The corporation created the plan in 1972, and initially resolved to terminate the plan as of December 31, 1996. In the mid-1990s, the corporation's only stockholder was also the sole participant of the pension plan. The participant was about 51 years of age when the corporation created the plan; the plan set normal retirement age at 55 years of age. On the proposed plan termination date, the participant was 76 years of age. The plan provided that:

- the accrued benefit of a participant who remains active beyond the normal retirement age will be increased according to a formula provided in the plan document;

- any participant could elect to commence benefits at any time after attaining the normal retirement age, even if the participant were still employed with the corporation;

- a participant could elect to receive plan benefits by segregating the actuarial equivalent of the accrued benefit into a separate account within the plan trust;

- the plan trustees would invest the segregated funds and credit or charge those segregated funds with their investment gains or losses, rather than with a proportionate share of the total plan gains and losses;
- the trustees would distribute the assets in a participant's separate account to the participant or the participant's beneficiary at the participant's retirement or death;
- a participant's surviving spouse would be the beneficiary in the absence of a contrary specific written designation;
- the plan provided only one death benefit--the trustees would distribute the accrued benefits to a deceased participant's beneficiary, if the participant died before the commencement of benefits, subject to the minimum survivor annuity requirement of Section 401(a)(11).

The plan's sole participant, when he was 74 years of age, elected to have his accrued benefit segregated into a separate account. The sole participant's segregated account was then credited with all the money and assets then held within the plan. In 1995, the trustees made several amendments to the plan, including the following:

- the level of death benefits payable to plan participants prior to commencement of benefits was increased;
- a subtrust feature was added to the plan;
- the plan would buy insurance on the life of the sole participant, in a face amount of not more than 100 times the projected normal retirement benefit (expressed as a monthly benefit), or whatever amounts would satisfy the "66% / 33% rule based on the theoretical individual-level-premium reserve";
- all policies purchased on the life of the sole participant were non-transferable, other than to the participant himself;
- the benefit payable upon the participant's death before commencement of benefits would be equal to the sum of the qualified pre-retirement survivor annuity, the proceeds of insurance policies maintained on the life of the participant, and the actuarial equivalent of the accrued benefit. This figure would be reduced by the sum of the actuarial equivalent of the qualified pre-retirement survivor annuity and the cash value of the insurance policies;
- any policies of insurance on the life of the sole participant would be owned by certain Special Trustees in a subtrust of the regular plan trust;
- in the event of the sole participant's death, the Special Trustees would administer the life insurance proceeds in accordance with a specified irrevocable life insurance trust agreement;

- under other specified circumstances, the Special Trustees could sell the policies to the participant for their cash values or, if greater, their interpolated terminal reserves;

- the cash values of the policies on the life of the sole participant were not to be used to provide benefits to the sole participant during his lifetime;

- there could be no further amendments or modifications to the new life insurance provisions or to any other of the new provisions addressing the coverage on the sole participant's life;

- the trustees would neither distribute the policies on the sole participant's life to him as partial or full payment of the benefits to which the sole participant was entitled under the plan, nor convert the policies into annuities providing benefits to the sole participant.

Both before and after the 1995 amendments, the plan made only modest mention of the benefits of participants who already were receiving retirement benefits. The plan stated that those death benefits were the benefits incorporated into the particular benefit option selected by the participant, such as the survivor benefit under a joint and survivor annuity. The plan trustee bought a policy of insurance on the sole participant's life in September of 1995. The name of the policy's beneficiary was left blank. The sole participant then created the specified irrevocable life insurance trust for the benefit of his wife and descendants. The trust granted the wife a right to the greater of 5% of the insurance proceeds or \$5,000, plus any investment earnings on the insurance proceeds. The Special Trustees could, at their discretion, pay out more to the sole participant's wife, if they deemed higher amounts to be "appropriate." The trustees would distribute the trust funds at the death of the latter to die of the sole participant and his wife, to the sole participant's grandchildren and their issue.

The IRS National Office stated in technical advice that the subtrust caused the defined benefit pension plan to be disqualified, under the several different pension rules, and that the subtrust constituted a currently taxable distribution to the sole participant.

Exclusive Benefit Rule. The memorandum first explains that the subtrust arrangement did not disqualify the plan under the exclusive benefit rule of Section 401(a)(2). The IRS noted that the exclusive benefit rule does not limit the plan to providing only retirement benefits. A plan may provide death benefits, through insurance or otherwise, for example. Thus, the IRS stated:

although we find that the "subtrust" feature causes the Plan to violate various requirements of Code Section 401(a), the "exclusive benefit" requirement is not one of the violated requirements.

The IRS commented that the mere purchase of insurance on the participant's life might have been a disqualifying event because, when the life insurance was bought, the participant's benefit had already been segregated into a separate account. Under the terms of this particular plan, the segregation of the participant's benefits into a separate account was a "commencement" of his benefit, and the IRS stated that the plan's terms "addressed" death benefits "only in the context of participants who die prior to the commencement of their benefit." If the participant were not eligible for the insurance coverage under the terms of the plan, the insurance purchase might mean the "plan operated in violation of its terms," which would cause plan disqualification. The IRS did not expressly reach this conclusion, however, because it had not been asked to do so. Since this IRS comment was based on the terms of this particular plan, it does not appear to have further implications for subtrusts within plans that do not limit life insurance coverage to participants who have not commenced their benefits.

Joint and Survivor Annuity Requirement. The IRS next considered whether the subtrust arrangement violated the joint and survivor annuity requirement. The IRS noted that the terms of the irrevocable life insurance trust did not require the distribution of the death benefits to the participant's wife. The Special Trustees had discretion to limit distributions to the wife, even if she demanded full distribution of the trust assets. This, the IRS stated, should have required the wife to consent to the use of funds in the segregated account to purchase life insurance, because failure of the plan trustees to obtain such consent would violate the joint and survivor annuity requirements of Section 401(a)(11). The memorandum does not state that the trustees obtained such consent.

Nonassignment and Nonalienation. The third problem raised by the subtrust under the memorandum was the effect of the arrangement under the nonassignment and nonalienation requirement for qualified plan benefits. Section 401(a)(13) and Regs. Section 1.401(a)(13)(c) provide an exception for the assignment or alienation of plan benefits to the natural objects of the plan participant's bounty, such as the participant's spouse or heirs, however. The beneficiaries of the subtrust under discussion were the participant's spouse and heirs, so the IRS found that the subtrust arrangement did not violate the nonassignment and nonalienation requirements of Section 401(a)(13).

Discrimination in Favor of Highly Compensated Employee. The IRS stated that the subtrust caused the plan to discriminate in favor of a highly compensated employee. Section 401(a)(4) requires that a plan must not discriminate in favor of "highly compensated" employees. The terms of the subtrust in this memorandum forbade the use of the cash values of the policy to provide the participant with lifetime retirement benefits. The IRS noted that the subtrust feature applied only to this individual participant, who was a highly compensated employee under Section 414(q).

