28th Annual Midwest/Midsouth Estate Planning Institute

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28th Annual
Midwest/Midsouth ESTATE PLANNING INSTITUTE

July 2001
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DEVELOPMENTS IN ESTATE PLANNING: 2000-2001

Legislative, Case Law and Regulatory Changes

Turney P. Berry
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SECTION A
2000 - 2001 NOTABLE DEVELOPMENTS OF INTEREST
TO ESTATE PLANNERS

A. INCOME TAX MATTERS

1. Taxable Income Upon Termination of Life Insurance Policies. In Stephen L. Atwood, et ux. v. Commissioner, T.C. Memo. 1999-61, the tax court held that the taxpayers received taxable income when insurance companies terminated life insurance policies where the taxpayers had borrowed amounts in excess of the premiums they had paid. The taxpayers had borrowed the maximum available against the policies and then had not paid the interest. The companies terminated the policies and sent the taxpayers Forms 1099.

2. Final Regulations on Estate Separate Share Rules. The purpose of the separate share rules is to produce fairness by limiting the application of sections 661 and 662 to distributions to beneficiaries so that no beneficiary pays income tax on more than the beneficiary's pro rata share of estate (or trust) income. The IRS statement of the General Separate Share rule is as follows:

The proposed regulations define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries (for example, rights to income or gains from specified items of property) are not affected by economic interests accruing to another beneficiary or class of beneficiaries. The proposed regulations conclude that there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has.

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Generally, the final regulations clarify the definition and narrow the application of the separate share rules that are in the proposed regulations. The final regulations generally define a separate share as a separate economic interest in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by economic interests accruing to another beneficiary or class of beneficiaries. The final regulations add "nor are affected by" to clarify the definition of a separate share. Under this revised definition, a separate share generally exists only if it includes both corpus and the income attributable thereto and is independent from any other share. Thus, income earned on assets in one share (first share) and appreciation and depreciation in the value of those assets have no effect on any other share. Similarly, the income and changes in value of any other share have no effect on the first share.

The separate share rules do not change the traditional understanding of payments of sums or specific property under section 663(a)(1):

The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.
On a related issue the explanation states:

Under these final regulations, any pecuniary formula bequest that is entitled to income and to share in appreciation or depreciation under the governing instrument or local law constitutes a separate share under the general definition. Further, under a special rule, a pecuniary formula bequest that is not entitled to income or to share in appreciation or depreciation is also a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments. This provision regarding three or fewer installments parallels the specific bequest requirements in section 663(a)(1).

One important area of clarification deals with the income tax consequences of a spouse's elective share. This issue attracted considerable discussion when the proposed regulations were issued. The IRS explanation states:

The proposed regulations provide that a surviving spouse's statutory elective share constitutes a separate share of an estate. As a result, the surviving spouse may be taxed on the estate's gross income only to the extent of the surviving spouse's share of that income under state law.

One commentator recommended that separate share treatment for a surviving spouse's elective share should be reconsidered. Elective shares should be a matter of further study because they are forced by state law, differ from state to state, and usually are part of an acrimonious conflict. Another commentator requested clarification of whether a surviving spouse's statutory elective share is included in the subchapter J estate. Further, this commentator recommended that an elective share that is not entitled to income or appreciation should be excluded from the subchapter J estate, but an elective share that is entitled to income and appreciation should be included in the subchapter J estate.

Conversely, other commentators agreed that separate share treatment should apply to a surviving spouse's statutory elective share regardless of whether the surviving spouse is entitled to income and shares in appreciation or depreciation. One commentator suggested that the separate share examples in the proposed regulations be revised to track more closely the Uniform Probate Code model because it will likely be adopted by most states.

These final regulations do not change the result of the proposed regulations. However, under these final regulations, a surviving spouse's elective share that under local law is entitled to income and to share in appreciation or depreciation constitutes a separate share under the general definition. Further, under a special rule in the final regulations, a surviving spouse's elective share that is not entitled to income or does not share in appreciation or depreciation is also a separate share.

The final regulations make some changes to the section 645 election:

The proposed regulations provide that a qualified revocable trust that elects under section 645 to be treated as part of the decedent's estate for income tax purposes constitutes a separate share. In response to comments, these final regulations include a reference that the electing revocable trust itself may have two or more separate shares. These final regulations further provide that qualified revocable trusts within the definition of section 645(b)(1) are subject to the separate share rules applicable to estates rather than trusts whether or not an election is made to be part of the estate.
The final regulations make several other points:

1. Separate shares come into existence "at the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate share exists."

2. In response to commentators' concerns about making adjustments after IRS audits the final regulations provide that a fiduciary must use a "reasonable and equitable method to determine the value of each separate share and the allocation of taxable income to each share. This approach gives the fiduciary flexibility, within limits, in applying the separate share rules. However, redeterminations in value of those separate shares must be taken into account."

3. When calculating distributable net income for a separate share income as determined under section 643(b) must be allocated to each share based on the instrument or applicable state law. With respect to IRD under section 691(a) the explanation states:

These final regulations clarify that such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether a share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount allocated to each share is based upon the relative value of each of those shares that could potentially be funded with such amounts.

The importance of this rule is that pecuniary bequests normally should state that they may not be funded with IRD.

4. No change is made to rules under Treas. Reg. S 1.663(c)-2 that an expense attributable solely to one separate share of a trust is not available as a deduction under another.

5. Interest owed on pecuniary bequests or delayed estate distributions is treated as a payment of interest by the estate and not a distribution for purposes of sections 661 and 662. Section 163(h) disallows a deduction for personal interest and Treasury regards that provision as determinative.

6. The effective date provisions have been modified from the proposed regulations:

These final regulations are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999-11 I.R.B. 41 (see section 601.601(d)(2)(ii)(b)). For trusts other than qualified revocable trusts, section 1.663(c)-2 is applicable for taxable years of such trusts beginning after December 28, 1999.
3. **Application of Section 1014.** Suppose Personal Representative values an asset on an estate tax return at 100, which value is accepted by the Internal Revenue Service. Beneficiary who inherits the asset sells it for 110. May beneficiary claim that 110 was the asset’s actual fair market value at date of death?

TAM 199933001 considers a similar situation: the beneficiaries inherited corporate stock which was redeemed by the company seven years after the decedent’s death. The IRS cited the following relevant authority:

Section 1.1014-3(a) of the Income Tax Regulations provides that the value of property as of the date of the decedent’s death as appraised for the purpose of the Federal estate tax shall be deemed to be its fair market value.

In Rev. Rul. 54-97, 1954-1 C.B. 113, the Service held that for the purpose of determining the basis under section 113(a)(5)(the predecessor of section 1014) of property transmitted at death (for determining gain or loss on the sale thereof or the deduction for depreciation), the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence.

There are two issues: first, does the duty of consistency estop the beneficiary, and, second, can the beneficiary rebut the presumption of estate tax correctness which clear and convincing evidence.

As to the first issue, in Shook v. U.S., 713 F.2d 662 (11th Cir.1983), the court held that Mrs. Shook was not estopped because, the IRS recited,

The court found nothing in the record to suggest that anyone other than the decedent’s executives and their attorney had or exercised any authority in handling the resolution of the estate’s tax liability. In addition, Mrs. Shook never had any contact with the IRS in connection with settling the decedent’s estate nor did the IRS rely on any representation made by her. Finally, the court found that the executor’s attorney’s discussion of the estate’s tax settlement with Mrs. Shook and the obtaining of an expression of her approval was a prudent measure based on the parties’ animosity and not a legal necessity. Thus, the court was unwilling to extend the estoppel doctrine to an estate beneficiary for “merely indicating approval of the executor’s handling over which they have total control and the beneficiary none.”

4. **Deductibility of Legal Fees.** In 1990, Red Stevens established a revocable trust. He died in 1991. The trust provided for certain payments to be made to his son by a prior marriage with the remaining assets passing into a marital trust with wife as trustee, son sued wife, as trustee, claiming lack of capacity and undue influence and seeking to void the trust. Trustee wife defended and won.

In Ruby Jean Stevens v. Commissioner, T.C. Memo. 1999-259, the issue was, are the legal fees deductible? The court held that the fees must be capitalized. The opinion states:

Section 212 authorizes a deduction for ordinary and necessary expenses paid or incurred for, inter alia, the management, conservation, or maintenance of property held for the production of income. To satisfy the requirements of section 212, the expenditure must be reasonable in amount and must bear a reasonable and proximate relationship to the management, conservation, or maintenance of

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The terms "management", "conservation", and "maintenance" have been construed to refer to the protection, safeguarding, or upkeep of physical assets and not to the taxpayer's retention of ownership of the property. See United States v. Gilmore, 372 U.S. 39, 44 (1963); Reed v. Commissioner, 55 T.C. 32, 42 (1970); Duntley v. Commissioner, T.C. Memo. 1987-579. Therefore, to be deductible under section 212, professional expenses must be directly connected or proximately related to the management, conservation, or maintenance of the property. See Bingham Trust v. Commissioner, supra at 375; Duntley v. Commissioner, supra.

Conversely, expenditures paid or incurred in defending or perfecting title to property, such as legal expenses in a suit to quiet title to real estate and expenses paid to protect one's right to property of a decedent as a beneficiary under a testamentary trust, constitute a part of the cost of property and are not deductible expenses. See Woodward v. Commissioner, 397 U.S. 572, 575 (1970); Boagni v. Commissioner, 59 T.C. 708, 711-712 (1973); sec. 1.212-1(k), Income Tax Regs.; see also sec. 1.263(a)-2(c), Income Tax Regs., which classifies "The cost of defending or perfecting title to property" as a capital expenditure.

Petitioner contends that the disallowed professional fees at issue in this case are deductible under section 212, because (1) defending against the lawsuit protected her taxable income stream, and (2) the fees were ordinary and necessary expenses incurred in that effort. Petitioner also contends that the disallowed professional fees qualify as ordinary and necessary litigation expenses incurred in connection with the performance of her duties of administration within the meaning of section 1.212-1(i), Income Tax Regs. Respondent contends that the disallowed professional fees represent capital expenditures within the meaning of section 263, because the fees were incurred to defend the validity of the Trust and its title to Trust property. We agree with respondent.

Whether professional fees incurred in connection with litigation are deductible expenses under section 212, or are capital expenditures under section 263, requires an examination of the origin of the claims giving rise to the professional fees. See United States v. Gilmore, supra at 49 ("the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal'"); Boagni v. Commissioner, supra at 712-713.

Petitioner cites Estate of Kincaid v. Commissioner, T.C. Memo. 1986-543, in support of her contention that, where the origin of the claim was the prevention of conduct which would be detrimental to her interest as income beneficiary, the litigation costs are deductible. Petitioner argues that, just like the taxpayer in Estate of Kincaid, she defended the lawsuit in her capacity as income beneficiary to prevent impairment of the production and collection of income from Trust assets. 
In the case before us, however, it is clear that the lawsuit had nothing to do with alleged abuses in the administration of the Trust. In fact, the lawsuit was a direct attack on the validity of the Trust. Garland's claims — undue influence, lack of capacity, conversion, fraud, etc. — were all alternate theories to invalidate the Trust and gain a larger share of his father's estate. Each claim for relief was based on allegations that Mr. Stevens was mentally incompetent and that petitioner caused, induced, deluded, misled, forced, and/or otherwise unduly influenced Mr. Stevens to execute the Trust. None of the claims included allegations of mismanagement or waste of Trust assets, or diversion of Trust income.

Garland's claims originated in his attempt, albeit unsuccessful, to invalidate the Trust and acquire an interest in the Trust assets. Unlike the Estate of Kincaid case, the professional fees were incurred by petitioner in a dispute over title to property between Garland and the Trust. Such expenses are nondeductible capital expenditures. See secs. 1.212-1(k) and 1.263(a)-2(c), Income Tax Regs.; see also Boagni v. Commissioner, 59 T.C. at 713; Arthur H. DuGrenier, Inc. v. Commissioner, 58 T.C. 931, 938 (1972); Seidler v. Commissioner, 18 T.C. 256 (1952); Duntley v. Commissioner, T.C. Memo. 1987-579.

Petitioner bases a second argument for deductibility of her professional fees on the fact that she incurred the expenses in her role as Successor Trustee. Petitioner argues that her fiduciary duty to defend the Trust renders the professional fees deductible as ordinary and necessary expenses of Trust administration, citing section 1.212-1(i), Income Tax Regs. There is no higher or more important duty than defending a trust against attack, petitioner contends, and thus her legal fees must be deductible. Respondent counters that, since the legal fees associated with petitioner's duties of administration originated in the defense of the Trust, the fees are capital expenditures under the origin-of-the-claim test.

5. General Partner Fees. It is often suggested that a general partner charge a fee for managing a family partnership. In Matthew W. Norwood, et ux. v. Commissioner, T.C. Memo. 2000-84 (2000), the court held that a general partner's interest automatically gave rise to self-employment income, regardless of the general partners’ activities.

6. Application of Section 121 to Trust. In PLR 200018021 the IRS determined that section 121 (allowing a $250,000 or $500,000 capital gain exclusion for the sale of a residence) does not apply to a residence held by a trust, because the taxpayer — the trust — is not using the residence as a residence. The exception is for a grantor trust (such as a revocable trust or, generally, a QPRT).

7. Court-Ordered Payments Deductible. In Sharon Purcell DiLeonardo v. Commissioner, T.C. Memo. 2000-120 (2000), the court held that the income beneficiary of a trust may deduct payments ordered after the taxpayer objected to a trustee's accounting. The objections were determined to be frivolous and the payments were essentially sanctions. The opinion states:

In general, if the origin and character of the claim arise out of a taxpayer's personality as a seeker after profit rather than satisfier of human needs, it does not matter that the taxpayer's expenditures are made because of the imposition of a sanction to compensate the victims of the taxpayer's improper actions. See, e.g., Ostrom v. Commissioner, 77 T.C. 608 (1981), in which the taxpayer was allowed
to deduct his payment of a jury award of damages imposed on account of the taxpayer's fraudulent misrepresentation on which the plaintiff had relied to his detriment. To the same effect are the cases described in Ostrom v. Commissioner, 77 T.C. at 611-613. In the instant case, the origin and character of the claim from which the liability arose are petitioner's personality as a seeker after profit. This is not affected by whether petitioner won or lost the underlying litigation or even by whether the California Court imposed the obligation on petitioner because that Court concluded that petitioner had acted in bad faith and out of vindictiveness.

8. **Section 67 - Application of 2% Floor for Miscellaneous Deductions.** The Court of Federal Claims has rejected the reasoning of the Sixth Circuit in O'Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993), in Mellon Bank, N.A., et al. v. United States, 47 Fed. Cl. 186 (2000). The issue was whether investment advisory fees were subject to the 2% floor of section 67(a) or were within the exception of section 67(e)(i).

Section 67, in relevant part, provides:

In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

I.R.C. section 67(e) applies subsection (a) to trusts as follows:

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that --

(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . .

The opinion states:

The Sixth Circuit's conclusion that different legal obligations apply depending upon whether or not assets are held in trust is correct. A trustee has a legal obligation to exercise proper skill and care with respect to the assets of the trust while an individual holding assets in a nontrust context ordinarily has no similar legal obligation. But the wording of the second prerequisite in I.R.C. section 67(e)(1) does not refer to legal obligations, trustee fees, or fiduciary responsibilities, but rather focuses on the particular costs incurred and whether those costs "would not have been incurred if the property were not held in such trust." The absence of a legal obligation in nontrust context arguably leaves open the possibility, for example, that in certain circumstances investment advisory fees MAY not have been incurred if the property were not held in trust, but it hardly supports the conclusion that in all situations investment advisory fees "WOULD not have been incurred if the property were not held in such trust" (emphasis added). The absence of a legal obligation to incur particular costs simply does not mean that an individual investor would not reasonably be expected to have incurred those costs.

As to plaintiff's proposed characterization of the investment advisory fees as trustee fees, assuming this characterization is appropriate, the fact that costs can be characterized as trustee fees in a trust context says nothing about whether those costs would not have been incurred in a nontrust context. When a trustee assumes responsibility over trust property, the trustee must perform a variety of tasks, some
of which are unique to a trust and some of which would have to be performed even if the property were not held in trust. Hence, characterizing the fees paid for the performance of these tasks as trustee fees and determining whether or not those fees would have been incurred in the absence of a trust are independent and not logically related inquiries. Whether costs for particular services can be characterized as trustee fees is not mentioned as a factor in I.R.C. section 67(e)(1) and is simply not relevant to the application of the statute's plain meaning.

The Court did not grant summary judgment to the government, stating:

Defendant's motion for summary judgment is deficient for a different reason. As described above, the dispositive issue before this court is whether the disputed costs involving investment advice and RKM&S services [an investment advisory firm] "would not have been incurred if the property were not held in such trust." To support its motion for summary judgment, defendant does not present any affidavits or point to any portions of the record that show that there is a lack of evidence to support a finding that the disputed costs "would not have been incurred if the property were not held in such trust." Instead, in its motion, defendant asks this court "to take judicial notice of facts manifested on the financial pages of any newspaper: individuals OFTEN pay investment-advisory fees for property not held in trust, and individuals also pay accounting and management fees for property not held in trust" (emphasis added). But with respect to the fees paid by the trustees to private investment advisors, assuming the court were to take such judicial notice, that notice itself would not be sufficient to support summary judgment. The term "often" is defined as follows: "on many occasions ... frequently." Webster's Third New Int'l Dictionary 1568 (1976). Hence, the fact that individuals "often" pay investment advisory fees for property not held in trust suggests that "on many occasions" they do not. In support of its motion, defendant offers no guidance as to why, on the particular facts of this case, the court should conclude that this case falls within the first group where investment advisory fees would have been incurred in the absence of a trust. With respect to the fees for accounting, tax preparation, and management services paid to RKM&S, defendant contends that the services RKM&S provides for individuals are "generally similar to the services it provides for trusts, except in format." But in their response to defendant's motion, plaintiffs present deposition testimony to support the conclusion that such services when provided for a trust are "more onerous" than those provided for individuals. If true, this indicates that at least some of the fees paid to RKM&S "would not have been incurred if the property were not held in such trust." Before the grant of summary judgment could be warranted, further amplification is needed as to the precise services provided by RKM&S and the extent to which each of these services is of a type which "would not have been incurred if the property were not held in such trust.

The result while less favorable to the taxpayer is sounder as a matter of policy.

9. **Proposed Regulations on Revocable Trusts as Part of Estate.** On December 18, 2000, the IRS published proposed regulations on electing to treat Qualified Revocable Trusts as part of an estate. REG - 106542-98. The regulations would become effective when final. Under section 645, if both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in section 645, the trust shall be treated and taxed for income tax purposes as part of the estate (and not as a separate trust) during the election period.
A Qualified Revocable Trust (QRT) is explained as follows:

A QRT is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under section 676 by reason of a power held by the decedent (determined without regard to section 672(e)). In accordance with the legislative history accompanying section 645, the proposed regulations provide that a trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party is not a QRT. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. at 711 (1997). In addition, a trust that was treated as owned by the decedent under section 676 by reason of a power held by the decedent that was exercisable by the decedent only with the approval or consent of another person is not a QRT. Further, a QRT must be a domestic trust under section 7701(a)(30)(E). A section 645 election for a QRT must result in a domestic estate under section 7701(a)(30)(D). A section 645 election may be made with respect to more than one QRT.

This definition is used in the carryover basis provisions of the 2001 Act.

Several areas dealt with are discussed as follows by the Supplementary Information:

1. Making the Election.

The section 645 election may be made whether or not a personal representative is appointed for the decedent's estate. Under the proposed regulations, if a personal representative is appointed for the decedent's estate, the personal representative and the trustee of the QRT make the section 645 election by attaching a statement to the Form 1041, "U.S. Income Tax Return for Estates and Trusts," filed for the first taxable year of the decedent's estate (related estate). If a personal representative is not appointed for the decedent's estate, the trustee makes a section 645 election for the QRT by attaching a statement to the Form 1041 filed for the first taxable year of the trust treating the trust as an estate.

Rev. Proc. 98-13 (1998-1 C.B. 370) sets forth procedures for making the section 645 election. These proposed regulations, when finalized, will replace Rev. Proc. 98-13. The proposed regulations, in some instances, contain different procedures than those provided in Rev. Proc. 98-13. Rev. Proc. 98-13, in most situations, requires a trust that will make a section 645 election to obtain a taxpayer identification number (TIN) and file a Form 1041 for the trust's short taxable year beginning with the decedent's death and ending December 31 of that year. In these situations, Rev. Proc. 98-13 provides that the section 645 election is made at the time the Form 1041 is filed for the trust. If a Form 1041 is not required to be filed for the trust, the election is considered made when the Form 1041 is filed for the estate. The proposed regulations, however, provide that if a section 645 election will be made for a trust, the trustee and the personal representative, if any, may choose not to obtain a TIN for the trust or file a Form 1041 for the trust's short taxable year. Under the proposed regulations, the section 645 election is considered made only upon the filing of a Form 1041, with the required election statement attached, for the first taxable year of the related estate, or, if there is no personal representative, the first taxable year of the trust filing as an estate.

2. Form 1041 Filing.

During the election period, the personal representative files one Form 1041 for the combined electing trust and related estate under the name and TIN of the related
estate. Thus, the electing trust must furnish payors of the trust with the TIN of the related estate. Except as required under the separate share rule of section 663(c), for purposes of filing the Form 1041 and computing the tax, the items of income, deduction, and credit of the electing trust and the related estate are combined. The proposed regulations do not provide rules for apportioning the tax liability of the combined estate and electing trust. The personal representative and trustee must allocate the tax burden of the combined electing trust and related estate to the trust and the estate in a manner that reasonably reflects the tax obligations of each. If the tax burdens are not reasonably allocated, gifts may be deemed to have been made.

If there is no personal representative, the trustee of the electing trust must file a Form 1041 treating the trust as an estate under section 645 during the election period. The trustee of the trust must obtain a TIN to be used by the trust during the election period to file as an estate and must furnish this TIN to payors of the trust.

3. Taxation of Estate and Trust.

Under the proposed regulations, the personal representative treats the electing trust as part of the related estate for all purposes of subtitle A of the Internal Revenue Code.

The electing trust and related estate are treated as separate shares under section 663(c) for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. The proposed regulations provide rules for adjusting the DNI of the separate shares with respect to distributions made from one share to another share of the combined electing trust and related estate to which sections 661 and 662 would apply had the distribution been made to a beneficiary other than another share. Under the proposed regulations, the share making the distribution reduces its DNI by the amount of the distribution deduction that it would have been entitled to under section 661 had the distribution been made to a beneficiary other than another share of the combined related estate and electing trust, and, solely for purposes of calculating its DNI, the share receiving the distribution increases its gross income by this amount.

If there is no personal representative, the trustee of the electing trust treats the trust as an estate for all purposes of subtitle A of the Internal Revenue Code. Thus, the trustee of the electing trust may adopt a taxable year other than a calendar year.

4. Termination of Election Period and Tax Treatment.

The proposed regulations provide that the election period begins on the date of the decedent's death and terminates on the day before the applicable date. If a Form 706 is not required to be filed for the decedent's estate, the applicable date is the day which is two years after the date of the decedent's death.

If a Form 706 is required to be filed, the applicable date is the day that is 6 months after the date of final determination of liability for estate tax. The proposed regulations provide that the final determination of liability for estate tax is the earliest day on which any of the following has occurred: (A) the issuance of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within six months after the issuance of the letter; (B) the final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is
instituted within six months of the disposition of the claim; (C) the execution of a settlement agreement that resolves the liability for estate tax; (D) the issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for estate tax unless a notice of appeal or petition for certiorari is filed within 90 days after the issuance of the decision, judgment, decree, or other order of a court; or (E) the expiration of the period of limitations for assessment of the estate tax provided in section 6501.

* * * * *

At the close of the last day of the election period, the combined related estate and electing trust, if there is a personal representative, or the electing trust, if there is no personal representative, is deemed to distribute all the assets and liabilities of the share (or shares) comprising the electing trust to a new trust in a distribution to which sections 661 and 662 apply. Thus, the combined related estate and electing trust, or the electing trust, as appropriate, is entitled to a distribution deduction to the extent permitted under section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust must include the deemed distribution in gross income to the extent required under section 662.

At the end of the election period, the new trust must obtain a new TIN. The related estate continues to report under the TIN assigned to the combined related estate and electing trust during the election period.

Following the termination of the election period, the taxable year of the new trust must be the calendar year. The related estate must continue to use the taxable year chosen by the combined related estate and electing trust during the election period.

B. CHARITABLE AND TAX-EXEMPT MATTERS - Sections 170, 642, 664, 501, 509, 2055, 2522, and 4940-4947

1. **Gain on Stock Taxable to Donor When Gift is Not Made Soon Enough.** The Tax Court opinion in *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999) has been upheld. This is an important case that must be considered when advising clients about funding charitable gifts including charitable remainder trusts. On July 18, 1988 American Health Companies, Inc. (“AHC”) entered into a merger agreement with CDI Holding, Inc. through its wholly owned subsidiary DC Acquisition Corp. The plan was for DC Acquisition to purchase the majority of the AHC stock through a tender offer and then have DC Acquisition merge into AHC leaving AHC as a wholly owned subsidiary of CDI. The tender offer, and merger, were conditioned on the acquisition by DC Acquisition of at least 85% of the outstanding shares of AHC by August 30, 1988, but that condition was waivable at the sole discretion of DC Acquisition, and was in fact extended to September 9, 1988. On September 12, 1988 DC Acquisition announced its acceptance of all tendered or guaranteed AHC shares and on October 14, 1988 the merger was effectuated.

Between August 9, 1988 and August 26, 1988 the Fergusons “transferred” AHC shares to certain charitable organizations. The date was a matter of dispute before the court. The Ninth Circuit affirmed the tax court factual findings that there was no completed delivery to the charities until September 9, 1988. The specific facts are worth quoting in detail:
The evidence shows that Brett Floyd was not acting on behalf of the Charities (as their agent, as the trustee of a voluntary trust created for their benefit, or in any other capacity) until the time that the Merrill Lynch clearance process had been completed, the AHC stock had been transferred on the books of Merrill Lynch from the Fergusons' account to the Charities' account, and the Fergusons had authorized the transfer, finally and effectively. Even if Brett Floyd had ceased to be acting under the control of the Fergusons at any time, not until Merrill Lynch's legal department had completed its two-week clearance process, would he even have been capable of acting at the Charities' behest with respect to any disposition of the AHC stock, which still remained in the Fergusons' personal accounts. Moreover, in the memorandum disposition cited by the Fergusons as support for their contentions, the Tax Court there held that, under Montana law, a voluntary trust would not be formed without some sign, some overt act, which demonstrated that, after receiving stock on behalf of a named beneficiary, the recipient bank had accepted its position as trustee for the benefit of the named beneficiaries. See Richardson v. Commissioner, T.C.M. (P-H) P 84,595 (T.C. Nov. 9, 1984). In that case, the contribution thus was not completed for tax purposes until the recipient bank had tendered the received shares on behalf of the named beneficiaries. See id. Likewise, in the present case, although controlled as to the formation of a voluntary trust by Idaho law (which does not address this issue), logic and common sense dictate that the Fergusons' gift could not be completed until Merrill Lynch, through its legal department and Brett Floyd, finally had decided that it was willing to transfer the shares according to the Fergusons' wishes and to tender the shares on behalf of the Charities.

Furthermore, contrary to the Fergusons' assertion, Brett Floyd's testimony as to the existence of the original letters of execution and as to the intended purpose of those letters, if they indeed existed, was not uncontroverted. The total absence of any trace of the original letters and the "substantial documentary evidence" that the Tax Court relied upon in its decision, easily could have supported a finding that Brett Floyd was not a credible supporting witness. This documentary evidence included: (1) the donation-in-kind records completed and dated "9-9-88" by Brett Floyd himself; (2) the donation-in-kind receipts submitted and dated September 9, 1988, by the Church; (3) the sole existence of "final versions" (as opposed to "new copies") of the signed letters of authorization; and (4) the disclosure documents dated September 9, 1988, submitted to the Securities and Exchange Commission and completed by Billy G. DuPree, Jr., AHC's very own vice president of legal affairs and secretary. Thus, the evidence in the record clearly supports the Tax Court's implicit finding that there were no original letters of authorization that were intended to be anything other than rough drafts, mere working copies, which in fact were thrown away once they had been replaced by final versions.

Therefore, in the absence of Brett Floyd's role as anything other than an agent of the Fergusons or Merrill Lynch, there could have been no contribution until the delivery of the AHC stock to the Charities' account had been completed. And in the absence of any earlier letters of authorization that were intended to be final and effective, there was no completed delivery to the Charities, no transfer that was legally binding and irrevocable, until the date that the Fergusons' letters of authorization were finally and effectively executed -- September 9, 1988.

The next issue before the court was whether a contribution on September 9, 1988 was too late to avoid the assignment of income doctrine. The tax court had found that by August 31, 1988 over 50% of the AHC stock had been
tendered and, thus, that it was "quite unlikely" that any of the relevant parties would back out of the tender offer for the merger or that the requisite number of shares could not be tendered by the close of the tender offer window. In particular, the court stated:

Third, the Fergusons and at least one commentator, see Note, Taxpayers Liable for Gain in Stock Donated to Charity During a Tender Offer: Ferguson v. Commissioner, 51 Tax Law. 441 (1998), contend that the Tax Court's analysis of the likelihood that as of August 31, 1988, the merger would proceed, was fundamentally flawed because it failed to take into account the bilateral nature of a merger. More specifically, they claim that as of August 31, 1988, even though more than 50% of the AHC shareholders had expressed their tacit approval of the pending merger by tendering their shares, there was still a significant possibility that DC Acquisition's own shareholders might not approve of the merger -- a threat until 90% ownership had been obtained by DC Acquisition, thereby eliminating the need for any formal shareholder vote. However, further analysis shows that it is the Fergusons' and the one commentator's analyses that are fundamentally flawed. Both make it sound as if there was much uncertainty as to how the many shareholders of DC Acquisition would vote. Both seem to have completely forgotten that DC Acquisition's sole shareholder was CDI, and that CDI's board of directors (along with DC Acquisition's single director -- another corporate insider) therefore effectively could approve the merger without turning to any outside shareholders. And for the reasons discussed above, it was most unlikely as of August 31, 1988, that CDI's board of directors was not fully committed to approving the merger once the tender offer had been completed. Thus, the Tax Court's analysis was sound.

On a final note, the Fergusons raise two policy considerations, but these considerations do not support their contentions. First, the Fergusons rightly point out that there is a distinction between tax evasion (i.e., choosing an impermissible path) and tax avoidance (i.e., choosing the least costly permissible path) and that so long as they are acting in accordance with the existing tax laws, the motives for their actions should not dictate the consequences of their actions. However, simply because the Fergusons have the right to choose the least costly path (from a tax perspective) upon which to walk, they do not have the right to be free from taxation if they decide to walk the line between what is and what is not permissible, and happen to stray across it, as they have here. Second, the Fergusons note that the logic of the Tax Court's decision implies that their AHC stock already might have ripened by some date even earlier than August 31, 1988. In essence, they note that there is no clear line demarcating the first date upon which a taxpayer's appreciated stock has ripened into a fixed right to receive cash pursuant to a pending merger. However, from the perspective of taxpayers, walking the line between tax evasion and tax avoidance seems to be a patently dangerous business. Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor. See, e.g., Gain on Tendered Stock Taxable Despite Charitable Donation, 26 Tax'n for Law. 114 (1997). Therefore, we will not go out of our way to make this dangerous business any easier for taxpayers who knowingly assume its risks. Moreover, from the perspective of judging such cases, there is no special reason that we should curtail the application of this doctrine simply because it requires "engaging in an exercise in line drawing, a
difficult task which nevertheless is part of the daily grist of judicial life. " Badger Pipe Line Co. v. Commissioner, 74 T.C.M. (CCH) P 856 (T.C. Oct. 8, 1997) (Tannenwald, J.) (discussing generally the determination of the character of a transferred interest).

[Emphasis added.]

2. **Generosity In Allowing Reformation for Scrivener’s Error.** PLR 199923013 allowed the proposed reformation of a charitable remainder unitrust where the drafting attorney provided a sworn affidavit that various disqualifying provisions were the result of drafting errors. The drafting errors were substantial: among other things, the trust gave the grantor a power of acquisition described in section 675(4)(C), allowed the trustee to pay death taxes from the trust assets, and allowed the trustee to terminate the trust if after the death of both of the grantors was not economically feasible to continue the trust's existence.

3. **Insurance Policy in Charitable Remainder Trust.** PLR 199915045 approved the transfer of a life insurance policy to a charitable remainder unitrust. A husband would create the trust for the benefit of his stepdaughter, purchase an insurance policy on his wife’s life, and transfer the policy to the trust. The trust would be a net income with makeup unitrust described in section 664(d)(3).