Insurance coverage if the death benefit is "incidental" to the main and

central purpose of the plan -- to provide the systematic payment of definitely determinable benefits to employees over a period of years after retirement (usually for the participant's life). Generally, life insurance coverage held by a qualified defined benefit or defined contribution plan is incidental if the death benefits are no more than one hundred times the anticipated normal retirement benefit under the plan. Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 68-453, 1968-2 C.B. 163. The application of this rule to different types of qualified plans involves several different tests. The IRS noted that the subtrust violated the incidental benefit rule, because the plan bars the use of the cash value of the policy during the participant's lifetime to provide retirement benefits. The IRS cited Rev. Rul. 56-656, 1956-2 C.B. 280, as stating that a provision or arrangement preventing the use of life insurance owned by a plan for lifetime benefits will cause a qualified plan to violate the incidental benefit rule.

Two Plans, One Qualified, One Not Qualified. The IRS concluded that the corporation's pension plan was not really one plan, but two plans, and that the subtrust was a separate non-qualified plan. The IRS noted that a plan is a "single plan" only if all of its assets are available to pay all of the benefits under the plan. More than one plan exists if part of the plan assets is not available to pay some of the benefits. Thus, the memorandum stated that the purchase of an insurance policy on the life of the sole participant, together with the plan provision that prevented the cash value of the policy from being used to provide lifetime benefits, caused the plan not to be a "single plan." The IRS concluded from this that the subtrust cannot be treated as part of the plan, but must be treated as a separate plan. The IRS also stated that treating the subtrust as a separate plan caused that separate plan not to be qualified, because the only benefit provided to the participant under the subtrust was life insurance protection; the subtrust did not provide any retirement benefits.

Taxable Distribution. Finally, the IRS stated that, because the subtrust was not itself a qualified plan, the use of funds from a separate account to buy life insurance constituted a taxable distribution to the participant under Section 402(a).

The Thousand-Pound Gorilla -- Estate Tax Treatment of the Subtrust. The subtrust arrangement is designed to create a life insurance policy purchased with funds that are deductible from the insured's gross income, and paying death benefits that are excludible from the participant's gross estate and that of his or her spouse. The IRS did not address estate tax questions in this technical advice memorandum, but a subtrust arrangement is successful only if it can be created within a qualified retirement plans while producing death benefits that are excludible from the insured's gross estate and that of the insured's surviving spouse. To obtain favorable estate tax exclusion, the insured must terminate all incidents of ownership over the policy held in the subtrust. Life insurance policies held as part of the general plan assets will usually be included in the insured's gross estate, if the insured holds

incidents of ownership as a plan trustee or has the power to alter or amend the plan trusts or the beneficial enjoyment of plan assets as the controlling shareholder of the sponsoring corporation.

The subtrust arrangement typically also involves an irrevocable designation of the beneficiary of the participant's retirement plan benefits, to remove this retained power to control the beneficial enjoyment. Merely designating an irrevocable beneficiary will not necessarily deprive the insured of all incidents of ownership, however, if the insured retains other powers to amend the plan and change the timing or incidence of beneficial enjoyment. Furthermore, even if the irrevocable beneficiary designation deprives the insured of all of the incidents of ownership over the plan, the proceeds will still be included in his or her gross estate if the insured dies within three years of the designation.

The availability of the cash value of the policy to provide retirement benefits to the insured participant could be an "incident of ownership" retained by the participant. Presumably to avoid that consequence, the plan discussed in the technical advice memorandum stated that the policy (despite being an asset of the participant's segregated account that was supposed to provide retirement benefits) "shall not under any circumstances" be distributed to the participant "in partial or full payment of his benefits under the plan," or used to purchase annuities to provide such benefits. The IRS stated that this violated the incidental benefit rule.

If the insured retires and buys the life insurance contract from the plan, the proceeds are, of course, included in his or her gross estate. The insured can then assign the policy, but if the insured dies within three years of the assignment, the proceeds will be included in his or her gross estate.

It is unclear whether the irrevocable designation of a beneficiary of a qualified plan life insurance is a current taxable gift. Regs. Section 25.2511-1(h)(8). The employer continues to make contributions to the pension plan on the insured participant's behalf, and it is uncertain whether those contributions are additional taxable gifts by the insured participant to the irrevocable beneficiary. The IRS could argue persuasively that these gifts exist in the same manner that an employee covered by group-term life is deemed to make a gift to the irrevocable assignee of his or her group insurance each time his or her employer pays group-term premiums on the employee's behalf. Rev. Rul. 76-490, 1976-2 C.B. 300. The best analysis is that a gift should be deemed to be made by the employee and that transfer would be a future interest gift that would not qualify for the annual gift tax exclusion, since the irrevocable beneficiary would have no immediate, unfettered and ascertainable right to use, possess or enjoy group insurance coverage held by the subtrust.

A participant who owns more than one half of the stock of a corporate plan sponsor will have a level of control over the corporation that could be viewed

as providing control over the plan and the plan trust, even if the participant is not a plan trustee. As the corporation's board of directors can be elected by the shareholder, and the board can change trustees at will (and even become the trustee), the incidents held by the trustee over the policy should be imputed to the insured stockholder.

Certainly, removing life insurance from a qualified plan (perhaps to invest plan assets more productively in terms of retirement income or to remove the policy from the insured's estate) requires great care. A plan trustee can allow a term insurance policy to lapse after an irrevocable trust or other third-party buys a new policy on the insured's life.

A plan trustee can sell a permanent life insurance contract (or a term contract on the life of an insured who is then an impaired risk), to an irrevocable trust that is a grantor trust deemed owned by the insured. The IRS has repeatedly stated in private rulings that such a sale does not constitute a transfer for value for income tax purposes.

Such a sale of a life insurance policy by a plan must also meet the prohibited transaction exceptions of §§4975(c)(1)(A) and 406(a)(1)(A). These exceptions require that, in exchange for the policy: (1) the retirement plan receives an amount equal to the policy's fair market value and has been placed in the same position it would have been in had it surrendered the contract and made the distribution owed to the plan participant, and (2) the contract would have been surrendered by the pension plan had the purchaser not bought it.

SELECTED ATTACHMENTS

Please note these are not the actual documents on which the IRS or court opined. They are an interpretation by the author of the rulings or cases cited, or of techniques that may address problems raised by these cases or rulings.

These forms have not been submitted to or approved by the IRS or any other agency or court, and they may contain provisions with which various IRS agents and attorneys may not agree.

Use your independent judgment -- neither the author nor tax management can take any responsibility for individual use of these sample documents.