The first issue for the Service was whether the trust would be a grantor trust because of the trustee’s powers to pay premiums on the life of the wife of the grantor under section 677(a)(3). A trust that is a grantor trust may not be a charitable remainder trust. Section 677(a)(3) provides that a grantor is treated as the owner of any portion of the trust whose income, without the approval or consent of any adverse party, is, or in the discretion of the grantor, a non-adverse party, or both, may be, applied to the payment of premiums on insurance policies on the life of the grantor and the grantor’s spouse, except with respect to policies irrevocably payable for a purpose specified in section 170(c). The trust provided that the insurance proceeds would be allocated to trust principal and not income. Thus, because the trust was a net income unitrust, the Service concluded that the insurance proceeds would never be payable to a non-charitable beneficiary and thus that the insurance policies would be irrevocably payable for a charitable purpose.

The ruling also concluded that the husband would be entitled to an income tax charitable contribution deduction for the present fair market value of the remainder interest in the insurance policy, and for a similar gift tax charitable deduction, and that the trust would not be included in the grantor’s estate. Neither the grantor nor the grantor’s spouse was trustee of the trust.

4. **Specificity of Charitable Beneficiaries.** At issue in Estate of Kenneth E. Starkey v. United States, 83 AFTR2d ¶ 99-843 (U.S. S.D. IN 1999) was whether the following disposition of residue created a charitable trust:

   All of the rest, residue and remainder of my property, I give and bequeath to Norma Jeanne Starkey, Cynthia Starkey Robinson, Christopher Kenneth Starkey, Theresa Carole Starkey, and Carrie Jeanne Starkey, whom I nominate and appoint as Trustees, to be held by said Trustees, in trust for the uses and purposes herein set forth.
Half of the income from the trust is to go to Lawndale Community Church in Chicago, Illinois provided that Wayne Gordon is still the pastor of it at the time of my death and that church will receive this until the time that he is no longer pastor. The Trustees are to manage the property of the Trust for the benefit of this beneficiary, missionaries preaching the Gospel of Christ, and Milligan College.

Subject to the provisions . . . relative to the termination of this trust and the provisions for distribution, the Trustees may distribute to a beneficiary or apply for such beneficiary's sole benefit, so much of the net income and corpus of the trust at any time and from time to time as the Trustees deem advisable. Any income which is not distributed may be accumulated as income or added to the trust.

The court held that it did not. The Will had been drafted by the decedent’s son who was not an estate planning attorney. After death, the estate filed for section 501(c)(3) status for the trust and the application was rejected by the IRS. The estate attempted to “reform” the trust in Indiana Probate Court, which was affirmed by the Indiana Court of Appeals in an unpublished decision. The United States was not a party to the action. The court declined to give effect to the reformation because, the court determined, that the court did not receive “the type of full and fair presentation of the issues that is the hallmark of adversarial proceedings.”

The court also determined that the post mortem reformation would not relate back to the date of death citing the case of Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir.), Cert. Denied, 393 U.S. 953 (1968) in which the 7th Circuit stated that “not even judicial reformation can operate to change the federal tax consequences of a completed transaction.”

The Seventh Circuit reversed, 223 F.3rd 694 (2000). The court held that the Indiana court’s construction was reasonable. The opinion states:

To qualify for the charitable deduction, the charitable bequest must be ascertainable at the time of the transfer. Estate of Marine v. Commissioner of Internal Revenue, 990 F.2d 136, 138 (4th Cir.1993) (“Ascertainability at the date of death of the amount going to charity is the test.”). If a will provides a trustee with discretion to distribute trust assets to charities and to individuals for their personal use, the amount bequeathed to the charities might not be ascertainable at the time of the transfer. See Merchants Nat. Bank of Boston v. Commissioner of Internal Revenue, 320 U.S. 256, 257-58, 263, 64 S.Ct. 108, 88 L.Ed. 35 (1943); see also Estate of Marine, 990 F.2d at 138-39. Such a trust, where the assets are "split" between charitable and noncharitable beneficiaries, is known as a "split-interest" trust. See 26 U.S.C. § 2055(e)(2). With such a trust, the estate can only take a charitable deduction if the charitable interest of the trust is presently ascertainable. See id. at §§ 2055(e)(2)(A) & (B), 2055(e)(3); see also Treas. Reg. § 20.2055-2(a) (“If a trust is created or property is transferred for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest.”).

The will's codicil clearly states that Mr. Starkey intended to set up a charitable trust, and the IRS acknowledges that this was indeed his intent. Its dispute with the Estate is over the type of charitable trust he intended to create and, more specifically, whom he intended to benefit. The IRS acknowledges that if Mr.
Starkey intended the "missionaries" phrase to create two beneficiaries (Lawndale Community Church and Milligan College, both of which are qualified charities), then the value of the charitable interest would be ascertainable and hence deductible. In that case, the trust would not be a split-interest trust because both the trust beneficiaries would be qualified charities and the trust assets could only be used for their benefit. As a result, the charitable portion of the trust would be ascertainable (it would be the entire value of the trust). If, however, Mr. Starkey intended to benefit a group of missionaries in addition to the church and the college, the IRS argues that then Mr. Starkey will have created a split-interest trust with both charitable and noncharitable beneficiaries. In that case the trust assets would not have been specifically divided among the charitable and noncharitable beneficiaries. Because the charitable portion of the trust would thus not be ascertainable, the Estate would not qualify for a charitable deduction. See Treas. Reg. § 20.2055-2(a). We agree with the IRS that this is the "ultimate issue" and thus must now determine whom Mr. Starkey intended to assist financially in preaching the Gospel of Christ, and if the will sufficiently expresses his intent.

Both parties agree that Indiana law governs our analysis of Mr. Starkey's will. Estate of Bowgren v. Commissioner of Internal Revenue, 105 F.3d 1156, 1161 (7th Cir.1997). In Indiana, the primary goal in interpreting a will is to determine and give effect to the testator's intent as expressed in the will, and determining this intent is a question of law. Gladden v. Jolly, 655 N.E.2d 590, 592 (Ind.Ct.App.1995); Hershberger v. Luzader, 654 N.E.2d 841, 842 (Ind.Ct.App.1995). The Estate notes that the probate court determined that Mr. Starkey intended the charitable trust to have only two beneficiaries, and it argues that the district court should have adopted this determination of Mr. Starkey's intent because it was affirmed by the Indiana Court of Appeals, "the highest Indiana Court which has addressed the issue."

The Supreme Court has made clear that we are not bound by the probate court's decision: "where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interests by a state trial court." Commissioner of Internal Revenue v. Estate of Bosch, 387 U.S. 456, 457, 87 S.Ct. 1776, 18 L.Ed.2d 886 (1967). Intermediate state appellate decisions, however, are presumed to be a correct indicator (or "datum") of state law which we may not disregard unless other decisions convince us "that the highest court of the state would decide otherwise." Id. at 465, 87 S.Ct. 1776 (emphasis omitted). But Bosch also tells us that if a state's supreme court has not resolved an issue, we have to apply what we "find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." Id.

While the Supreme Court did not expand upon what it meant by "proper regard," we note that the Indiana Court of Appeals did not publish its decision. As a result, it is questionable whether we may simply presume that it correctly indicates Indiana law—whether we may "properly regard" it as precedent—even though it is, of course, directly on point. See Ind. R.App. P. 15(A)(3) (unpublished decisions shall not "be regarded as precedent nor cited before any court except for the purpose of establishing the defense of res judicata, collateral estoppel or the law of the case."); Horn v. A.O. Smith Corp., 50 F.3d 1365, 1370 n. 10 (7th Cir.1995) (quoting Ind. R.App. P. 15(A)(3)) ("Although admittedly on point, Colglazier v. A.O. Smith Corp., No. 28A01-8810-CV-00310, 541 N.E.2d 316 (Ind.Ct.App. June 22, 1989)

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is an unpublished memorandum opinion, and Indiana's rules make plain that such
opinions shall not 'be regarded as precedent...: ".). But while an unpublished
opinion is normally not presumed to be an indicator or "datum" of state law as a
published (precedential) decision would be, Bosch, 387 U.S. at 465, 87 S.Ct. 1776,
we note that arguably (although no one seems to have made the argument) it is the
law of the case, which is one of the exceptions under Ind. R.App. P. 15(A)(3) for
when unpublished decisions "may be regarded as precedent." Supra. Anyway,
regardless of the extent to which it may be viewed as a "datum" of state law, we are
persuaded by the Indiana Court of Appeals' analysis in this matter.

The Court of Appeals concluded that the "missionaries" phrase was ambiguous and
then construed this ambiguity. A will is ambiguous if it is reasonably susceptible
to different interpretations. Hauck v. Second Nat'l Bank of Richmond, 153
Ind.App. 245, 286 N.E.2d 852, 863 (1972). In this case, the Estate contends that
the "missionaries" phrase is unambiguous and modifies "this beneficiary" (which
everyone agrees refers to the Lawndale Community Church). This is an entirely
reasonable grammatical construction. See In re City of Fort Wayne's Petition to
Establish a Conservancy Dist., 484 N.E.2d 584, 589 (Ind.Ct.App.1985) ("in the
phrase 'freeholder ..., who owns land,' the clause 'who owns land' is a descriptive
clause. Note the clause is set off from the antecedent noun by a comma indicating
a rather loose relationship to 'freeholder.' "). The IRS, though, seems to contend
that this phrase is ambiguous and that it should be construed to denote a second
beneficiary in a series of three beneficiaries. On its face, this construction is also
(Ind.Ct.App.1981). (In the phrase 'stores and shops... the words are connected with
the conjunctive 'and,' and are set apart from the other items in the [series] by a
comma."). Because the "missionaries" phrase is reasonably susceptible to different
meanings, we agree that it is ambiguous. As a result, and like the Indiana Court of
Appeals, we must use rules of construction to determine Mr. Starkey's intent. See
id. (ambiguity must exist before a court may construe a will).

Rules of grammar may be used to construe a will. See Donahue v. Watson, 411
N.E.2d 741, 750 (Ind.Ct.App.1980); Nichols v. Alexander, 90 Ind.App. 520, 152
N.E. 863, 864 (1926) (en banc); cf. Faris Mailing, Inc. v. Indiana Dept. of State
Revenue, 557 N.E.2d 713, 716 (Ind.Tax 1990) ("rules of grammar can be used to
construe an ambiguous statute"). We are reluctant, however, to hang our hat on the
cases the parties have cited to support their competing interpretations of the
"missionaries" phrase (modifier versus an item in a series). In the case the Estate
cites, the court was determining what a phrase modified; it was not passing upon
the question presented in this case: whether a phrase is a modifying phrase or a
separate item in a series. See Donahue (and other cases), note 4, supra. And the
case the IRS cites, Cape v. State, 272 Ind. 609, 400 N.E.2d 161, 164 (1980), also
did not address this specific issue. See also Pleasureland Museum, Inc., supra.

However, Dr. Franken (the English professor whom the Indiana courts relied upon
as a grammatical aid) did address this precise question. She concluded that the
"missionaries" phrase most likely modified "this beneficiary" because for the
phrase to denote an item in a series would be "inconsistent ... with the parity of
value generally intended by such a seriatim listing. It is not a reasonable
interpretation that the decedent could have intended an elaborate item in the middle
surrounded by two very specific and short items." She also rejected the notion of
a seriatim listing because "[r]ead as three items in a series, the phrase fails to
produce three distinct categories." Dr. Franken's expert opinion provides a sound grammatical reason for the Indiana Court of Appeals to conclude "that the phrase 'missionaries preaching the Gospel of Christ' is most logically interpreted in the context of the will as standing in apposition to, and describing, the Lawndale Community Church."

[Footnotes omitted.]

The opinion suggests that if lower courts issue reasonable opinions they may be accepted for tax purposes.

5. **No Income Tax Deduction Available to an Estate for a Charitable Bequest.** In *Crestar Bank, et al. v. IRS, et al.*, 83 AFTR2d ¶ 99-839 (U.Va. 1999) the District Court determined that an estate was not entitled to an income tax deduction for a charitable bequest. The decedent died in 1989 bequeathing half of certain closely-held stock to a charitable trust. The estate claimed an estate tax deduction under section 2055 for the bequest. Some years later, the estate claimed an income tax deduction for the value of the bequest, approximately $1 million, under section 642(c). The court found that the stock was not part of the estate’s gross income and thus no income tax deduction would be allowed.

6. **Private Inurement.** In an important case to the tax-exempt community, the 7th Circuit has held that there was no private inurement in the relationship of a fund raiser to the charity where about 90% of the contributions received by the charity during the period the fund raiser was employed were paid to the fund raiser for fund raising costs. *United Cancer Council, Inc. v. Commissioner*, 83 AFTR2d ¶ 99-416 (7th Cir. 1999). In a very direct opinion, Judge Posner stated that the private inurement prohibition was designed "to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm’s length contracts made by charitable organizations with the firms that supply them with essential inputs." The Tax Court had not considered the private benefit claim made by the IRS so the court did not either, although the opinion suggests that the court might view such a claim favorably.

7. **Charitable Remainder Trust Final Regulations.** Final regulations dealing with certain aspects of a charitable remainder trust have been issued. T.D. 8791.

   (1) **Flip Unitrusts.** A charitable remainder unitrust may change from a net income unitrust (with or without makeup) and a fixed percentage unitrust, upon a date or event outside the control of the trustee or any other person. Examples given include marriage, divorce, death or birth of a child, or the sale of an unmarketable asset. The conversion is effective for the tax year following the tax year in which the conversion event occurs. Upon conversion any makeup amount, under section 664(d)(3)(b), will be forfeited.

   An unmarketable asset is an asset other than cash or cash equivalents, or other assets that can readily be sold for cash or cash equivalents. Examples include real property, closely-held stock, an unregistered stock exemption which would allow a public sale.

   The existing charitable remainder trust may be reformed if proceedings are begun by June 8, 1999, or, as extended, completed by June 30, 2000.
(2) **Time of Payment of Unitrust or Annuity Amount.** Applicable for tax years ending after April 18, 1997, an annuity or unitrust amount may be paid in a reasonable time after the close of the year for which it is due so long as the character of the amount in the recipient’s hands is income under section 664(b)(1), (2), or (3) or the trust distributes other property that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects to treat any income generated by the distribution as occurring on the last day of the tax year for which the amount is due. Such an election is made on a Form 5227, trust Information Return.

For a trust created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time up to the close of the tax year for which it is due if the original percentage used to calculate the annuity, or the annual unitrust percentage, is 15% or less.

A “reasonable time” will normally be up until the time required to file the trust information return, Form 5227.

(3) **Appraising Unmarketable Assets.** If a charitable remainder unitrust has unmarketable assets and the only trustee is the grantor, a non-charitable beneficiary, or a related insubordinate party to the grantor, grantor’s spouse, or non-charitable beneficiary (as defined in section 672(c)), the trustee must value those assets using a current qualified appraisal from a qualified appraiser, as both are defined in Treas. Reg. §1.170A-13. A co-trustee who is an independent trustee may value the trust in marketable assets. PLR 200029031 approved the grantor serving as sole trustee where the trust can invest only in assets with an objectively ascertainable market value.

The rules for valuing unmarketable assets are effective for trusts created on or after December 10, 1998.

(4) **Application of Section 2702 to NIMCRUTs.** The abuse that the regulations are attempting to prevent may be illustrated as follows. Suppose a parent creates a NIMCRUT for herself for five years with subsequent payments to child for life. The trust is to pay the lesser of net income or 5% each year. If the trust is invested during the parents’ term to produce 1% it will generate a 4% arrearage annually. After the child becomes the beneficiary the trust could be reinvested to produce a greater than 5% return, with the arrearage being paid to the child. The valuation of the parent’s retained interest would have been overstated, and the gift to the child understated.

The regulations provide that unitrust interest in a NIMCRUT that are retained by the donor or any applicable family member will be valued at zero when a non-charitable beneficiary of the trust is someone other than the donor, the donor’s spouse who is a U.S. citizen, or both.

(5) **Allocation of Pre-contribution Gain to Trust Income and Makeup Amount as liability.** The regulations prohibit allocation of pre-contribution gain to trust income for a NIMCRUT. However, the governing instrument may, if allowable under applicable state law, allow the trustee to allocate post-contribution capital gains to trust income. The makeup amount in a NIMCRUT does not need to be taken into consideration as a liability when valuing the assets of the NIMCRUT. PLR 199907013 continues the Service’s ruling position that a trust provision may allow the trustee to allocate capital gain to income so long as the trust provision is not directly adverse to applicable state law and that it pertains only to post-contribution appreciation.
8. **Division of Charitable Lead Trust.** In PLR 199929021 the IRS allowed three children -- co-trustees of one lead trust -- to divide the trust into three shares without adverse income or transfer tax consequences or self-dealing penalties.