REVOCABLE TRUST GRANTING SPOUSE A GENERAL POWER OF APPOINTMENT OVER ASSETS CONTRIBUTED BY GRANTOR, TO EXTENT NEEDED TO TAKE ADVANTAGE OF FIRST SPOUSE'S APPLICABLE EXCLUSION AMOUNT -- ASSUMES ALL STATE DEATH TAXES EITHER REPEALED OR INCORPORATE FULL FEDERAL APPLICABLE EXCLUSION AMOUNT -- SEE, E.G., PLR 200604028 (1/27/06)

Revocable Trust of *Grantor*1

I, *Grantor*, of [locality, state] (sometimes in the first person

singular, sometimes the "grantor," and sometimes the "trustee"), make this trust (defined below), which may be referred to as *TrustName*.

Article 1. My Family

I am married to *Spouse* (sometimes referred to as "my *husband/wife*") and I have [number of children] children, *Children*.

Article 2. Trustee Shall Hold Trust Funds

The trustee (defined below) shall hold certain property, which may be listed in Schedule A, to be administered according to the terms of the trust instrument. I and anyone else may transfer additional property (including life insurance proceeds, where appropriate), to any trustee (which the trustee may refuse to accept if acceptance is not in the best interests of the trust), at any time during my life or after my death, to be held and administered according to the terms of the trust instrument.

Article 3. Revoking the Trust

I may revoke or amend all or any part of the trust fund at any time, without the consent of anyone else, by delivering to the trustee a written instrument specifying the character and date of the intended amendment or revocation, or by specific reference to the trust in my last will. The duties, powers, or liabilities of the trustee (other than me) cannot, however, be changed without such trustee's prior written consent. The trustee shall transfer all of the trust funds to me or to my estate, if the trust is completely revoked. My right to revoke under this Article may be terminated, in whole or in part, upon the death of my *husband/wife* during my lifetime, to the extent so provided elsewhere in this instrument.

Article 4. Administering the Trust During My Life

A. Making Payments to Me. During my life, the trustee shall pay any taxes, commissions, or other expenses incurred with respect to the trust, and distribute to me all of the trust's net income at least annually, and so much of its principal and undistributed income (including all or none) as I may request from time to time, or as the trustee shall deem appropriate for my comfort and care. The trustee may also make gifts to my *husband/wife*

1. My Absolute Power to Withdraw Trust Funds. My power to withdraw principal and income from the trust is absolute, and exercisable as to all of the trust funds, by me alone and in all events.

2. Assuring Productivity of Trust Assets. I may direct the trustee not to retain any asset or assets that I shall deem not to be sufficiently productive.

B. My *Husband/Wife* May Appoint Trust Fund. At my *husband/wife*'s death, if I am still living, my *husband/wife* may appoint the "appointment share" of the trust fund (defined below), to or for the benefit of *his/her* estate, or to any other person, persons, entity, or entities, in such proportions, outright, in trust, or otherwise, as *he/she* may deem desirable, by specific reference to this article in my *husband/wife*'s last will. My right to revoke this trust shall terminate with respect to the appointment share, at my *husband/wife*'s death.

1. Calculating the Appointment Share. The "appointment share" of the trust fund shall be a fractional share of the trust fund.

a. The numerator of this fraction shall be equal to

i. the largest value of my *husband/wife*'s estate, that may or that can pass free of Federal estate tax by reason of the applicable exclusion amount allowable with respect to *his/her* estate. This value shall be determined taking into account my *husband/wife*'s adjusted taxable gifts, all other dispositions of property included in *his/her* gross estate for which no deduction is allowed in computing *his/her* Federal estate tax, and administration expenses and other charges to principal that are not claimed and allowed as Federal estate tax deductions. It shall also be calculated treating any items of income in respect of a decedent that would otherwise be included in my *husband/wife*'s gross estate for Federal estate tax purposes as assets unavailable to satisfy *his/her* applicable exclusion amount; less

ii. the value of my *husband/wife*'s taxable estate determined by excluding the amount of those assets subject to this power.

b. The denominator of this fraction shall be the value of the entire trust fund on the date of my death.

2. Exercisable Alone. My *husband/wife* may exercise this power of appointment alone and in all events.

3. Satisfaction of Appointment. The trustee shall select the assets to satisfy the appointment share of the trust fund, and shall value each asset on the date of my *husband/wife*'s death.

4. Unappointed Trust Fund. The trustee shall continue to hold any portion of the trust fund as to which my *husband/wife* does not validly exercise this power of appointment, under the article entitled "The Appointment Share Trust."

5. Intent. I intend that, if my *husband/wife* shall predecease me, the appointment share of this trust fund shall be included in my *husband/wife*'s gross estate for federal estate tax purposes, and that any portion of my trust

deemed transferred by me to my *husband/wife* for federal gift or estate tax purposes on account of this paragraph B, shall qualify for the federal gift or estate tax marital deduction. All provisions of this trust shall be construed consistent with these intents and no trustee shall exercise any power or discretion in a manner inconsistent with this intent.

Article 5. Disposing of the Residuary Trust Fund

At my death, the trustee shall divide and distribute the residuary trust fund (defined below), under this article.

A. If My *Husband/Wife* Survives Me. If my *husband/wife*, *Spouse*, survives me, the trustee shall divide the residuary trust fund into a descendants' nonmarital share, a spouse's nonmarital share, a GST exempt marital share, and a marital share (all defined below).

1. Descendants' Nonmarital Share. The descendants' nonmarital share shall be held under the article entitled "The Descendants' Trust."

2. Spouse's Nonmarital Share. The spouse's nonmarital share shall be held under the article entitled "The *Spouse* Nonmarital Trust."

3. GST Exempt Marital Share. The GST exempt marital share shall be held under the article entitled "The Reverse QTIP Marital Trust."

4. Marital Share. The marital share shall be distributed to my *husband/wife* outright and free of trust.

B. If My *Husband/Wife* Does Not Survive Me. If my *husband/wife* does not survive me, the trustee shall divide the residuary trust fund into a descendants' GST exempt share and a descendants' power of appointment share (both defined below).

1. Descendants' GST Exempt Share. The descendants' GST exempt share shall be held under the article entitled "The Descendants' Trust."

2. Descendants' Power of Appointment Share. The trustee shall distribute the descendants' power of appointment share to my descendants who survive me, per stirpes, except that the share for any child of mine shall be added to the trust fund for such child under the article entitled "Child's Power of Appointment Trust," for that child, and the share for any more remote descendant of mine who shall then not yet have reached the age of thirty-five (35) years, shall be held under the article entitled "Contingent Trust for Certain Beneficiaries."

C. Debts and Expenses of Administration. The trustee shall pay to the personal representative of my estate such amounts as the personal

representative of my estate shall certify as needed for the payment of my debts and expenses of estate administration.

Article 6. The Descendants' Trust

The descendants' trust shall be held under this article.

A. Distributing Trust Fund Before Descendants' Trust Termination Date. Until the descendants' trust termination date (defined below), the trustee shall distribute to or expend for the benefit of my then-living children and my then-living more remote descendants, as much of the net income and principal of the descendants' trust as the trustee may deem appropriate for any purpose, annually adding to principal any undistributed income. The trustee may distribute income and principal of the descendants' trust unequally and may make distributions to some beneficiaries and not to others. The trustee may distribute income and principal of the descendants' trust either outright or in further trust, and if distributed in further trust, may distribute them on such trust terms as the trustee may deem appropriate.