9. **Borrowing by Charitable Remainder Trust to Make Payment.** Treas. Reg. § 1.643(a)-8, T.D. 8926 (January 4, 2001) provides:

(a) Purpose and scope. This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules regarding the characterizations of distributions from those trusts in the hands of the recipients and should be interpreted in a manner consistent with this purpose. This section applies to all charitable remainder trusts described in section 664 and the beneficiaries of such trusts.

(b) Deemed sale by trust. (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year in which a distribution of an annuity or unitrust amount is made from the trust, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount would (but for the application of this subparagraph (b)) be characterized in the hands of the recipient as being from the category described in section 664(b)(4) and exceeds the amount of the previously undistributed

(i) cash contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), plus

(ii) basis in any contributed property (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522) that was sold by the trust.

(2) Any transaction that has the purpose or effect of circumventing the rules in this paragraph (b) shall be disregarded.

(3) For purposes of paragraph (b)(1) of this section, "trust assets" do not include cash or assets purchased with the proceeds of a trust borrowing, forward sale, or similar transaction.

(4) Proper adjustment shall be made to any gain or loss subsequently realized for gain or loss taken into account under paragraph (b)(1) of this section.

(c) Examples. The following examples illustrate the rules of paragraph (b) of this section:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of $2 million to a charitable remainder unitrust with a unitrust amount of 50 percent of the net fair market value of the trust assets and a two-year term. The stock has a total adjusted basis of $400,000. In Year 1, the trust receives dividend income of $20,000. As of the valuation date, the trust's assets have a net fair market value of $2,020,000 ($2 million in stock, plus $20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows $990,000 against the value of the stock. The trust then distributes $1,010,000 to the beneficiary before the end of Year 1. Under section 664(b)(1), $20,000 of the distribution is characterized in the hands of the beneficiary as
dividend income. The rest of the distribution, $990,000, is attributable to an amount received by the trust that did not represent either cash contributed to the trust or a return of basis in any contributed asset sold by the trust during Year 1. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore, in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold $990,000 of stock and as having realized $792,000 of capital gain (the trust's basis in the shares deemed sold is $198,000). Thus, in the hands of the beneficiary, $792,000 of the distribution is characterized as capital gain under section 664(b)(2) and $198,000 is characterized as a tax-free return of corpus under section 664(b)(4). No part of the $990,000 loan is treated as acquisition indebtedness under section 514(c) because the entire loan has been recharacterized as a deemed sale.

Example 2. Adjustment to trust's basis in assets deemed sold. The facts are the same as in Example 1. During Year 2, the trust sells the stock for $2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(4) of this section, the trust's adjusted basis in the stock is $1,192,000 ($400,000 plus the $792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of $908,000.

Example 3. Distribution of cash contributions. Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to $x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the $x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

(d) Effective date. This section is applicable to distributions made by a charitable remainder trust after October 18, 1999.

The final regulations provide an exception to the general rule explained as follows:

In addition, in order to make it less likely that a non-abusive trust would violate the payment rule, two new exceptions have been added to sections 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g). These new exceptions provide that a distribution of cash made within a reasonable period of time after the close of the year may be characterized as corpus under section 664(b)(4) to the extent it was attributable to (i) a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, or (ii) a return of basis in any asset contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, and sold by the trust during the year for which the annuity or unitrust amount was due.
10. **Securities Purchased on Margin Give Rise to UBIT.** The Second Circuit has decided *Henry E. & Nancy Horton Bartels Trust v. United States*, 85 AFTR2d Par. 2000-572; No. 98-6141 (April 11, 2000). A trust that was a supporting organization as defined in section 509(a)(3) bought securities on margin. The opinion states:

Under the plain language of the UBIT, the purchase of securities on margin is a purchase using borrowed funds; therefore, under section 514(c), the securities are subject to an "acquisition indebtedness." See Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347, 348-51 (3d Cir. 1980). Thus, the margin-financed securities constitute "debt-financed property" under section 514(b)(1). As "debt-financed property," section 512(b)(4) and section 514(a)(1) require that the income derived from these securities be treated "as an item of gross income derived from an unrelated trade or business" (in the proportion that the basis of the property bears to the amount financed), and, therefore, this income is included in the section 512 computation of unrelated business taxable income. See, e.g., *id.* (holding securities purchased on margin are subject to UBIT, as margin-financed securities are debt-financed property, and section 514(a) requires treating income derived therefrom as income from unrelated trade or business). Thus, Taxpayer's reliance on Supreme Court decisions construing "trade or business" in other contexts and under the general test for determining unrelated business taxable income is misplaced because section 512(b)(4) and section 514(a)(1) require that Taxpayer's income derived from margin-financed securities be treated as income derived from an unrelated trade or business.

The opinion rejected the argument that because there was no unfair competition there was no UBIT. The court rejected a final argument:

Next, Taxpayer argues that its margin-financed securities are not "debt-financed property" because section 514(b)(1) defines "debt-financed property" as property that is "held to produce income," and this phrase should be interpreted to include only "periodic" income. We find no merit to this argument for at least two reasons. First, Taxpayer cites no authority for this construction of section 514(b)(1), and there is nothing in the statutory language or legislative history of the UBIT supporting this restrictive interpretation. Second, the applicable regulation specifically construes "income" under section 514(b)(1) as including both capital gains and recurring or "periodic" income (e.g., dividends). In this respect, Treasury Regulation section 1.514(b)-1(a) defines "debt-financed property" as any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. THE TERM "INCOME" IS NOT LIMITED TO RECURRING INCOME BUT APPLIES AS WELL TO GAINS FROM THE DISPOSITION OF THE PROPERTY.

Treas. Reg. section 1.514(b)-1(a) (emphasis added). Although Taxpayer urges us to reject the Commissioner's interpretation of the UBIT, we must sustain the regulation unless it is "unreasonable and plainly inconsistent" with the statute. Fulman v. United States, 434 U.S. 528, 533 (1978); Bingler v. Johnson, 394 U.S. 741, 749-51 (1969).
Section 61(a) of the Code broadly defines income to include "all income from whatever source derived," and lists, as examples, both periodic income (e.g., dividends and interest) and nonperiodic income (e.g., compensation for services; gross income derived from business; and gains derived from dealings in property). 26 U.S.C. section 61(a)(1), (2), (3), (4), (7). There is nothing in the statutory language to suggest that this general definition of "income" is inapplicable to section 514(b)(1) or to justify limiting section 514(b)(1) to "periodic" income. Moreover, the legislative history of the UBIT does not indicate that Congress intended to tax only "periodic" income under those provisions. Accordingly, we reject Taxpayer's argument that section 514(b)(1)'s reference to "debt-financed property" includes only "periodic" income.

11. **LLC as Grantor of Charitable Remainder Trust.** PLR 199952071 determined that an LLC may be the grantor and recipient of a term of years charitable remainder trust.

12. **Charitable Bequest of Deferred Compensation.** PLR 200002011 dealt with a bequest to charity of the following items by a corporate executive:

During the course of Taxpayer’s employment, the has elected to defer receipt of certain amounts to which he was entitled, consisting of (1) compensation that had been payable to Taxpayer but the receipt of which he elected to defer pursuant to Corporation’s deferred compensation plan, (2) shares of Corporation stock that had been payable to Taxpayer as a result of his exercise of compensatory stock options granted to him by Corporation, the receipt of which he elected to defer pursuant to Corporation’s deferred stock option plan. Furthermore, Taxpayer negotiated with Corporation for the Corporation to provide a death benefit to his estate or designated beneficiaries upon his death. Collectively, these three items are referred to as the deferred compensation.

Pursuant to Taxpayer’s agreement with Corporation with respect to the deferred compensation, Taxpayer may designate any one or more beneficiaries within a certain class, which would include charitable organizations, to whom the deferred compensation would be payable in the event of his death.

Taxpayer intends to name as the designated beneficiaries of the deferred compensation one or more charitable organizations, each of which qualifies for tax-exempt status pursuant to section 501(a) as an organization described in section 501(c)(3).

During the course of his employment with the corporation, Taxpayer also has been granted certain rights (options) to purchase shares of corporation stock at specified option prices. No option price was less than the fair market value of the stock to which it applied on the date the option was granted.

It is represented that the options are the type of options commonly known as "nonstatutory options" because they do not meet the requirements for special income tax treatment under sections 421 through 424 ("statutory options"). It is further represented that at the time of their grant, the options did not have a readily ascertainable fair market value.
Pursuant to Taxpayer's agreement with Corporation under which the options were granted, in the event of his death, Taxpayer may transfer the options by will to any one or more beneficiaries within a certain class, which would include charitable organizations. Taxpayer intends to bequeath the options under his will to one or more of the charitable organizations.

The IRS ruled:

1. Taxpayer's estate will be eligible for a federal estate tax charitable deduction under section 2055(a) for the deferred compensation passing to the charitable organizations and for the value of the options passing to the charitable organizations.

2. The deferred compensation to which the charitable organizations will become entitled following Taxpayer's death will be income in respect of a decedent under section 691 which will be included in the gross income of the charitable organizations in the year in which the charitable organizations receive such income.

3. When, following Taxpayer's death, the charitable organizations exercise the options which Taxpayer bequeaths to them under his Will, the charitable organizations will recognize income in respect of a decedent under section 691 which will be included in the gross income of the charitable organizations.

The IRS referred to the application of section 83 as follows:

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, the excess of -- (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-1(d) provides that if substantially nonvested property has been transferred in connection with the performance of services and the person who performed the services dies while the property is still substantially nonvested, any income realized on or after such death with respect to the property under this section is income in respect of a decedent to which the rules of section 691 apply. In such a case the income in respect of the property shall be taxable under section 691 (except to the extent not includible under section 101(b)) to the estate or beneficiary of the person who performed the services, in accordance with section 83 and the regulations thereunder.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value (determined in
accordance with section 1.83-7(b)) at the time the option is granted. If section 83(a) does not apply to the grant of the option because it does not have a readily ascertainable fair market value at the time of the grant, sections 83(a) and 83(b) will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm’s length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the test to be applied in determining whether an option has a readily ascertainable fair market value. However, section 1.83-7 is silent regarding the transfer of a nonstatutory option in a non-arm’s length transaction.

13. **What is in a CRT?** [John T. Jorgl v. Commissioner](#), TCM 2000-10, considered an interesting issue. The taxpayers transferred a corporation (a child care center) into a charitable remainder trust which sold the corporation. Of the sale proceeds $300,000 were allocated to a covenant not to compete for the officers of the corporation, who were the taxpayers. The $300,000 was paid to the trust and the taxpayers tried to avoid paying income tax on it. The court held that income tax was owed.

14. **IRA Proceeds and Qualified Plan Proceeds - IRD Consequences.** In [PLR 199939039](#) the IRS ruled that a private foundation would have IRD when it received IRA and qualified plan proceeds but that the decedent’s estate would not have IRD.

15. **Lead Trust May Invest in FLP.** [PLR 200018062](#) determined that the investment by a charitable lead trust in a limited partnership would not be self-dealing nor would payments to the general partners be prohibited transactions. The issue of excess business holdings was not considered.

16. **Division of CRT to Meet 10% Test.** In [PLR 200022014](#) the IRS allowed a trustee to divide a trust, pursuant to court order, so that instead of being one trust with four beneficiaries, and flunking the 10% remainder interest rule of section 664(d)(2)(D), it became four trusts each with one beneficiary.

17. **Division of CRT in Divorce.** Husband and wife were joint grantors, trustees and unitrust recipients who upon their divorce desired to divide the CRT into two CRTs, in [PLR 200045038](#). The IRS allowed the division. Interestingly, however, the IRS declined to rule on whether the division was an income tax event under sections 61,170, 1001, or 1041.

18. **Failure to Operate as a CRT.** In [Atkinson v. Commissioner](#), 115 T.C. No. 3 (2000) no estate tax charitable deduction was allowed where a charitable remainder annuity trust never made any annuity payments and failed to require that the secondary recipients, those after the grantor, pay the estate tax due on account of the trust being included in the grantor’s estate before receiving their annuity interests. With respect to the first issue, the opinion states:

Section 664 provides for a narrow exception to the general disallowance of deductions for charitable remainder interests under section 2055(e)(2)(A). In order
to qualify, all section 664 requirements for CRAT's must be met upon creation and must continue to be met throughout the existence of the CRAT. See sec. 1.664-1(a)(4), Income Tax Regs. One of those requirements is that a minimum payment of 5 percent of the initial fair market value of the trust's assets be distributed each year to the noncharitable beneficiary. Petitioner argues that this distribution requirement should be set aside or ignored because it only serves to decrease the charitable contribution and because decedent had no need for the distribution. One of the primary reasons for sections 2055 and 664 was to ensure that any amount set aside for charity was not diminished by payments to noncharitable beneficiaries.

The trust here, however, provides for four potential secondary beneficiaries who could have survived decedent and elected to receive payments that could have reduced the amount due to charity. An expressed focus of Congress in enacting the 5-percent distribution requirement was to prevent a charitable remainder trust from being used to circumvent the current income distribution requirements imposed on private foundations. See S. Rept. 91-552 (1969), 1969-3 C.B. 423, 481. If there were no such requirement, a charitable remainder trust could be used to accumulate trust income tax-free, while a private foundation would remain limited in the amount of income it might accumulate. See id.

Though the terms of the annuity trust met the letter of the statutory requirement providing for distributions equal to 5 percent annually, the trust did not operate in accordance with those terms. Petitioner bears the burden of proof in this matter, including the burden of substantiation. See Rule 142(a). Petitioner has presented no persuasive evidence that checks for the 5 percent annuity ever existed or were ever sent to decedent. Purportedly, MacQuarrie [the trustee] remitted checks to decedent that were not cashed. However, there is no record of canceled or uncanceled checks, nor did petitioner present any evidence demonstrating a gap in the check sequence. Though MacQuarrie testified that he made copies of checks written on the trust account, no such copies were presented to evidence these alleged payments. On the other hand, we do have evidence that no payments were ever actually consummated before decedent's death. The trust was never diminished by any payments during decedent's life. Because the trust value was undiminished and no transfer of funds occurred, operationally the trust did not meet the express 5-percent requirement of the statute and cannot qualify for treatment as a charitable remainder trust. Accordingly, section 2055 applies, and the estate is not entitled to a deduction for the bequest of a charitable split-interest.

As for the payment of estate taxes the court notes that the decedent's estate and revocable trust are insufficient to pay debts, expenses, and taxes, thus: The shortfall will have to come out of the trust corpus. Pursuant to section 664(d)(1)(B), no amount of the trust, other than the annuity, may be paid to or for the use of any person other than an organization described in section 170(c). Because the trust corpus will be invaded to pay expenses or debts of the estate, including estate taxes, a substantial part of the trust funds may be diverted from the charitable remainder. This is an additional reason for concluding that the trust failed to function exclusively as a CRAT from the date of its creation. See sec. 1.664-1(a)(6), Example (3), Income Tax Regs. (reservation of power to pay grantor's debts precludes qualification as CRAT); see also Rev. Rul. 82-128, 1982-2 C.B. 71 (ruling *that* a trust does not qualify as a charitable remainder trust and no deduction is allowable under sections 170 and 2522 of the Code if it is
possible that federal estate and state death taxes may be payable from the trust assets).

The court also pointed out that this is an operational problem which is not reformable:

Though only mentioned in passing by petitioner, we also note that reformation of the trust pursuant to section 2055(e)(3) would not be an available remedy to petitioner. Section 2055(e)(3) provides that a trust or will may be reformed if it was improperly created and yet conforms to the CRAT requirements. The definition of "qualified reformation" demonstrates that the reformation is meant to address only those problems arising in the documentation of the trust. Section 2055(e)(3)(B) defines qualified reformation as "a change of governing instrument by reformation, amendment, construction, or otherwise". The legislative history indicates that reformation under section 2055 was created to address problems in trust creation as follows: "The bill provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules." Staff of the Senate Comm. on Finance, 98th Cong. 2d Sess., Explanation Of Provisions Approved By The Committee On March 21, 1984, S. Prt. 98-169, Vol. I at 732 (Comm. Print 1984). Here the trust was validly formulated, and its terms were within the statutory threshold requirements. Accordingly, reformation is not needed to "rewrite" incorrect terms. The operational failure cannot be corrected by reformation. Therefore, the concept of reformation has no application here.

If the trust had been a charitable remainder unitrust then the argument could have been made that the payments were made but were recomtributed to the trust, which might save the CRT but would not affect the recipients income tax reporting. In PLR 200052026, a CRUT did not allow additional contributions but they were made anyway. The ruling states:

H and W established Trust under the laws of State on D1. At that time, H and W contributed shares of X, having an aggregate value of $x, to Trust. H and W are the trustees and income beneficiaries of Trust. Trust was intended to qualify as a charitable remainder unitrust under section 664(d)(2) of the Code.

On D2 of Year 1, H and W made an additional contribution of shares of X to Trust. The X stock of the second contribution was sold by Trust on D3 of Year 1 for $y. Article Sixth of Trust's governing instrument provides that no additional contributions shall be made to Trust after the initial contribution. Soon after the second contribution was made, H and W realized that the second contribution was not permitted under Article Sixth. After this discovery, the custodian of Trust, at the instruction of H and W, identified and maintained records of the proceeds of the second contribution. No charitable deduction was taken by H and W relating to the second contribution, and the proceeds of the second contribution was not used when calculating any unitrust payments of Trust.

H and W, as trustees, propose to return the proceeds of the second contribution to themselves as the grantors. H and W represent that they will amend their individual tax returns for the Year 1 and Year 2 taxable years. H and W will report any capital gains and dividend income generated by the second contribution of X stock while it was in Trust's account.

* * * * *
Based solely on the information submitted, we conclude that the second contribution of X stock will be ignored for federal tax purposes and will not disqualify the Trust as a charitable remainder unitrust under 664(d)(2) of the Code, provided that H and W amend their Year 1 and Year 2 taxable years tax returns to report any capital gains and dividend income generated by the second contribution of X stock while it was in the Trust's account.

19. **Payments from CRAT to Charitable During Annuitant's Lifetime.** PLR 200052035 approved a modification to a CRAT as follows:

The information submitted states that X established Trust on D1. X died on D2, and was survived by A. Pursuant to the terms of Trust, a trust represented as being a charitable remainder annuity trust under section 664 (the CRAT) was established for the benefit of A.

Article 4.01(A) of Trust provides for the trustees of the CRAT to distribute annually to A, for the duration of A's life, an annuity amount equal to 5 percent of the initial fair market value of the assets placed in the CRAT. Upon A's death, the trustees shall distribute the remaining principal and undistributed income of the CRAT to any one or more charities selected by the trustees that are organizations described in sections 170(c) and 2055(a) (Qualified Charities).

The trustees of the CRAT propose to modify Trust to authorize the trustees to make distributions of principal and income from time to time during A's lifetime to any one or more Qualified Charities selected by the trustees, but only to the extent that the fair market value of the assets of the CRAT exceeds $x at the time of such distribution. The trustees shall make no distribution of principal or income from the CRAT to the extent that such distribution would endanger the ability of the CRAT to pay the required fixed 5 percent annuity to A for the duration of A's lifetime.

The trustees have obtained the consent of A to the proposed modification. The trustees have also obtained the consent of the attorney general of State, the laws of which govern the rights and duties of the parties and beneficiaries of Trust, pursuant to the terms of Trust. The trustees have petitioned Court for an order directing the modification of Trust as described above.

20. **Final Regulations for Lifetime Charitable Lead Trusts.** Final regulations have been issued whose purpose is to prevent use as a measuring life a person with a short, but not too short, life expectancy. T.D. 8923 (January 4, 2001). The final regulations are more lenient than the proposed regulations. The Treasury explanation states:

In general, in order to qualify as a guaranteed annuity interest or unitrust interest for purposes of the income, estate, and gift tax charitable deductions under sections 170(c), 2055(e)(2), and 2522(c)(2), respectively, the permissible term for the charitable lead interest must be either a specified term of years, or the life or lives of individuals living at the date of the transfer. The proposed regulations limit the individuals who may be used as measuring lives to the donor, the donor's spouse, and a lineal ancestor of all the remainder beneficiaries. This proposed limitation is intended to eliminate abusive schemes utilizing seriously ill individuals, who are unrelated to the grantor or the remainder beneficiaries, as measuring lives for charitable lead trusts.
Commentators argued that by limiting the class of individuals who can be used as measuring lives in a charitable lead trust, the regulations preclude the use of these trusts in certain nonabusive situations. In response to these comments, several changes were made to the final regulations to provide a greater degree of flexibility for selecting a measuring life.

The final regulations expand the class of permissible measuring lives to include an individual who, with respect to all noncharitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. Thus, remainder beneficiaries can include step-children and step-grandchildren of the individual who is the measuring life, and charitable organizations (described in section 170, 2055, or 2522).

The final regulations also provide that a trust will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus. This probability must be computed at the date of transfer to the trust taking into consideration the interests of all individuals living at that time. This change will afford drafters the flexibility to provide for alternative remainder beneficiaries in the event the primary remainder beneficiary and his or her descendants predecease the individual who is the measuring life for the term of the charitable interest.

The probability test is illustrated by the following example:

The application of the probability test may be illustrated by assuming a grantor establishes a charitable lead annuity trust (CLAT) that provides for the annuity to be paid to a charity for the life of A who is age 75 on the date the CLAT is created. On A's death, the corpus is to pass to A’s only child, B, age 50 on the date the CLAT is created. If B predeceases A, the corpus is to pass to B’s issue then living and if B has no living issue at that time, then to A’s heirs at law (which class could include A’s siblings, uncles, aunts, nieces and nephews). B has no living children on the date the CLAT is created. Based on the current applicable Life Table contained in section 20.2031-7 of the Estate Tax Regulations (Life Table 90CM), the probability that B will predecease A, and the trust will pass to individuals who are not lineal descendants of A is 10.462%, taking into account the interests of remainder beneficiaries living at the time the trust was created. Since the probability that any trust corpus will pass to beneficiaries who are not lineal descendants of A is less than 15%, the CLAT will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of A or A's spouse.

The final regulations provide for transitional relief and for potential reformation:

The rule in paragraphs (e)(2)(vi)(a) and (vii)(a) of this section that guaranteed annuity interests or unitrust interests, respectively, may be payable for a specified term of years or for the life or lives of only certain individuals is generally effective in the case of transfers pursuant to wills and revocable trusts where the decedent dies on or after April 4, 2000. Two exceptions from the application of this rule in paragraphs (e)(2)(vi)(a) and (vii)(a) of this section are provided in the case of transfers pursuant to a will or revocable trust executed on or before April 4, 2000. One exception is for a decedent who dies on or before July 3, 2001 without having republished the will (or amended the trust) by codicil or otherwise. The other exception is for a decedent who was on April 4, 2000, under a mental disability to
change the disposition of the decedent's property, and either does not regain competence to dispose of such property before the date of death, or dies prior to the later of: 90 days after the date on which the decedent first regains competence, or July 3, 2001 without having republished the will (or amended the trust) by codicil or otherwise. If a guaranteed annuity interest or unitrust interest created pursuant to a will or revocable trust where the decedent dies on or after April 4, 2000, uses an individual other than one permitted in paragraphs (e)(2)(vi)(a) and (vii)(a) of this section, and the interest does not qualify for this transitional relief, the interest may be reformed into a lead interest payable for a specified term of years. The term of years is determined by taking the factor for valuing the annuity or unitrust interest for the named individual measuring life and identifying the term of years (rounded up to the next whole year) that corresponds to the equivalent term of years factor for an annuity or unitrust interest. For example, in the case of an annuity interest payable for the life of an individual age 40 at the time of the transfer, assuming an interest rate of 7.4% under section 7520, the annuity factor from column 1 of Table S(7.4), contained in IRS Publication 1457, Book Aleph, for the life of an individual age 40 is 12.0587 (Publication 1457 is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402). Based on Table B(7.4), contained in Publication 1457, Book Aleph, the factor 12.0587 corresponds to a term of years between 31 and 32 years. Accordingly, the annuity interest must be reformed into an interest payable for a term of 32 years. A judicial reformation must be commenced prior to the later of July 3, 2001, or the date prescribed by section 2055(e)(3)(C)(iii). Any judicial reformation must be completed within a reasonable time after it is commenced. A non-judicial reformation is permitted if effective under state law, provided it is completed by the date on which a judicial reformation must be commenced. In the alternative, if a court, in a proceeding that is commenced on or before July 3, 2001, declares any transfer made pursuant to a will or revocable trust where the decedent dies on or after April 4, 2000, and on or before March 6, 2001, null and void ab initio, the Internal Revenue Service will treat such transfers in a manner similar to that described in section 2055(e)(3)(J).

21. **Transfer of Stock But Not Voting Rights.** Rev. Rul. 81-282, 1981-2 C.B. 78, provides that a contribution of stock with retention of voting rights by the donor is a gift of a partial interest for which a deduction is denied. In PLR 200108012 the IRS ruled differently where the voting of the stock was subject to a 1992 agreement and had been transferred for a business purpose.

22. **Accrual Basis S Corporation May Not Make § 170(a)(2) Election.** Section 170(a)(2) allows an accrual basis corporation to “deduct a charitable contribution in the year in which the board of directors authorizes the contribution, if the payment is made by the 15th day of the third month following the close of the taxable year.” Rev. Rul. 2000-43, 2000-41 IRB 333, determined that an S corporation may not make the election:

Under section 1363(b), a subchapter S corporation computes its taxable income in the same manner as an individual. The election in section 170(a)(2) is not available to an individual. An individual taxpayer may deduct a charitable contribution only in the year in which payment is actually made to the charitable organization. Furthermore, the rationale behind section 170(a)(2), a corporation’s difficulty in determining its charitable contribution limit under section 170(b)(2), does not apply to subchapter S corporations because a subchapter S corporation is not subject to the same section 170(b)(2) limit.
23. **Collective Investment of CRUT Assets.** In PLR 200043047 husband and wife formed 15 charitable remainder trusts for their children and grandchildren. Subsequently, an LLC was formed to invest the family’s assets.

The ruling described the purpose and operation of the LLC:

In recent years, the family of A and B established K, a limited liability company ("the LLC"), to coordinate the investment of the family's assets. The LLC is managed by its Voting Members, who consist of the children of A and B (and any descendants to whom the children may transfer all or part of their Voting Membership Interest). The 15 CRUTs propose to invest in the LLC, in order to (1) diversify their portfolios, (2) pool their assets to obtain economies of scale and more negotiating power, and (3) obtain access to investments with higher minimums than each could satisfy using its assets alone.

The LLC is expected to be a disqualified person with respect to each of the CRUTs from time to time, as disqualified persons with respect to each CRUT will be deemed to own more than 35% of the profits interest in the LLC from time to time, either directly or under the attribution rules of section 267(c).

The LLC currently maintains multiple investment funds. Each fund has its own rules of governance ("Fund Rules"), including investment and redemption rules. Some funds that invest in nonmarketable, illiquid-type investments impose significant restrictions on the right of a fund participant or investor to withdraw. In contrast, those funds that invest solely in marketable securities grant each fund participant the right as of the end of each month upon reasonable advance notice (typically seven days) to withdraw from the fund in whole or part upon written request to the fund manager, and to receive fair market value in return for such withdrawal based on the participant's allocable share of the value of the securities held by the fund. The CRUTs will participate only in funds that invest solely in marketable securities and which, therefore, have liberal withdrawal rights.

L represents that its contribution to an LLC fund in exchange for a membership interest does not constitute a sale or exchange of property under the applicable State law. The LLC has elected partnership treatment for federal tax purposes.

The combined assets of the CRUTs to be contributed equal about 80% of the LLC's current assets. The percentage is expected to decline over time as individual family members contribute more assets to the LLC.

The LLC does not charge a member any fee for investing in its funds other than the member's pro rata share of expenses (investment, legal, accounting, administrative). However, each CRUT will not be charged for any expenses other than the marginal increase in investment expenses attributable to the CRUT's participation in the fund. Thus, no disqualified person will have fees reduced as a result of a CRUT's participation. Neither the LLC nor any disqualified person with respect to any of the CRUTs will, as a result of the participation in a fund by the CRUTs, receive compensation or any benefit other than some benefits also accruing to the CRUTs from the arrangement (i.e., increased negotiating power and access to investments with higher minimums). The CRUTs will incur substantially lower investment expenses in the LLC than they currently incur for essentially equivalent investments, which will increase the value of the charitable remainder interest of the CRUTs.
Under the representations made, there is no participation in the investment activities of the LLC by an organization described in section 501(c)(3) and classified as a private foundation.

In compliance with section 4941(d)(1)(A) of the Code, it is represented that the LLC will not buy, sell, or lease property in a sales or lease transaction with any disqualified person with respect to any of its members. In compliance with section 4941(d)(2)(A), neither the LLC nor its holdings are or will be subject to a mortgage or similar lien. In compliance with section 4941(d)(1)(B) of the Code, the LLC will not receive credit from, or extend credit to, a disqualified person with respect to any of its members. In compliance with section 53.4941(d)-2(f)(1) of the regulations, the LLC will not purchase or sell investments in an attempt to manipulate the price of the investments to the advantage of a disqualified person.

The rulings requested were given:

1. We have considered the issue whether a contribution by a CRUT to the LLC in exchange for a membership interest constitutes a sale or exchange of property for purposes of section 4941(d)(1)(A) of the Code. If so, there would be an act of self-dealing where the ownership interests in the LLC were such as to constitute the LLC a disqualified person with respect to the CRUT immediately before the contribution. However, given the taxpayer's representations regarding the applicable State law principles, we find no sale or exchange of property under the circumstances.

2. We find that any benefits that the LLC and its disqualified person members may derive from a CRUTs participation in the LLC funds will be incidental and tenuous as described in section 53.4941(d)-2(f)(2) of the regulations. We note that section 4943 of the Code contemplates co-investment arrangements between foundations and disqualified persons under specified circumstances, and in the case of section 4943(d)(3)(B), without ownership limitations. We also note that, under the facts presented, participation by the CRUTs will not benefit the disqualified person investors by reducing their allocable administrative expenses.

3. Under the facts presented and represented, we find the reimbursement of investment expenses incurred by the LLC to be payment for personal services reasonable and necessary to carry out exempt purposes (assuming that the charges are not excessive). The situation is similar to that described in section 53.4941(d)-3(c)(2), Example (2) of the regulations.

The key representation was that under applicable state law the contribution by a CRUT to the LLC for a membership interest would not be a sale or exchange of property.

C. SECTION 408 -- IRAs AND RETIREMENT PLANS

1. New Proposed Regulations Dealing With Minimum Distributions. On January 11, 2001, the IRS issued new proposed regulations under section 401(a)(9). REG-130477-00; REG-130481-00. The proposed regulations are easier to understand than the previous set but are nonetheless complicated.

   a. Lifetime required distributions. Most taxpayers will use one Uniform Table. The Uniform Table will be used in all but one situation; namely, where the spouse is more than 10 years younger than P ("P"). The
initial division under the Uniform Table for a P who is age 70 is 26 years, and this is recalculated annually -- the plan need never be exhausted. No beneficiary need be named, nor does the age of the beneficiary, nor the identify of the beneficiary-(i.e. a charity) matter. If the spouse is more than 10 years younger than P the life expectancy tables may be applied using the age of P and spouse in the distribution year. Note that the spouse must be the sole beneficiary. Query: What if spouse ceases to be the sole beneficiary because of death, divorce or beneficiary change? It would make sense if P then began using the Uniform Table. It appears that P, who marries a much younger spouse after P’s required beginning date (“RBD”), may then begin using the mortality tables.

b. Post-death distributions - the “applicable distribution period” will be the life expectancy of the designated beneficiary who actually inherits the benefits when the P dies. The identity of this beneficiary will not be finalized until December 31 of the year following the year of death. At P’s death, benefits will be distributed over the beneficiary’s life expectancy or, if there is no beneficiary, over the remaining fixed term life expectancy of P based on P’s birthday in the year of death.

Remember that Ps now past their RBD may switch to the Uniform Table. The choice of beneficiaries at the RBD is no longer significant. Beneficiaries are determined by December 31 of the year following P’s death. Thus, disclaimers may “create” new beneficiaries. Distributions to beneficiaries before that date, take those beneficiaries “out of the mix”, ie, charities. Note: P must still name beneficiaries and you cannot correct the situation where P’s estate is the beneficiary.

c. Distributions Before RBD

- **One Beneficiary who is P’s Spouse:** (1) 5 year rule; over spouse’s life expectancy in the year P would have been 70 1/2 (and if spouse dies before that year, the rules will be applied as if spouse were the P and died before spouse’s RBD).

- **One Beneficiary, not the Spouse:** (1) 5 year rule; or (2) beneficiary’s life expectancy based on beneficiary’s age on beneficiary’s birthday in the year after P died.