B. Distributing Trust Fund at Descendants' Trust Termination Date. Upon the descendants' trust termination date, the trustee shall distribute the remaining trust fund to my then-living descendants, per stirpes.

C. "Descendants' Trust Termination Date" Defined. The "descendants' trust termination date" shall be the date of the death of my last then-living child.

Article 7. The *Spouse* Nonmarital Trust

The *Spouse* nonmarital trust shall be held under this article.

A. DISTRIBUTING TRUST FUND DURING MY *HUSBAND/WIFE*'S LIFE.

1. Distributing Net Income. The trustee shall distribute the net income of the *Spouse* nonmarital trust quarterly or more frequently to my *husband/wife*, *Spouse*, during *his/her* life.

2. Distributing Principal. The trustee shall also distribute to my *husband/wife* as much of the principal of the *Spouse* nonmarital trust as is appropriate for any purpose.

B. DISTRIBUTING TRUST FUND AT MY *HUSBAND/WIFE*'S DEATH.

1. Distributing Income. At my *husband/wife*'s death, the trustee shall distribute to my *husband/wife*'s estate any undistributed income of the *Spouse* nonmarital trust.

2. Appointing Trust Principal. At my *husband/wife*'s death, the trustee

shall distribute the principal of the *Spouse* nonmarital trust, as my * husband/wife* may direct by specific reference to this special power of appointment in *his/her* will. My *husband/wife* may appoint the principal of the *Spouse* nonmarital trust, either outright or in further trust, only to or among any one (1) or more of my descendants.

3. Distributing Unappointed Assets. The trustee shall add the unappointed principal of the *Spouse* nonmarital trust to the trust held under the article entitled "The Descendants' Trust."

Article 8. The Reverse QTIP Marital Trust

The reverse QTIP marital trust shall be held under this article.

A. Distributing Trust Fund During My *Husband/Wife*'s Life. The trustee shall distribute the net income of the reverse QTIP marital trust quarterly or more frequently to my *husband/wife* during *his/her* life. The trustee shall also distribute to my *husband/wife* as much of the principal of the reverse QTIP marital trust as is appropriate for any purpose.

B. DISTRIBUTING TRUST FUND AT MY *HUSBAND/WIFE*'S DEATH.

1. Distributing Income. At my *husband/wife*'s death, the trustee shall distribute to my *husband/wife*'s estate any undistributed income of the reverse QTIP marital trust.

2. Appointing Trust Principal. At my *husband/wife*'s death, the trustee shall distribute the principal of the reverse QTIP marital trust, to the extent it is not used to pay transfer taxes (defined below) as provided below, as my * husband/wife* may direct by specific reference to this special power of appointment in *his/her* last will.

a. My *husband/wife* may appoint the reverse QTIP marital trust fund, either outright or in further trust on such trust terms as my *husband/wife* may deem appropriate, but only to or among any one (1) or more of my descendants.

b. My *husband/wife* may not appoint any portion of the reverse QTIP marital trust fund to my *husband/wife*, *his/her* creditors, *his/her* estate, or the creditors of *his/her* estate.

3. Distributing Unappointed Assets. The trustee shall add the unappointed principal of the reverse QTIP marital trust to the descendants' trust, to be held under the article entitled "The Descendants' Trust."

Article 9. The Appointment Share Trust

The appointment share trust shall be held under this article.

A. No Right to Revoke. Notwithstanding the provisions of the article entitled "Revoking the Trust," I shall have no right to alter, amend, revoke, or terminate the appointment share trust, except as may be otherwise expressly stated in this article.

B. Distributing Trust Fund During My Life. Until the date of my death, the trustee shall distribute to or expend for the benefit of my then-living children and my then-living more remote descendants, as much of the net income and principal of the appointment share trust as the trustee may deem appropriate for any purpose, annually adding to principal any undistributed income. The trustee may distribute income and principal of the appointment share trust unequally and may make distributions to some beneficiaries and not to others. The trustee may distribute income and principal of the appointment share trust either outright or in further trust on such terms as the trustee may deem appropriate.

1. My Right to Veto Distributions. The trustee shall notify me in writing of any proposed distribution of income or principal of the appointment share trust, and I may, within thirty (30) days of the date of such notice of proposed distribution, veto any such proposed distribution.

2. Income Taxes. I anticipate that the appointment share trust shall be a grantor trust deemed owned by me for Federal income tax purposes. The trustee shall not pay or reimburse me for the payment of any incremental income taxes imposed upon me with respect to income or gains received by the trust and not distributed to me.

C. DISTRIBUTING THE TRUST FUND AT MY DEATH.

1. My Testamentary Power of Appointment. At my death, the trustee shall distribute the principal and any undistributed income of the appointment share trust, as I may direct by specific reference to this special power of appointment in my will.

a. I may appoint the appointment share trust fund, either outright or in further trust, but only to or among any one (1) or more of my descendants.

b. I may not appoint any portion of the appointment share trust fund to myself, my creditors, my estate or the creditors of my estate.

2. Unappointed Trust Fund. At my death, the trustee shall add any unappointed portion of the appointment share trust fund to the descendants' trust, to be held under the article entitled "The Descendants' Trust."

Article 10. Child's Power of Appointment Trust

The child's power of appointment trust for each child of mine shall be held as a separate trust under this article.

A. Distributing Trust Fund During the Child's Life. The trustee shall distribute to or for the benefit of each child for whom a trust is created under this article, as much of the net income and principal as the child shall request at any time or as the trustee may consider appropriate for any purpose, annually adding to principal any undistributed income.

B. Distributing Trust Fund at the Child's Death. Upon the death of a child of mine who survives me, the trustee shall distribute the remaining principal and income of such child's trust under this article as that child may direct by specific reference to this power of appointment in that child's last will.

1. Appointing Everything but Limited Portion. Each such child may appoint the remaining principal and income of such child's trust under this article (other than the limited portion (defined below)) of such trust fund, either outright or in further trust, to or among any persons, including such child's estate.

2. Appointing Limited Portion. Each such child may appoint the limited portion of the principal and income of such child's trust under this article outright or in further trust, only to or among my then-living descendants, and such child may not appoint any of the limited portion to such child himself or herself, such child's creditors, such child's estate, or the creditors of such child's estate.

3. Distributing Unappointed Trust Fund. The trustee shall distribute any unappointed portion of the fund of a deceased child's trust under this article to such child's then-living descendants, per stirpes, or if there are no such descendants then living, to my then-living descendants, per stirpes, except that the fund that would thus be distributed to any then-living child of mine shall be added to such child's trust under this article.

4. "Limited Portion" Defined. The "limited portion" of the fund of a child's trust under this article is that portion which would pass to one or more persons assigned to the same or a higher generation as the deceased child for Federal generation-skipping transfer tax purposes, were such child to die without a valid will.