- **Multiple beneficiaries and they have not established separate accounts by December 31 in the year after P’s death and they are all individuals:** (1) 5 year rule; or (2) over the oldest beneficiary’s life expectancy based on beneficiary’s birthday in the year after P died.

- **One beneficiary, not an individual or more than one beneficiary, one of whom is not an individual, and separate accounts have not been established by December 31 of the year after P died:** P is treated as having no designated beneficiary and all benefits must be distributed under the 5 year rule.

- **Multiple beneficiaries who have established separate accounts by December 31 of the year after P’s death:** The rules above apply to each separate account. This is a significant liberalization of the prior rules.
d. **Distributions on or after RBD -** Beneficiaries must take P's distribution for the year of death, (and in the year of death), based on the Uniform Table, if P has not done so. Then:

- **Surviving spouse is sole beneficiary:** Use the spouse's life expectancy in the year after P's death and based on spouse's age. After spouse's death, benefits are based on spouse's remaining (fixed) life expectancy. Spouse should roll-over and name spouse's designated beneficiaries to provide for longer pay-out period.

- **One beneficiary, not the spouse:** use the beneficiary's life expectancy.

- **Multiple beneficiaries, all individuals:** unless they are able to established separate accounts, use the life expectancy of the oldest beneficiary.

- **One beneficiary, not an individual, or multiple beneficiaries and one is not an individual:** Unless separate accounts are established, P is treated has having no designated beneficiary and benefits must be paid out over P's life expectancy based on P's age in year of death.

If P's account has been divided into separate accounts, the rules, above, are applied to each separate account.

- **Trust for sole benefit of spouse** - may not roll over unless trust is totally a grantor trust (under §678) as to the surviving spouse.

- **Other Trusts as Beneficiaries** - the proposed regulation provides:

Q-4. When is the designated beneficiary determined?

A-4. (a) **General rule.** Except as provided in paragraph (b) and section 1.401(a)(9)-6, the employee's designated beneficiary will be determined based on the beneficiaries designated as of the last day of the calendar year following the calendar year of the employee's death. Consequently, except as provided in section 1.401(a)(9)-6, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that later date (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.

(b) **Surviving spouse.** As provided in A-5 of section 1.401(a)(9)-3, in the case in which the employee's spouse is the designated beneficiary as of the date described in paragraph (a) of this A-5, and the surviving spouse dies after the employee and before the date on which distributions have begun to the spouse under section 401(a)(9)(B)(iii) and (iv), the rule in section 401(a)(9)(B)(iv)(II) will apply. Thus, the relevant designated beneficiary for determining the distribution period is the designated beneficiary of the surviving spouse. Such designated beneficiary will be determined as of the last day of the calendar year following the calendar year of surviving spouse's death. If, as of such last day, there is no designated beneficiary under the plan with respect to that surviving spouse, distribution must be made in
accordance with the 5-year rule in section 401(a)(9)(B)(ii) and A-2 of section 1.401(a)(9)-3.

(c) Multiple beneficiaries. Notwithstanding anything in this A-4 to the contrary, the rules in A-7 of section 1.401(a)(9)-5 apply if more than one beneficiary is designated with respect to an employee as of the date on which the designated beneficiary is to be determined in accordance with paragraphs (a) and (b) of this A-4.

Q-5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust with respect to the trust's interest in the employee's benefit be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)?

A-5. (a) Only an individual may be a designated beneficiary for purposes of determining the distribution period under section 401(a)(9). Consequently, a trust is not a designated beneficiary even though the trust is named as a beneficiary. However, if the requirements of paragraph (b) of this A-5 are met, the beneficiaries of the trust will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met:

1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument within the meaning of A-1 of this section.

4) The documentation described in A-6 of this section has been provided to the plan administrator.

(c) In the case of payments to a trust having more than one beneficiary, see A-7 of section 1.401(a)(9)-5 for the rules for determining the designated beneficiary whose life expectancy will be used to determine the distribution period. If the beneficiary of the trust named as beneficiary is another trust, the beneficiaries of the other trust will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)(A)(ii), provided that the requirements of paragraph (b) of this A-5 are satisfied with respect to such other trust in addition to the trust named as beneficiary.
Q-6. If a trust is named as a beneficiary of an employee, what documentation must be provided to the plan administrator?

A-6. (a) Required minimum distributions before death. In order to satisfy the documentation requirement of this A-6 for required minimum distributions under section 401(a)(9) to commence before the death of an employee, the employee must comply with either paragraph (a)(1) or (2) of this A-6:

(1) The employee provides to the plan administrator a copy of the trust instrument and agrees that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each such amendment.

(2) The employee --

(i) Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement);

(ii) Certifies that, to the best of the employee's knowledge, this list is correct and complete and that the requirements of paragraphs (b)(1), (2), and (3) of A-5 of this section are satisfied;

(iii) Agrees that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator corrected certifications to the extent that the amendment changes any information previously certified; and

(iv) Agrees to provide a copy of the trust instrument to the plan administrator upon demand.

(b) Required minimum distributions after death. In order to satisfy the documentation requirement of this A-6 for required minimum distributions after the death of the employee, by the last day of the calendar year immediately following the calendar year in which the employee died, the trustee of the trust must either --

(1) Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of the end of the calendar year following the calendar year in which the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A-5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

One issue that arose under the previous proposed regulations and that persists under these is whether the presence of a broad special power of appointment means that the trust does not have identifiable beneficiaries and, consequently, cannot be a “designated beneficiary.”
e. **Effective Dates** - IRS propose that these regulations become final on January 1, 2002. IRA owners may, however begin using the new rules now. Qualified Plan Ps may not use the new rules until the plan is amended.

f. **Conclusions**
1. There is no longer a debate over whether or not to recalculate - all Ps and spouse now receive the benefits of recalculation, without its drawbacks.
2. Significance of required beginning date is eliminated except for 2 items: (1) must begin withdrawing by that date; and (2) after P’s death, the post death distributions rules are slightly different.
3. Use disclaimers to create younger beneficiaries.
4. No need for separate accounts for charities, because you may make distributions to older and non-individual (charities) prior to December 31 of the year following P’s death.
5. Any beneficiaries, regardless of when P died, should be able to use the new rules in 2001.

g. **Administrative**
IRA providers must now report the end of year IRA account values, and also the amount of the RMD for that year.

2. **Qualified Plan Benefits and IRAs Payable to QTIP Trust.** The IRS has made Rev. Rul. 89-89 obsolete and replaced it with Rev. Rul. 2000-2, 2000-2 IRB 305 (January 18, 2000). The holding of the ruling is:

An executor may elect under § 2056(b)(7) to treat an IRA and a trust as QTIP when the trustee of the trust is the named beneficiary of the decedent's IRA, the surviving spouse can compel the trustee to withdraw from the IRA an amount equal to all the income earned on the IRA assets at least annually and to distribute that amount to the spouse, and no person has a power to appoint any part of the trust property to any person other than the spouse.

The ruling is in accordance with Treas. Reg. S 20.2056(b)-5(f)(8) which provides that if a spouse may demand all the income of a trust that will give the spouse the necessary entitlement to all of the income to meet the requirements of section 2056. Provisions in trust documents that require a trustee to demand all the income should be modified.

3. **Effect of Facility of Payment Clause on Designated Beneficiary Rules.** The IRS determined in PLR 199912041 that a revocable trust that became irrevocable upon the grantor’s death would not qualify as a designated beneficiary under section 401(a)(9) for qualified plan benefits because the revocable trust allowed the trustee to pay amounts needed to pay claims, administration expenses, and taxes to the grantor’s estate. The IRS decided that a facility of payment clause to create the estate as a beneficiary and only individuals, in certain trusts, may be “designated beneficiaries.”
D. SECTIONS 671-678 -- GRANTOR TRUST RULES

1. **Income Tax Consequences of Powers of Withdrawal** PLR 199942037 involved a trust with Crummey powers and a gift of subchapter S stock. The IRS ruled that the minor child who is the beneficiary of the trust and who had the power of withdrawal would be treated as the owner of the trust under section 678(a) whether or not the child withdrew the property or allowed the right to withdraw to lapse.

   PLR 200022035 confirms that a person who has a 5 x 5 withdrawal right over a trust will be the owner under section 678 of an ever increasing fraction of the trust.

2. **Grantor Trust Status for GRAT**. PLRs 200001013 and 200001015 approved grantor trust status for GRATs which provided that the retained annuity would first be paid from income, gave the nonadverse trustee the power to pay additional income to the grantor/annuitant, and the grantor/annuitant would have a general testamentary power of appointment during the term. The ruling states:

   Under the terms of the of Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under section 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under section 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term. Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of section 671 during the Trust term.

   If the trust had income and capital gains in excess of the annuity the trustee was required to reimburse to grantor for the excess income tax owed. The ruling is silent about the effect of the section 675(4)(c) power which was described as follows:

   Section VIIA of the Trust provides that at any time during the Trust term, Taxpayer is to have the power, exercisable in a nonfiduciary capacity (either personally or by an attorney-in-fact under a power of attorney expressly referring to this power), without the consent or approval of any person in any capacity, to reacquire any property held by the Trust by substituting other property having the same fair market value (determined without regard to the nature of the assets or the relative value of the asset to any person having an interest in the Trust).

   The taxpayer also asked whether the trust would be included in the taxpayer’s estate under section 2036 if the grantor survived the trust term. The ruling was favorable.

E. SECTION 1361 - S CORPORATIONS

1. **Power to Make Distributions From ESBT**. PLR 199930035 proved ESBT status for a trust in which the trustee could distribute income and principal among the grantor’s descendants and could divide the trust property among separate trusts for the grantor’s descendants, per stirpes. Specifically, the IRS determined that the
trustee's power to create separate trusts would not affect qualification of the single trust as ESBT. The IRS noted that if the trust property were divided, each separate trust would have to qualify under section 1361(c)(2)(A) and each beneficiary of the trust would have to be described in section 1361(b)(1).

2. **Proposed ESBT Regulations.** The IRS issued proposed regulations on December 28, 2000. REG-251701-96. The most important issues covered are which trusts are ESBTs and what is the income tax treatment of an ESBT with both S corporation stock and other assets. The Supplementary Information provides:

1. **Beneficiary**

   The proposed regulations provide guidance as to who is an ESBT beneficiary. Generally, a beneficiary includes any person who has a present, remainder, or reversionary interest in the trust other than a remote, contingent interest. If an ESBT makes distributions to another trust (the distributee trust), the distributee trust is not treated as a beneficiary of the ESBT. However, the beneficiaries of the distributee trust will be counted as beneficiaries of the ESBT. Persons whose future beneficial interest is so remote as to be negligible are not beneficiaries. Generally, when the probability that a person will receive any distribution from the trust is less than 5 percent, at a particular time, that person's interest would be so remote as to be negligible. Finally, the term beneficiary does not include a person in whose favor a power of appointment may be exercised until the power is actually exercised.

   This provision is helpful because most trusts have alternate beneficiaries.

2. **Interests Acquired by Purchase**

   The proposed regulations provide guidance regarding the prohibition on acquiring an interest in an ESBT by purchase. The proposed regulations provide that the prohibition applies if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012. Thus, a part-gift, part-sale of a beneficial interest will terminate the trust's status as an ESBT. Beneficiaries may not purchase interests in the trust, but the ESBT itself is allowed to purchase S corporation stock.

3. **Grantor Trusts**

   The proposed regulations provide that a trust, all or a portion of which is treated as owned by an individual under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (Code) (a grantor trust), may elect to be an ESBT. The Treasury Department and the IRS believe that Congress did not intend to preclude this type of trust, which is a common family estate planning tool, from electing ESBT status. The proposed regulations provide rules for the treatment of grantor trusts electing ESBT status.

   This provision is important because it allows trusts with multiple grantors to qualify as ESBTs.

4. **Potential Current Beneficiaries**

   The proposed regulations provide that the term potential current beneficiary means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. In general, a person who may receive a distribution
from the ESBT under a currently exercisable power of appointment is a potential current beneficiary. In addition, in the case of an ESBT that is a grantor trust, the proposed regulations provide that the deemed owner of the grantor trust is also to be treated as a potential current beneficiary.

Under the definitions set forth in the proposed regulations, a potential current beneficiary is not necessarily a beneficiary of the trust and vice versa. For example, a person in whose favor property could currently be appointed, but to whom no such appointment has been made, is a potential current beneficiary, but not a beneficiary. Conversely, a person who is a non-contingent remainder beneficiary of a non-grantor trust is a beneficiary, but not a potential current beneficiary.

The proposed regulations provide special rules if current distributions can be made to a distributee trust. If the distributee trust does not qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), then the trust is considered the potential current beneficiary and thus a shareholder. In that case, the corporation's S election terminates because the corporation has an ineligible shareholder. For this purpose, a trust is deemed to qualify to be a shareholder of an S corporation under section 1361(c)(2)(A) if it would be eligible to make a QSST or ESBT election if it owned S corporation stock.

If the distributee trust does qualify to be a shareholder of an S corporation under section 1361(c)(2)(A), in general, the potential current beneficiaries of the distributing ESBT will include the potential current beneficiaries of the distributee trust. However, if the distributee trust is a former grantor trust prior to the owner's death (that is, a trust described in section 1361(c)(2)(A)(ii)), or is a trust receiving a distribution of S stock from a decedent's estate (that is, a trust described in section 1361(c)(2)(A)(iii)), the estate of the decedent is treated as the only potential current beneficiary of the trust. In no case will the same person be counted twice when determining the number of S corporation shareholders.

5. ESBT Election

Notice 97-12 (1997-1 C.B. 385) provides the procedures for making the ESBT election. Under that notice, the ESBT election is required to contain certain information and representations, and is required to be filed with the service center where the S corporation files its income tax returns. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, the trustee of an ESBT makes a single ESBT election by filing a statement with the service center where the ESBT files its Form 1041, U.S. Income Tax Return for Estates and Trusts. This procedure will be more convenient for taxpayers than the procedures of Notice 97-12 if the ESBT holds stock in more than one S corporation. No trust documents are required to be attached to the election statement.

The proposed regulations provide that if a trust satisfies the ESBT requirements and makes an ESBT election, the trust will be treated as an ESBT for federal income tax purposes as of the effective date of the ESBT election. These effective dates generally follow the rules of section 1.1361-1(j)(6)(iii) for qualified subchapter S trust (QSST) elections. Protective ESBT elections, which are intended to become effective only if the trust fails to satisfy the requirements for a trust
described in section 1361(c)(2)(A)(i) through (iv), are prohibited. Unlike a protective QSST election, a protective ESBT election could result in a change in the incidence of taxation from the owner of the trust to the trust itself. If a trust fails to qualify as an eligible S corporation shareholder under section 1361(c)(2), and consequently the S corporation election is ineffective or terminated, relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation termination.

6. Conversions of QSSTs and ESBTs

Rev. Proc. 98-23 (1998-1 C.B. 662) provides procedures for the conversion of a QSST to an ESBT and an ESBT to a QSST. The proposed regulations, when finalized, will modify and replace the procedures of Rev. Proc. 98-23 and provide rules with respect to these conversions.

The conversion procedure provided in the proposed regulations differs from that provided in Rev. Proc. 98-23, in that the election must be filed with the service center where the trust files its income tax return, as well as with the service center where the S corporation files its income tax return. The election must be filed in both service centers if the service center for the trust is different from the service center for the S corporation because QSST elections are filed with the service center where the S corporation files its income tax return and ESBT elections will be filed where the trust files its income tax return under the new procedures set forth in these proposed regulations, when finalized. The IRS and the Treasury Department specifically request comments on whether the rules for filing QSST elections similarly should be changed to permit the filing of a QSST election with the service center where the trust files its return rather than with the service center for the S corporation(s).

7. Consent to the S Corporation Election

Notice 97-12 provides that, for purposes of the ESBT's consent to the S corporation election under section 1362(a), only the trustee needs to consent to the S corporation election because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election. These proposed regulations, when finalized, will modify and replace the rules in Notice 97-12.