Article 11. Contingent Trust for Certain Beneficiaries

If a beneficiary (other than a child of mine) is entitled to receive any portion of any trust fund held under this instrument while the beneficiary is under the age of thirty-five (35) years, the trustee may retain such assets in a separate trust for that beneficiary.

A. Distributing Trust Fund Before the Contingent Trust Termination Date. Until the contingent trust termination date (defined below), the trustee shall distribute to or for the benefit of the beneficiary as much of the net

income and principal as the trustee may consider appropriate for the beneficiary's health, education, support, or maintenance, annually adding to principal any undistributed income.

B. Distributing Trust Fund at the Contingent Trust Termination Date. Upon the contingent trust termination date, the trustee shall distribute the remaining assets to the beneficiary if the beneficiary is then living or otherwise to the beneficiary's estate to be distributed as part of that estate.

C. "Contingent Trust Termination Date" Defined. The "contingent trust termination date" shall be the earlier of (1) the date on which the beneficiary dies or (2) the date on which the beneficiary reaches the age of thirty-five (35) years.

Article 12. Special Limits on Powers of Interested Trustee

The following limitations shall apply, notwithstanding other provisions of this instrument.

A. Limiting Actions by Interested Trustees. No interested trustee (defined below) may participate in the exercise of any discretion to distribute principal to him or herself, except as is appropriate for his or her health, education, support, and maintenance, or any of them. No interested trustee may participate in the exercise of any discretion to distribute or expend principal or income in a manner that would discharge that trustee's personal obligation to support the beneficiary.

B. Disinterested Trustees Exercising Certain Powers. A disinterested trustee (defined below) who is serving as a co-trustee with an interested trustee, may exercise those discretions granted under this instrument the exercise of which by an interested trustee are precluded.

1. If Multiple Trustees Include an Interested Trustee Who Cannot Act. The number of trustees who must consent to the exercise of a power granted under this instrument, as determined under the article entitled "The Trustees" shall be determined by treating the interested trustees who are not entitled, under this article, to participate in the exercise of the power or discretion, as if they were not then serving.

2. If All Trustees Are Precluded from Acting. If this article precludes every then-serving trustee from exercising a power otherwise granted to the trustee under this instrument, the then-serving trustee shall appoint a disinterested trustee who may exercise such power (or decline to exercise it) as if that disinterested trustee were the sole then-serving trustee.

Article 13. Paying Transfer Taxes

The trustee shall pay from the residuary trust fund all transfer taxes,

other than generation-skipping transfer taxes, payable by reason of my death on assets passing under this trust.

A. Apportioning Transfer Taxes. The trustee shall pay transfer taxes imposed on any trust assets includible in my gross estate for Federal estate tax purposes, from those assets, as provided by the laws of the state in which I reside at my death, except as expressly provided elsewhere in this instrument.

B. Apportioning Generation-Skipping Transfer Taxes. The trustee shall pay all generation-skipping transfer taxes imposed on transfers under this trust from those transfers.

C. Apportioning Transfer Taxes Away from Deductible Assets. Assets passing as the GST exempt marital share or as the marital share shall have the full benefit of the Federal estate tax marital deduction allowed with respect to any transfer taxes, and shall not bear any transfer taxes. Other assets passing to my *husband/wife* or to any charitable organization, whether under this trust or otherwise, shall have the full benefit of any available marital or charitable deduction for Federal and other transfer tax purposes, in determining the share of transfer taxes that should be borne by those assets.

Article 14. The Trustees

A. Naming the Trustee. I shall be the initial trustee of this trust.

B. Naming Successor Trustees. I name *FirstTrustee*, of [locality, state], to be the successor trustee, to serve if I am unable or unwilling to serve or to continue serving. I name *SecondTrustee*, of [locality, state] to be the successor trustee, to serve if both I and *FirstTrustee* are unable or unwilling to serve or to continue serving.

C. No Surety or Bond. No trustee named by me or by another trustee shall be required to provide surety or other security on a bond.

D. Naming Additional Trustees. I authorize the trustee to appoint any person as an additional trustee, to serve at the pleasure of the appointing trustee.

E. Delegating Powers and Authorities. The trustee may delegate to another trustee any power or authority granted by me to The trustee, to continue at the pleasure of the delegating trustee, unless otherwise agreed. Any person dealing in good faith with a trustee may rely upon that trustee's representation that a delegation has been made and remains in effect under this paragraph.

F. Trustee Resigning. Any trustee may resign by giving written notice specifying the effective date of the resignation to me, if I am then-serving as a trustee, or otherwise to the designated successor. If I am not alive or am

not then-serving as a trustee, and if no successor is designated, the resigning trustee shall give notice to each adult beneficiary to whom trust income then may be distributed.

G. Removing a Trustee. A trustee may be removed by the vote of two-thirds (2/3) of the then-living adult beneficiaries to whom trust income may then be distributed.

H. Filling Trustee Vacancies. A corporation no substantial portion of the stock of which is owned by beneficiaries of this trust, may be named as successor trustee to fill any vacancy, by majority vote of the adult beneficiaries to whom trust income then may be distributed.

I. No Liability for Acts or Omissions of Predecessors. No trustee shall be responsible for or need inquire into any acts or omissions of a prior trustee.

J. Compensating Trustees. In addition to reimbursement for expenses, each individual trustee is entitled to reasonable compensation for services. Each corporate trustee is entitled to compensation based on its written fee schedule in effect at the time its services are rendered or as otherwise agreed, and its compensation may vary from time to time based on that schedule.

K. Management Powers. I authorize the trustee to exercise all powers conferred by applicable state law and to do the following in a fiduciary capacity.

1. Prudent Investor Rule. The trustee may hold and retain as part of any trust fund any property transferred by me to the trustee, whether or not such investment would be appropriate for a prudent investor. The trustee may also hold and retain as part of any trust fund any property received from any source, and invest and reinvest the trust fund (or leave it temporarily uninvested) in any type of property and every kind of investment in the same manner as a prudent investor would invest his or her own assets.

2. Holding Assets for Use of Trust Beneficiaries. The trustee may buy and hold in trust, assets that will be used personally by one or more beneficiaries, even if those assets would not otherwise be acquired by a prudent investor investing his or her own assets.

3. Transferring Assets. The trustees may sell or exchange any real or personal property contained in any trust, for cash or credit, at public or private sale, and with such warranties or indemnifications as the trustee may deem advisable.

4. Borrowing Money. The trustee may borrow money (even from a trustee, a beneficiary, or any trust) for the benefit of any trust and secure these debts with assets of the trust.

5. Granting Security Interests. The trustee may grant security interests and execute all instruments creating such interests upon such terms as the trustee may deem advisable.

6. Compromising Claims. The trustee may compromise and adjust claims against or on behalf of any trust on such terms as the trustee may deem advisable.