Under the proposed regulations, if the ESBT is also a grantor trust, the deemed owner must also consent to the S corporation election because such owner will be taxed on all or a portion of the S corporation's income. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

8. ESBT Taxation

The proposed regulations provide that, for federal income tax purposes, an ESBT consists of an S portion, a non-S portion, and in some instances a grantor portion. The items of income, deduction, and credit attributable to any portion of the ESBT treated as owned by a person under the grantor trust rules of subpart E, including S corporation stock and other property (the grantor portion), are taken into account on that individual's tax return pursuant to the normal rules applicable to grantor trusts. Other items of income, deduction, and credit are, pursuant to these proposed
regulations, attributed to either the S portion, which includes the S corporation stock, or the non-S portion, which includes all other assets of the trust. The S portion is subject to tax under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The other requirements of section 642(c)(1) must also be met for the contribution to be deductible by the S portion, and the deduction is limited to the amount of the gross income of the S portion. If a payment is made to a charitable organization by the ESBT pursuant to the terms of its governing instrument, such payment is deductible, subject to the provisions of section 642(c)(1), to the extent it is paid from the gross income of the non-S portion of the trust. Thus, if the ESBT contributes S corporation stock to a charitable organization, no deduction is allowed under section 642(c)(1) because the contribution is not paid out of the gross income of the non-S portion.

The proposed regulations provide guidance regarding the treatment of proceeds received by an ESBT from the sale of S corporation stock when income from the sale is reported on the installment method under section 453. The income recognized with respect to the installment proceeds is taken into account by the S portion. The interest on the installment obligation is taken into account by the non-S portion.

The proposed regulations provide that if a trust holds S corporation stock and is already an eligible S corporation shareholder and the trust makes an ESBT election during the trust's taxable year, the electing trust will be treated as a separate taxpayer for purposes of allocating S corporation items under section 1377(a)(1). However, the ESBT election does not result in the prior trust being treated as terminating its entire interest in its S corporation stock for purposes of section 1.1377-1(b), unless the prior trust is one described in section 1361(c)(2)(A)(ii) or (iii). Therefore, the S corporation is generally not permitted to make the election to terminate the taxable year under section 1377(a)(2). The trust will be treated as a single taxpayer for purposes of determining the taxation of distributions from the trust. Thus, distributions made after the effective date of the ESBT election may still carry out distributable net income of the trust earned during the taxable year before the effective date of the ESBT election.

The proposed regulations provide that for purposes of determining whether the exception to estimated taxes under section 6654(d)(1)(B) applies, the trust will not be considered a different taxpayer as a result of the ESBT election. Therefore, if the ESBT makes estimated tax payments equal to 100 percent of the prior year's tax liability, no penalties will apply.

The proposed regulations provide that interest expenses paid on loans used to purchase the S corporation stock must be allocated to the S portion of the ESBT but are not deductible by the S portion because they are not administrative expenses.
9. ESBT Terminations

The proposed regulations provide that generally a trustee must seek the consent of the Commissioner to revoke its ESBT election by obtaining a private letter ruling. However, the Commissioner's consent is granted for revocations that occur on the conversion of an ESBT to a QSST under the procedures set forth in the proposed regulations.

The proposed regulations provide that if an ESBT fails to meet the definitional requirements of an ESBT under section 1361(e), the trust's ESBT status terminates immediately upon such failure to qualify. However, if an ESBT acquires an ineligible potential current beneficiary, the ESBT has 60 days in which to dispose of all of its S corporation stock to prevent termination of the S corporation election. If the S corporation stock is not disposed of within the 60-day period, then the S corporation election will terminate as of the first day that the ineligible person became a potential current beneficiary.

Finally, the proposed regulations provide that an ESBT election generally is terminated if the ESBT fails to hold any S corporation stock. However, a trust will continue to be treated as an ESBT if it is reporting income from the sale of S corporation stock under the installment method of section 453.

10. Proposed Effective Date

The regulations regarding ESBTs under section 1.641-1(d) through (k), section 1.1361-1(h)(1)(vi), (h)(3)(i)(F), (j)(12), and (m), section 1.1362-6(b)(2)(iv), section 1.1377-1(a)(2)(iii) and (c) Example 3 are proposed to apply on and after the date the final regulations are published in the Federal Register. The IRS and the Treasury Department have become aware of potentially abusive transactions involving ESBTs that assume the applicability of the rules of section 641(c) to the taxation of the grantor portion of such trusts. See Notice 2000-61, 2000-49 I.R.B. 1. Thus, the regulations regarding taxation of ESBTs under section 1.641(c)-1(a), (b) and (c) are proposed to be applicable for taxable years of ESBTs that end on and after the proposed regulations are published in the Federal Register.

F. SECTIONS 2031 and 2512 – VALUATION

1. Valuation of Voting Stock of Closely-Held Corporation. The case of the Estate of Richard R. Simplot v. Commissioner, 112 T.C. No. 13 (1999), is very important. In 1993 Richard Simplot died owning 18 of the 76,445 shares of the Class A voting stock, and 3,942.48 of the 141,288,584 shares of the Class B non-voting stocks of J.R. Simplot Co., a closely-held corporation best known for being the primary supplier of potatoes to McDonalds but also operating in a variety of other businesses. At issue was the value of the decedent's stock.

After determining the underlying value of the company as a whole, the court calculated the per share value of the Class A and Class B shares. The court then applied to the Class A shares a 3% premium of the value of the whole company. Finally the court applied a 35% discount for the Class A shares, and a 40% discount for the Class B shares, based on the lack of marketability. That result was a value for a Class A share of $215,539.01 and the value of a Class B share of $3,417.05.
The rationale for the 3% premium for the voting stock was not entirely clear. An important consideration was the ratio of the number of Class A shares to the number of Class B shares, which was approximately 1 to 1,848. The opinion states:

We recognize that on the valuation date the hypothetical buyer of decedent's 18 shares of class A voting stock would not have the ability to control the Company's management and would be subject to the philosophy of the other three class A shareholders, all of whom were related and had family interests to protect. And obviously, an investor would pay more for a block of stock that represents control than for a block of stock that is only a minority interest in the Company. On the other hand, here, no one individual had a controlling block of voting stock.

We also recognize that Don, Gay, and Scott [the other voting Shareholders] would want to maximize their children's interest in the Company and that if a sale or liquidation of J.R. Simplot Co. occurred or if the Company merged with or into another, the benefits derived therefrom would probably be distributed not by class of stock, but rather on an equal per-share basis, regardless of class. In other words, after having paid for voting privileges, if on or after June 24, 1993, the Company were merged, sold, or liquidated, the hypothetical buyer would suffer a loss if the proceeds of the sale, merger, or liquidation were to be distributed among all shareholders of J.R. Simplot Co. on a pro rata share basis, rather than on a class basis.

On the other hand, we agree with Mr. Matthews [one of the IRS experts] that although on the valuation date decedent's class A voting shares constituted a minority interest in J.R. Simplot Co., it was foreseeable that one day (but NOT ON the valuation date) the voting characteristics associated with them could have "swing vote" potential if the hypothetical buyer combined his 18 class A voting shares with Scott's 22,445 shares or joined with Don and Gay (combined having 36 class A voting shares) to form a control group.

Considering and weighing all of these factors, we adopt Mr. Matthews' lower range figure of 3 percent of J.R. Simplot Co.'s equity value as the fair premium for the voting privileges (NOT voting control) associated with the class A stock of J.R. Simplot Co. We have adopted Mr. Matthews' 3-percent premium for voting privileges because we give the greatest weight to the fact that Don, Gay, and Scott would be inclined to vote in a manner that would maximize their children's interests. Thus, we believe the collective premium for the voting privileges of the 76,445 shares of class A stock of J.R. Simplot Co. as of the valuation date is $24.9 million (3 percent x $830 million), or $325,724.38 per share.

The court appeared uncomfortable with its decision:

A few final words before leaving the valuation issues. We recognize the disparate ratio of our determined value before consideration of a liquidity discount of the class A voting stock ($331,595.70 per share) to that of the class B nonvoting stock ($5,695.09 per share), that is a ratio of approximately 58 to 1. This disparity is the consequence of the unique capital structure of J.R. Simplot Co. and the skewed ratio of the number of class A voting shares to the class B nonvoting shares, that is, approximately 1 to 1,848.
The decision is unprecedented and can be criticized. In the real world would a buyer pay more unless acquiring control? The benefit of being a director, for instance, seems ephemeral as an economic matter.

If the Simplot rationale were followed with respect to transfers of general partnership interests, significant taxable gifts could result. To illustrate, suppose a family limited partnership were formed with 100 general partnership units and 9,900 limited partnership units and owned $10 million in marketable securities. If a 3% premium were attributed to the general partnership units then the value of the 100 general partnership units would increase from $100,000 to $400,000.

The Ninth Circuit reversed and remanded the Tax Court on May 14, 2001, 87 AFTR2d ¶2001-923, in a 2-1 decision. The majority opinion was straightforward:

The Tax Court in its opinion accurately stated the law: "The standard is objective, using a purely hypothetical willing buyer and willing seller . . . . The hypothetical persons are not specific individuals or entities." The Commissioner himself in his brief concedes that it is improper to assume that the buyer would be an outsider. The Tax Court, however, departed from this standard apparently because it believed that"the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value." Obviously the facts that determine value must be considered.

The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. "All of these factors," i.e., all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers.

The Tax Court erred further by finding what premium all the Class A shares as a block would command and then dividing this premium per each Class A share. Doing so, the Tax Court valued an asset not before it -- all the Class A stock representing complete control. There was no basis for supposing that whatever value attached to complete control a proportionate share of that value attached to each fraction of the whole. Under the applicable regulations, the fair market value of"each unit of property" is to be ascertained; in the case of shares of stock, "such unit of property is generally a share of stock." 26 C.F.R. section 20.2031- 1(b).

The Tax Court committed a third error of law. Even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the Commissioner can show that a purchaser would be able to use the control "in such a way to assure an increased economic advantage worth paying a premium for." Ahmanson Foundation v. United States, 674 F.2d 761, 770 (9th Cir. 1981). Here, on liquidation, all Class B shareholders would fare better than Class A shareholders; any premium paid for the 18 Class A shares be lost. Class A and B had the right to the same dividends. What economic benefits attended 18 shares of Class A stock? No"seat at the table" was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special
advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders. See Estate of Curry v. United States, 706 F.2d 1424, 1430 (7th Cir. 1983).

Much of the Commissioner's argument is devoted to speculation as to what might happen after the valuation date -- the Simplots might fall out with each other, the purchaser might find ways of making Simplot more profitable and persuade the company to adopt his strategy, the purchaser might be willing to wait fifteen years to get any return. The speculation is as easily made that the company would go downhill when its founder, J. R. Simplot, 84 at the valuation date, retired; or that McDonald's, Simplot's largest customer for its potatoes, would change its supplier; or that Micron would prove to be an unwise investment. Speculation is easy but not a proper way to value the transfer at the time of the decedent's death. Olson v. United States, 292 U.S. 246, 259 (1934). In Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share.

The dissent's view was that the purchaser would pay a premium in hopes of reselling the shares to form a majority block:

The question then becomes whether Scott, who owns 29.35% of the A shares, would be willing to pay a little less than four million dollars in order to gain voting control of a company worth $830 million, or whether Don and Gay, who together own 47.10% of the A shares, would be willing to pay that amount to gain such control. I believe the answer is clear. Scott, Don, and Gay would each be extremely interested in controlling the A shares, because with control of the A shares they could make decisions -- such as issuing dividends or taking the company public -- that would be of economic advantage to them and their descendants given their substantial ownership interest of the B shares and their descendants' beneficial ownership of B shares. Scott, Don, and Gay themselves have substantial ownership of B shares, and trusts benefitting their descendants have much greater ownership of B shares. Once the B share interest is taken into account, the disjunction between voting rights and economic interests disappears with respect to Scott, Don, and Gay. Given these facts, our hypothetical buyer, "maneuvering a course between them," would be able to able to sell 18 A shares for a substantial amount. In my view, that amount probably exceeds the $3.9 million valuation reached by the Tax Court. At the very least, I can find no clear error in the Tax Court's valuation of $3.9 million.

2. **Partnership Interests.** The value of a 25% assignee interest in a Texas general partnership that automatically dissolved upon the decedent's death was entitled to a 5.4% discount for selling expenses in Patricia M. Adams, et al. v. United States, 83 AFTR2d ¶ 99-691 (U.S. N.D. Tx. 1999). The decedent created a general partnership with her siblings which had a net asset value of approximately $33 million at her death which consisted of ranch land, marketable securities, and mineral interests. At the decedent's death, the partnership dissolved according to Texas law because the partnership agreement did not provide for it to continue and, also by operation of Texas law, the decedent's heirs became assignees of her interest. Texas law allows the remaining partners to either wind up the partnership or continue it as a new partnership.
The district court concluded that a hypothetical buyer would choose to receive 25% of the partnership’s net assets rather than continuing as an assignee because of the limited rights an assignee has. The estate argued that a hypothetical buyer would not pay full value for the interest. The court disagreed noting that the existing partners had a strict fiduciary duty to the assignee while liquidating and valuing the assets to determine the assignee’s share. Thus the court did not apply a lack of marketability or minority interest discount.

The district court also rejected a “portfolio discount” even though the partnership had a mix of assets because, again, the purchaser would receive actual assets not a partnership interest. The estate also argued that a hypothetical buyer would pay less for an interest that has uncertain rights and obligations or carry the high potential for litigation but the court did not find any such potential because it found that estate law was very clear.

The district court did conclude that a discount for the cost of selling the assets was appropriate and found the discount to be 5.4%.

On July 5, 2000, the Fifth Circuit reversed and remanded, 96 AFTR2d 2000-5090, because the district court likely misinterpreted Texas law:

This estate tax case presents a single issue: Whether discounts for lack of control, lack of marketability, and poor portfolio diversity are applicable when appraising the value of an assignee's fractional interest in a Texas general partnership for estate tax purposes. The district court correctly identified the relevant interest of the partnership in question — that of a partner's assignee, not that of a full-fledged partner — but reached the erroneous legal conclusion that the assignee of a 25 percent partner's interest has a "well-established" right to receive a 25 percent pro rata share of the partnership's net asset value ("NAV") without being reduced by such discounts. Proceeding on the basis of this erroneous conclusion of law, the district court held that the assignee's interest would change hands between a willing buyer and a willing seller for a price equal to such an undiscounted 25 percent ratable share of the partnership's NAV.

Our "Erie Guess" would likely be that — under the Texas partnership law, which is applicable to this case — an assignee's interest in a partnership would be subject to such discounts; but, more significant to today's inquiry, we are firmly convinced that it is anything but "well-established" that a partner's assignee has the right to receive a 25 percent share of NAV. We discern a very real possibility that, as a matter of law, the holder of an assignee interest in the partnership could be stuck with an unmarketable interest in a partnership that owns a poorly diversified mix of assets and over which the assignee has no legal control. If this proved to be the case, the fair market value of the 25 percent assignee interest would be substantially less than a straight, ratable 25 percent share of the partnership's NAV, thereby reflecting these undesirable characteristics. More to the point, the legal uncertainty that obscures the extent, if any, to which an assignee has the right to provoke liquidation or, alternatively, to force a straight pro rata redemption of his interest, suggests that any effort to exercise such putative rights would be met with strong resistance from the remaining partners. This legal uncertainty — which raises the specter of costly litigation in addition to an adverse result — is itself a factor that must be taken into account when appraising the fair market value of an assignee's interest for estate tax purposes. We therefore reverse the district court's judgment in favor of the government and remand the case for further proceedings.
Texas law is substantially similar to most states' partnership law in this respect.

3. **Aggregation of Stock.** The holding in *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996) was followed in a case appealable to the Ninth Circuit by the Tax Court in *Estate of Harriett R. Mellinger v. Commissioner*, 112 T.C. No. 4 (1999). The decedent and her husband originally owned, as community property, 4.9 million shares of Frederick's of Hollywood, Inc. Frederick died first and left his community property interest of 2.46 million shares in a QTIP trust for the benefit of Harriett. The remaining 2.46 million shares were owned by Harriett in her own revocable trust.

Together the two blocks of stock represented 55.7% of the stock. The estate valued these shares as separate 27.8% interests using a discount of about 30%.

The court valued the interests separately but applied a 25% discount. The court rejected the IRS argument that the decedent should be treated as the owner of the QTIP property for valuation purposes under section 2044. The court noted that neither decedent had any power of disposition over the assets of the QTIP trust. The Tax Court followed *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999) in the *Estate of Ambrosinia Blanche Lopes v. Commissioner*, T.C. Memo. 1999-225.

*Estate of Ethel S. Nowell v. Commissioner*, T.C. Memo. 1999-15, came to the same conclusion as *Mellinger* with respect to a partnership interest. Chief Judge Mary Ann Cohen wrote the opinion in both *Nowell* and *Mellinger*.

Also at issue in *Nowell* was whether the interest in the partnerships passing at the death of the decedent should be valued as an assignee interest or as partnership interest. The Tax Court determined that the interest should be valued as an assignee interest because the estate tax is levied on the property interests that were transferred at decedent’s death as determined by applicable state law.