7. Not Disclosing Nominees. The trustee may take title to any securities in the name of any custodian or nominee without disclosing this relationship.

8. Allocating Between Income and Principal. The trustee may determine whether receipts are income or principal and whether disbursements are to be charged against income or principal to the extent not clearly established by state law. A determination made by the trustee in good faith shall not require equitable adjustments.

9. Making Tax Elections. The trustee may make all tax elections and allocations the trustee may consider appropriate; however, this authority is exercisable only in a fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties. A tax election or allocation made by the trustee in good faith shall not require equitable adjustments.

10. Distributing to Custodians for Minors. The trustee shall distribute any of any trust fund to a beneficiary under the age of twenty-one (21) years by distribution to any appropriate person (who may be a trustee) chosen by the trustee as custodian under any appropriate Uniform Transfers (or Gifts) to Minors Act, to be held for the maximum period of time allowed by law. The trustee may also sell any asset that cannot be held under this custodianship and invest the sales proceeds in assets that can be so held.

11. Employing Advisors. The trustee may employ such lawyers, accountants, and other advisers as the trustee may deem useful and appropriate for the administration of any trust. The trustee may employ a professional investment adviser and delegate to this adviser any discretionary investment authorities to manage the investments of any trust, including any investment in mutual funds, investment trusts, or managed accounts, and may rely on the adviser's investment recommendations without liability to any beneficiary.

12. Buying and Holding Life Insurance. The trustee may buy and hold insurance policies on the life of any beneficiary or any person in whom a beneficiary has an insurable interest and may pay the premiums on such policies from income or principal, as the trustee may deem advisable.

13. Dividing and Distributing Assets. The trustee may divide and distribute the assets of any trust fund in kind, in money, or partly in each, without regard to the income tax basis of any asset and without the consent of any beneficiary. The decision of the trustee in dividing any portion of any

trust fund between or among two or more beneficiaries, if made in good faith, shall be binding on all persons.

Article 15. Trust Administration

A. Spendthrift Limits. No interest in a trust under this instrument shall be subject to the beneficiary's liabilities or creditor claims or to assignment or anticipation.

B. Protecting Trust Beneficiaries from Creditors. If the trustee shall determine that a beneficiary would not benefit as greatly from any outright distribution of trust income or principal because of the availability of the distribution to the beneficiary's creditors, the trustee shall instead expend those amounts for the benefit of the beneficiary. This direction is intended to enable the trustee to give the beneficiary the fullest possible benefit and enjoyment of all of the trust income and principal to which he or she is entitled.

C. Combining Multiple Trusts. The trustee may invest the assets of multiple trusts in a single fund if the interests of the trusts are accounted for separately.

D. Merging and Consolidating Trust Funds. The trustee may merge or consolidate any trust into any other trust that has the same trustee and substantially the same dispositive provisions.

E. Dividing Trust Funds. The trustee may divide any trust fund into multiple separate trusts.

F. Accountings. The trustee shall not be required to file annual accounts with any court or court official in any jurisdiction.

G. Changing Trust Situs. A disinterested trustee may change the situs of any trust, and to the extent necessary or appropriate, move the trust assets, to a state or country other than the one in which the trust is then administered if the disinterested trustee shall determine it to be in the best interests of the trust or the beneficiaries. The disinterested trustee may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances.

Article 16. Calculating Shares of the Residuary Trust Fund

A. My Purposes. I intend that:

1. Minimizing Federal Estate Taxes. The division of the residuary trust fund into a descendants' nonmarital share, a spouse's nonmarital share, a GST exempt marital share and a marital share, shall minimize the Federal estate taxes at my *husband/wife*'s death to the extent I can do so while deferring all Federal estate taxes until both my *husband/wife* and I have died.

2. Taking Advantage of My GST Exemption. The creation of a descendants' share, a spouse's nonmarital share, a GST exempt marital share, and, if my *husband/wife* does not survive me, the descendants' GST exempt share, shall take advantage of my available GST exemption (defined below).

3. Qualifying for Federal Estate Tax Marital Deduction. The GST exempt marital share and the marital share shall qualify for the Federal estate tax marital deduction and all provisions of this trust shall be construed accordingly. The trustee shall, in all matters involving the GST exempt marital share and the marital share, exercise no power in a manner that would infringe upon any legal requirement for the allowance of the Federal estate tax marital deduction.

B. Defining the "Descendants' Nonmarital Share." If my *husband/wife* survives me, the "descendants' nonmarital share" shall be a fractional share of the residuary trust fund.

1. Calculating the Numerator. The numerator of the fraction shall equal the smaller of:

a. one million dollars (\$1,000,000); and

b. the largest value of the residuary trust fund that can pass free of Federal estate tax by reason of the unified credit allowable with respect to my estate. This value shall be determined after being reduced by reason of my adjusted taxable gifts, all other dispositions of property included in my gross estate for which no deduction is allowed in computing my Federal estate tax, and administration expenses and other charges to principal that are not claimed and allowed as Federal estate tax deductions.

2. Calculating the Denominator. The denominator of the fraction shall equal the value of the residuary trust fund.

C. Defining the "Spouse's Nonmarital Share." If my *husband/wife* survives me, the "spouse's nonmarital share" shall be a fractional share of the residuary trust fund.

1. Calculating the Numerator. The numerator of the fraction shall be equal to the excess of:

a. the largest value of the residuary trust fund that can pass free of Federal estate tax by reason of the unified credit and the credit allowable with respect to my estate. This amount shall be determined after being reduced by reason of my adjusted taxable gifts, all other dispositions of property included in my gross estate for which no deduction is allowed in computing my Federal estate tax, and administration expenses and other charges to principal that are not claimed and allowed as Federal estate tax deductions; over

b. the numerator of the fraction that is used to determine the descendants' nonmarital share.

2. Calculating the Denominator. The denominator of the fraction shall equal the value of the residuary trust fund.

D. Defining the "GST Exempt Marital Share." If my *husband/wife* survives me, the "GST exempt marital share" shall be a fractional share of the residuary trust fund.

1. Calculating the Numerator. The numerator of the fraction shall be the amount of my available GST exemption (to the extent not allocated to the descendants' nonmarital share and any spouse's nonmarital share.)

2. Calculating the Denominator. The denominator of the fraction shall equal the value of the residuary trust fund.

E. Defining the "Marital Share." If my *husband/wife* survives me, the "marital share" shall be the remaining fractional share of the residuary trust fund after subtracting the descendants' nonmarital share, any spouse's nonmarital share, and the GST exempt marital share.

F. Defining the "Descendants' GST Exempt Share." If my *husband/wife* does not survive me, the "descendants' GST exempt share" shall be a fractional share of the residuary trust fund.

1. Calculating the Numerator. The numerator of the fraction shall be equal to the amount of my available GST exemption.

2. Calculating the Denominator. The denominator of the fraction shall equal the value of the residuary trust fund.

G. Defining the "Descendants' Power of Appointment Share." If my *husband/wife* does not survive me, the "descendants' power of appointment share" shall be the remaining fractional share of the residuary trust fund after subtracting the descendants' GST exempt share.

H. Calculating Shares Based on Certain Assumptions. The spouse's nonmarital share shall be computed as if no election is made to qualify any property passing as such share under the Federal estate tax marital deduction, and the maximum possible election is made to qualify all property passing as the GST exempt marital share and the marital share for the Federal estate tax marital deduction.

I. DETERMINING THE EFFECT OF DISCLAIMERS.

1. Disclaiming the GST Exempt Marital Share or Marital Share. The trustee

shall add to the spouse's nonmarital share any portion of the GST exempt marital share or the marital share as to which a qualified disclaimer by or for my *husband/wife* is made. Both the descendants' nonmarital share and the spouse's nonmarital share shall be calculated before any qualified disclaimer by or for my *husband/wife* of any of the GST exempt marital share or of the marital share.

2. Disclaiming Spouse's Nonmarital Share. Any portion of the spouse's nonmarital share as to which a qualified disclaimer by or for my *husband/wife* is made shall be added to the descendants' nonmarital share.

3. Apportioning Transfer Taxes to Disclaimed Funds. Transfer taxes imposed on assets as to which my *husband/wife* has made a qualified disclaimer shall be apportioned to those disclaimed funds.

J. ALLOCATING ASSETS BETWEEN OR AMONG SHARES.

1. Making Certain Allocations if My *Husband/Wife* Survives Me. If my *husband/wife* survives me:

a. The trustee shall allocate to the marital share and the GST exempt marital share only assets that can qualify for the Federal estate tax marital deduction.

b. The trustee shall not, to the extent possible, allocate to the marital share or the GST exempt marital share assets upon which a foreign death tax is payable.

c. The trustee shall allocate to the descendants' nonmarital share, the spouse's nonmarital share, the GST exempt marital share and, if my *husband/wife* does not survive me, the descendants' GST exempt share, solely of assets includable in my gross estate for Federal estate tax purposes.

2. Making Other Allocations. The trustee shall, in other respects, allocate assets as the trustee shall consider to be in the best interests of the beneficiaries, valuing each asset on the date or dates of allocation.

K. Allocating Income. The trustee shall allocate to each share a ratable portion of all of the income earned by my estate or the trust after my death, whether earned before or after the assets are in the possession of the trustee, and income earned on assets used to pay charges according to the same fractional shares.

L. My "Available GST Exemption" Defined. For the purposes of this article, my "available GST exemption" means an amount equal to (1) my GST exemption, determined for Federal tax purposes, minus (2) all allocations of my GST exemption made or deemed made to transfers other than those to transfers under this trust instrument.

Article 17. Administering the Reverse QTIP Marital Trust

A. Making Elections. The trustee may elect to qualify all or any portion of the reverse QTIP marital trust for the Federal estate tax marital deduction, and to treat me as the transferor of the reverse QTIP marital trust for Federal generation-skipping transfer tax purposes.

1. Making Partial Elections. If the trustee shall elect to qualify less than all of the reverse QTIP marital trust for the Federal estate tax marital deduction, the trustee shall divide the trust fund as to which such partial election was made into two (2) separate trusts and make all principal payments first from the trust fund that qualifies for the Federal estate tax marital deduction.

2. Allocating Assets Between or Among Shares. The trustee shall allocate assets between these shares as the trustee shall consider to be in the best interests of the beneficiaries, valuing each asset on the date of allocation.

B. Assuring Productivity of Assets. My *husband/wife* may direct the trustee to make any unproductive or underproductive assets of the reverse QTIP marital trust productive or to convert them to productive assets within a reasonable time.

C. Receiving and Administering Retirement Payments. If the reverse QTIP marital trust is entitled to receive distributions under any retirement plan or individual retirement arrangement, of which my *husband/wife* is the designated beneficiary for Federal income tax purposes, then the trustee shall do the following:

1. Distributing Greater of Income or Required Minimum Distribution. The trustee shall annually withdraw from such retirement plan trust fund or arrangement the greater of all of the income earned by my *husband/wife*'s share of such plan or arrangement, or the required minimum distribution with respect to my *husband/wife*, as determined for Federal income tax purposes.

2. Distributing Withdrawn Amounts. The trustee shall annually distribute to my *husband/wife* all amounts withdrawn from such plan or arrangement.

D. PAYING TRANSFER TAXES.

1. Paying Transfer Taxes Generally. The trustee shall, unless my *husband/wife* provides otherwise by specific reference to this paragraph in a valid will or other writing, pay or make arrangements for the payment of the incremental transfer taxes imposed on the reverse QTIP marital trust upon the death of my *husband/wife*, from the QTIP marital trust and not from the marital share.

2. Paying Transfer Taxes in Case of a Partial QTIP Election. If the

trustee shall elect to qualify only part of the reverse QTIP marital trust and shall create two trusts as required by this article, the transfer taxes imposed on both trusts at my *husband/wife*'s death shall be paid from the qualified trust fund to the extent possible.

Article 18. Definitions and Miscellaneous

A. Definitions. The following terms shall have the meaning set forth below for all purposes of this trust:

1. "Children" and "Descendants" Defined. "Children" and "descendants" include those now or hereafter born and, in addition to natural born, any child or descendant now or hereafter legally adopted.

2. "Disinterested Trustee" Defined. A "disinterested trustee" means a trustee who is not an interested trustee.

3. "Interested Trustee" Defined. An "interested trustee" means a trustee who is also (a) a beneficiary of the trust of which he or she is a trustee; (b) married to and living together with a beneficiary of the trust of which he or she is a trustee; (c) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (d) an employee of a beneficiary of the trust of which he or she is a trustee; (e) a corporation or any employee of a corporation in which the stock holdings of the trustee and the trust are significant from the viewpoint of voting control; or (f) a subordinate employee of a corporation in which the trustee is an executive.

4. "Personal Representative" Defined. A "personal representative" means the legal representative of a decedent's estate. The "personal representative" shall include any executor, ancillary executor, administrator, or ancillary administrator, whether local or foreign and whether of all or part of my estate, multiple personal representatives, and their successors.

5. "Residuary Trust Fund" Defined. The "residuary trust fund" means the real and personal property passing under this instrument, after paying any amounts certified by the personal representative of my estate as needed to settle my debts and expenses of estate administration.

6. "Transfer Taxes" Defined. "Transfer taxes" means all estate, inheritance, legacy, succession, and other transfer taxes, including any tax on excess retirement accumulations, imposed with respect to my death by any state, the United States, or by any foreign country. "Transfer taxes" also includes all taxes that are reimbursable under Section Section 2207 through 2207B of the Internal Revenue Code of 1986, as amended, which right of reimbursement I hereby waive. "Transfer taxes" also includes all interest and penalties on such taxes.

7. "Trustee" Defined. The "trustee" or "trustees" shall include each

trustee individually, multiple trustees, and their successors.

B. Absence of Trust Beneficiaries. If all of the beneficiaries of any trust under this instrument should die before the trust assets have vested in them, the trustee shall distribute all of the remaining assets of that trust as follows:

1. One-Half to My Heirs and Distributee. One half (1/2) (or all, if there are no persons to take under subparagraph B.2. of this article) to the heirs and distributees who would have inherited my personal estate, and in such shares as they would have inherited it, had I died unmarried and without a valid will, determined on the later of the date of my death or the date of the death of the last of the trust beneficiaries to die; and

2. One-Half to My *Husband/Wife*'s Distributees. One half (1/2) (or all, if there are no persons to take under subparagraph B.1. of this article) to the heirs and distributees who would have inherited my *husband/wife*'s personal estate, and in such shares as they would have inherited it, had he died unmarried and without a valid will, determined on the later of the date of my death or the date of the death of the last of the trust beneficiaries to die.

C. Applicable Law. This instrument shall be governed by and construed according to the laws of the *State*.

D. Number. Whenever the context requires, the singular includes the plural and the plural the singular.

E. Survivorship. No person shall be deemed to have survived me for purposes of this instrument, unless he or she is living on the date ninety (90) days after the date of my death.

F. Tax-Related Terms. All tax-related terms shall have the same meaning they have in the Internal Revenue Code of 1986, as amended.

[Signature, notary clauses and schedule of assets]

AGREEMENT WITH SCHOOL TO PREPAY EDUCATION FOR GRANDCHILD THROUGH GRADE TWELVE.
FOLLOWSPLR 200602002 (1/13/06)2

AGREEMENT

This agreement (the "Agreement") is entered into between *Full Name of Donor* ("*Shorthand for Donor*"), of [address], and *Full Name of School* ("*Shorthand for School*"), located at [address], on [date].

RECITALS:

A. *Shorthand for Donor* wishes to pay for the Tuition (defined below) for *Full Name of Grandchild*, *his/her* grandchild ("*Shorthand for Grandchild*"), who is currently a full-time student at *Shorthand for School*; and

B. *Shorthand for School* wishes to provide educational services to *Shorthand for Grandchild* for the next school year and all school years thereafter, if *Shorthand for Grandchild* becomes and remains a student in good standing at *Shorthand for School*; and

C. *Shorthand for School* is an educational organization described in Section 170(b)(1)(A)(ii) of the U.S. Internal Revenue Code; and

D. *Shorthand for School* wishes to accept prepayment for those services, in whole or in part;

NOW, THEREFORE, *Shorthand for Donor* and *Shorthand for School* agree as follows:

Section 1. Prepayment

Shorthand for Donor agrees to pay to *Shorthand for School* the sum of [amount], in good personal check, on the date of this contract. This amount represents the projected total annual tuition for *Shorthand for Grandchild* for each grade level through graduation (grade 12), based on the current tuition rates charged by *Shorthand for School*. This prepayment is nonrefundable, and once paid becomes the sole property of *Shorthand for School*. If *Shorthand for Grandchild* ceases to be a student at *Shorthand for School*, this prepayment shall be forfeited and shall remain the sole property of *Shorthand for School*.

Section 2. Educational Services

Shorthand for School agrees that it will apply these amounts to pay the Tuition for *Shorthand for Grandchild* while *Shorthand for Grandchild* is a student at *Shorthand for School*.

A. Tuition Increases. The parties both acknowledge that Tuition may increase in subsequent years and the balance due after the application of the prepayment for that year will be paid by *him/her*, or the parents of *Shorthand for Grandchild*, who will sign the consent and joinder attached hereto.

B. No Additional Rights or Benefits. The prepayment under this Agreement does not afford *Shorthand for Grandchild* any additional rights or privileges over any other student attending or applying for attendance at *Shorthand for School*, does not guarantee enrollment, and the *Shorthand for School*

expressly reserves all rights under its standard policies and procedures.

C. "Tuition" Defined. "Tuition," for purposes of this Agreement, has the same meaning as it has in Section 2503(c) of the Internal Revenue Code. It shall not include amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs.

Section 3. Overriding Purpose

Shorthand for Donor intends that these gifts qualify as a direct payment of educational expenses, under Section 2503(e) of the U.S. Internal Revenue Code. All provisions of this agreement shall be construed so as to effect this intent.

Section 4. Miscellaneous

4.1 Successors. This agreement inures to and binds the parties, their heirs and legal representatives.

4.2 Nonassignment. Neither party may assign or otherwise transfer or encumber any interest in this agreement.

4.3 Entire Agreement. This instrument constitutes the parties' entire agreement with respect to this transaction, and supersedes any prior oral or written understandings or agreements. The Agreement may be amended only in writing.

4.4 Choice of Law. This agreement shall be interpreted and construed under the law of [state].

4.5 Construction. No presumption shall apply because of the preparation of the Agreement by counsel for one party.

4.6 Tax-Related Terms. All tax-related terms shall have the same meaning that they have in the U.S. Internal Revenue Code.

4.7 Copies. Anyone may rely on a copy of this instrument certified by a notary public or similar official to be a true copy of the signed original as if that copy were the signed original.

[Signatures and notary clauses]

CONSENT AND JOINDER

Agreed and acknowledged by the following persons who are not themselves parties to the Agreement, but who are the parents of *Full Name of Grandchild*, and who themselves have read the Agreement and who agree that they shall be

bound by all of its provisions, including (but not limited to) the provisions requiring them to pay for the education of *Shorthand for Grandchild* in the situations described in the Agreement.

[Signatures and notary clauses]

FN1 KEY:

Grantor -- Full name of the grantor

TrustName -- What to call the trust in other documents

Spouse -- Full name of grantor's spouse

husband/wife -- The word "husband" or "wife," as the case may be

Children -- Full names of the grantor's children

he/she -- The word "he" or "she" (referring to the spouse)

his/her -- The word "his" or "her" (referring to the spouse)

him/her -- The word "him" or "her" (referring to the spouse)

FirstTrustee -- Name of the first alternate trustee

SecondTrustee -- Name of the second alternate trustee

FN2 KEY:

Full Name of Donor -- Full name of the donor

Shorthand for Donor -- A shorter way to refer to the donor in this instrument, such as "Donor," "Frank" or "the Party of the First Part."

Full Name of School -- Full legal name of the school to which payments are being made.

Shorthand of School -- A shorter way to refer to the school in this instrument, such as "Woodbury Forest Academy," "the School" or "the Party of the Second Party."

Full Name of Grandchild -- Full legal name of the individual grandchild for whom the donor is prepaying tuition.

his/her -- The word "his" or "her," referring to the donor

Shorthand for Grandchild -- A shorter way to refer to the grandchild in this instrument, such as "Frank," "Stinky" or "the Grandchild."

him/her -- The word "him" or "her," referring to the donor

32 TMEGTJ 3

END OF DOCUMENT