The partnership was created under the Arizona limited partnership act which provided that a limited partner could not transfer the partner's interest without the consent of the general partner unless the partnership agreement provided otherwise. Here, the partnership agreement did not provide otherwise. The court noted that whether general partners will consent is a subjective factor that would not be taken into consideration under the objective standard of the hypothetical buyer, hypothetical seller analysis, citing *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982), *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982), and *Kolom v. Commissioner*, 71 T.C. 235 (1978), affd. 644 F.2d 1282 (9th. Cir. 1981).

The opinion did not state whether the previous practice of the partnership had been to admit assignees as limited partners.

In FSA 200119013 the IRS took the position that the *Bonner* line of cases did not apply to assets held in a general power of appointment marital trust.

Further, this position is consistent with the recent litigation concluding that fractional or minority interests in property held in a trust qualifying as qualified terminable interest property (QTIP), includible in the decedent's gross estate under section 2044, is not aggregated for valuation purposes with fractional or minority interests in property owned outright by the decedent. *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996).
States, 84 F.3d 196 (5th Cir. 1996); Estate of Mellinger v. Commissioner, 112 T.C. 4 (1999), acq., 1999-2 C.B. xvi; Estate of Lopes v. Commissioner, TCM 1999-225; Estate of Nowell v. Commissioner, TCM 1999-225. As discussed below, the nature of the surviving spouse's interest in a marital deduction trust subject to a general power of appointment and includible in the gross estate under section 2041 is fundamentally different from the QTIP trust situations previously addressed by the courts.

The FSA discussed one aspect of Mellinger:

The estate next cites language in the Tax Court's decision in Estate of Mellinger v. Commissioner where the court, in reaching the conclusion that assets includible under section 2044 are not aggregated with assets includible under section 2031, stated:

Furthermore, at no time did decedent possess, control, or have any power of disposition over the ... [property] in the QTIP trust. Cf. secs. 2035, 2036, 2041 (requiring inclusion in the gross estate where a decedent had control over the assets at some time DURING HER LIFE).

Estate of Mellinger v. Commissioner, 112 T.C. 35-36 (emphasis added.)

The estate infers that the reference to control "during her life" indicates that the Tax Court would not view a testamentary general power, which can only be exercised to dispose of the property at death, as according the decedent sufficient control over the property to justify aggregation. For several reasons, we do not agree.

First, we believe the statement, as it applies to testamentary powers, merely recognizes that in the case of a testamentary power, the power holder has the power to dispose of the assets at death but exercises that power during life by executing the appropriate instrument. Thus, the power holder has lifetime control over the property in the sense that the power holder's control is exercised during life, and becomes effective on death. Many courts have characterized testamentary general powers of appointment as providing the holder with lifetime control. For example, in Fidelity-Philadelphia Trust Co., v. Rothensies, 324 U.S. 108 (1945), the decedent held a contingent testamentary general power of appointment and the Court commented that, "[T]he ultimate disposition of all the trust property was suspended during the life of the decedent." See also, Goldstone v. United States, 325 U.S. 687 (1945) (applying the decision in Fidelity-Philadelphia Trust Co. to a decedent's reversionary interest). In Peterson Marital Trust v. Commissioner, 102 T.C. 790, 800 (1994), aff'd, 78 F.3d 795 (2d Cir. 1996), the Tax Court characterized the surviving spouse, as the holder of a testamentary general power of appointment, as having "maintained effective control over the disposition of the property in the marital trust until her death." Thus, we do not believe the quoted language can reasonably be viewed as referencing only inter vivos general powers of appointment.

In Nowell, the decedent had a testamentary special power of appointment:

Finally, the estate argues that in Estate of Nowell the decedent possessed a testamentary limited power of appointment over the trust assets, and, thus, could exercise a degree of control over the disposition of the trust assets at death. Nonetheless, the court did not take this power into account in finding that
aggregation was not appropriate. We recognize that in some situations, a limited power of appointment may afford the holder broad powers of disposition. However, the power holder would not, in any event, be authorized to appoint the property to his or her estate (or his or her creditors) as is the situation presented with a general power.

Thus, there is a significant practical difference between the two kinds of powers, and this difference is reflected in the tax treatment accorded the two powers. For tax purposes, property subject to a limited power is not treated as effectively owned by the power holder, and is not subject to inclusion in the gross estate. Given the nature of a limited power, and the fact that a limited power is not recognized for estate and gift tax purposes as affording the power holder sufficient control to generate any transfer tax consequences when possessed or exercised, the court in Estate of Nowell was justified in treating a QTIP trust subject to a limited power in the same manner as a QTIP trust where the remainder beneficiaries are designated by the first spouse to die. However, as discussed above, it does not follow that the same result should obtain in this case where the Decedent possessed a general power of appointment over Trust A.

4. Valuation of Construction Company Using Discounted Cash Flow Method. The Tax Court adopted the discounted cash-flow method to determine the value of a construction business in May T. Rakow v. Commissioner, T.C. Memo, 1999-177, finding that a 31% minority discount was appropriate. The taxpayer argued that future cash flows were too uncertain in the construction business to be a basis for valuation because of the risk inherent in the business — such as poor estimates, delays, litigation over accidents, defects, non-performance, and cyclical demands — but the court rejected that argument because this particular construction company did not suffer disproportionately from any of those risks. On the other hand, the court rejected the use of an asset base valuation approach because the construction company was not a holding or an investment company.

The gift involved 1,780 shares of common stock out of a total of $6,340. The taxpayer’s original value was $354.89 per share, and the IRS assessed value was $606.65 per share. The court determined the value to be $413.59 per share.

5. Importance of Reliable Experts and Relevance of Post-Death Sales. The case of Estate of Alice Friedlander Kaufman v. Commissioner, T.C. Memo. 1999-119, illustrates the importance of having a competent and credible appraiser. At issue was the value of almost 20% of the stock in a closely-held company, Seminole Manufacturing Co., a maker of uniforms. The taxpayer contended that the value of the shares was $29.77 based on sales two months after the valuation date of two blocks, one of 4.7% and another of 3.25%, sold to other family members. The court found that those sales were not truly at arm’s length because the sellers were not reasonably informed about the facts relating to the stocks’ value before they sold.

The estate had engaged an expert as had the IRS. However, the IRS’ expert’s report used the wrong valuation date and made other mistakes and thus was held irrelevant other than as a rebuttal to the taxpayer’s expert.

The court found that the taxpayer’s expert was unpersuasive, and the taxpayer’s expert testimony was unsupported by the record, so that the court gave no weight to the taxpayer’s expert and accepted the IRS determination.
of the stock which was $56.50 per share. The case contains a lengthy discussion of the inadequacy of the taxpayer’s expert, ranging from confusion about the expert’s assumptions, to mistakes in the interpretation of valuation methods. The case should be reviewed by any expert preparing valuation opinions.

However, on the substance, the Ninth Circuit reversed in James J. Morrissey, et.al. v. Commissioner, 87 AFTR2d ¶2001-643 (2001). The Court held that the post-death sales were reliable:

In 1993, A. Max Weitzenhoffer, Jr. (Weitzenhoffer) asked Merrill Lynch to appraise the value of a minority interest. The Merrill Lynch final report was delivered to him on July 5, 1994. However, on March 29, 1994 Merrill Lynch wrote Weitzenhoffer giving its formal opinion that the fair market value of a minority interest was $29.77 per share.

On the basis of this report Weitzenhoffer advised two shareholders that Merrill Lynch set the value at $29.70 per share, and each sold to him at this price. Edmund Hoffman sold him his 10,000 shares on May 12, 1994; Jacquelyne Weitzenhoffer Branch sold him her 6,960 shares on June 16, 1994. Each seller subsequently testified before the Tax Court that the price was fair and that the sale had been under no compulsion.

The Estate filed an estate tax return valuing the stock at $29.77 per share. The Commissioner of Internal Revenue assessed the stock at $70.79 per share and asserted a deficiency based on this amount.

No good reason existed to reject the sales by Branch and Hoffman as evidence of the fair market value of Seminole stock on April 14, 1994. The sales took place close to the valuation date. The sellers were under no compulsion to sell. There was no reason for them to doubt Weitzenhoffer's report of the Merrill Lynch valuation. That the final report was delivered only in July did not undercut the weight of the formal opinion letter written in March. The sellers had no obligation to hire another investment firm to duplicate Merrill Lynch's work.

The Commissioner tries to make something out of the family connections of the sellers with the buyers. They were not especially close. Hoffman had an uncle related by marriage to Weitzenhoffer's uncle; there is no English word to name this relationship. Branch was Weitzenhoffer's first cousin. Each seller testified that there was no intention to make a gift to Weitzenhoffer.

The Commissioner notes that Hoffman was a very successful businessman, so that the Seminole stock may not have meant much to him. People don't get to be very successful in business by treating valuable property carelessly. To be sure, there was a seven cents spread between Merrill Lynch's price and Weitzenhoffer's offer; the resulting difference of $700 and $487.20 were in context de minimis.

The Commissioner also notes that Branch had a misimpression that Seminole still owned a losing facility that it had, in fact, already sold. Nonetheless Branch was rightly aware that a substantial loss had occurred due to this facility in 1991 when no dividends had been paid. Both sellers were aware that dividends had, even in prosperous years, been meager.
On the other hand, in *William J. Desmond v. Commissioner*, T.C. Memo. 1999-76, the court largely accepted the estate’s expert in valuing Deft, Inc. The court looked at two methods to determine value, what is described as the income method, the discounted cash-flow method, and the market method, comparing the stock to public companies.

The chart shows the calculations of the court, following the taxpayer’s expert:

<table>
<thead>
<tr>
<th></th>
<th>Income</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unadjusted Value</td>
<td>$8,109,000</td>
<td>$10,410,000</td>
</tr>
<tr>
<td>Less Marketability Discount:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonenvironmental</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Environmental</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>Add Control Premium</td>
<td>25%</td>
<td>0%</td>
</tr>
<tr>
<td>Fair Market Value of 100 percent Interest</td>
<td>7,703,550</td>
<td>8,328,000</td>
</tr>
<tr>
<td>$x$ Decedent's Interest</td>
<td>81.93%</td>
<td>81.93%</td>
</tr>
<tr>
<td>$x$ Weight Given</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Fair Market Value of Decedent's Interest</td>
<td>3,155,759 + 3,411,565 =</td>
<td>6,567,324</td>
</tr>
</tbody>
</table>

As the chart shows, there was a significant environmental liability potential in the company because it was a manufacturer of paints, and that went into the lack of marketability discount when value was determined using the cash-flow method. In addition, because the decedent owned a majority of the stock the decedent could liquidate the company, which was an S corporation, at any time. Thus the court found that a control premium should be added in the discounted cash flow method. A control premium had already been added in the market method when reaching the $10,410,000 value.

With respect to calculating the amount of the lack of marketability discount, the court stated:

The following factors favor a high lack of marketability discount: (1) There was no public market for Deft’s stock; (2) Deft’s profit margins were below the industry average; (3) all stock in Deft was subject to a restrictive share agreement which provided that a shareholder could transfer his or her stock to a nonshareholder only after the shareholder offered the shares to the remaining shareholders; (4) given the size and low profitability of Deft, a public offering of the stock was unlikely in the future; (5) the size of the interest is so large that it may be hard to find potential buyers in the future who could finance such a purchase; and (6) where not already considered, Deft has large potential environmental liabilities.

Only one factor favors a low lack of marketability discount: Deft had an historical favorable distribution policy (it distributed most of the company’s earnings to its shareholders through higher-than-market compensation in the past).
We conclude that a 30-percent lack of marketability discount is appropriate for the Deft stock. Of this 30-percent discount, 10 percent is attributable to Deft's potential environmental liabilities. We shall apply the 30-percent lack of marketability discount to the unadjusted value we determined under the income method. We however shall apply only a 20-percent lack of marketability discount to the unadjusted value we determined under the market method because as discussed supra, the environmental liabilities have already been included in the unadjusted value under that method.

6. Discount for Built-in Capital Gains. Last year we saw the Davis case, which, for the first time, allowed a reduction in fair market value for built-in capital gains based on the theory that a hypothetical willing buyer would take into consideration and realize capital gains when valuing assets after the repeal of the General Utilities doctrine. How the reduction for built-in gains needs to be calculated is only beginning to be worked out. In Davis the court considered the reduction as part of a lack of marketability discount.

The Second Circuit held that built-in capital gains must be considered when valuing a C corporation, even if the corporation has no plan to liquidate. Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1998). The IRS has acquiesced in the decision. 1999-4 IRB 4. The only asset of the corporation was a rental building. The opinion states:

We disagree with the Commissioner's reasoning that the critical point in this case is that there was no indication a liquidation was imminent or that "a hypothetical willing buyer would desire to purchase the stock with the view toward liquidating the corporation or selling the assets, such that the potential tax liability would be of material and significant concern." Eisenberg v. Commissioner, 74 T.C.M. (CCH) 1046, 1048-49 (1997). The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the TRA any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute the fact that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer's inability to eliminate the contingent tax liability. See John Gilbert, After the Repeal of General Utilities: Business Valuations and Contingent Income Taxes on Appreciated Assets, Mont. Law, Nov. 1995, at 5 (citing a 1994 study that analyzed the impact of contingent tax liability on a buyer of a private, closely-held corporation and concluded a large majority of buyers would discount the stock and negotiate a lower purchase price due to the existence of a contingent tax liability on the corporation's appreciated property).

Further, we believe, contrary to the opinion of the Tax Court, since the General Utilities doctrine has been revoked by statute, a tax liability upon liquidation or sale for built-in capital gains is not too speculative in this case. Courts previously have allowed discounts for built-in capital gains if, among other factors, payment of tax on a capital gain is likely. See, e.g., Obermer v. United States, 238 F. Supp. 29, 34-36 (D. Haw. 1964) (finding expert testimony showed built-in capital gains tax would necessarily adversely affect value of stock at issue to willing buyer, and in allowing discount, contrasted the facts with Estate of Cruikshank, 9 T.C. 162, a case relied on by appellee); see generally Clark v. United States, No. 1309, 1309, 1975 WL 610, at *4,5 (E.D.N.C. May 16, 1975) (stating a well-informed willing
buyer of stock in corporation would consider that underlying assets of corporation included inactive investment portfolio that, upon liquidation, would incur substantial capital gains tax liability).

Although the Tax Court in this case held that "the primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative," Eisenberg, 74 T.C.M. (CCH) at 1048, we disagree. We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. We therefore remand this matter to the Tax Court to ascertain the gift tax to be paid by the taxpayer consistent with this opinion.

The only guidance given by the court for the way in which the potential capital gains tax should be considered is provided by footnote 16:

Where there is a relatively sizable number of potential buyers who can avoid or defer the tax, the fair market value of the shares might well approach the pre-tax market value of the real estate. Potential buyers who could avoid or defer the tax would compete to purchase the shares, albeit in a market that would include similar real estate that was not owned by a corporation. However, where the number of potential buyers who can avoid or defer the tax is small, the fair market value of the shares might be only slightly above the value of the real estate net of taxes. In any event, all of these circumstances should be determined as a question of valuation for tax purposes.

More recently, in Estate of Helen Bolton Jameson v. Commissioner, T.C. Memo. 1999-43, the court calculated the discount as the net present value of the capital gains tax liability as the court estimated it would be incurred. The company at issue was a timber company. The estate valued the stock on the basis of income not assets but the court disagreed and accepted the IRS's expert opinion as valuing the assets as a holding company was more appropriate.

As a holding company, the court found that the company would recognize its built-in gain as it cuts timber over time based on four variables: (1) the rate at which the timber grows, (2) the effects of inflation, (3) capital gains tax rates, and (4) the discount rate. The court selected variables within the range of figures offered by the various experts and assumed annual timber growth of 10%, 4% inflation, 34% in capital gains tax rate, and 20% discount rate. The court assumed 9 years of timber sales on a sustainable yield basis.

The estate owned virtually all of the company stock and the court rejected a 10% lack of marketability discount in favor of a 3% lack of marketability discount primarily because no expert testimony was offered by the taxpayer on that subject. The court found that approximately 3% of the company's total assets were completely unmarketable.

The court also rejected the estate's argument that having a small -- 2 or 3 percent minority shareholder -- should give rise to a nuisance discount.

The IRS had claimed a value of $77.00 per share, the estate $50.94 per share, and the court $71.00 per share.

The Sixth Circuit has reversed and remanded to the Tax Court the case of Estate of Pauline Welch v. Commissioner, 85 AFTR2d Par. 2000-534, No. 98-2007 (March 1, 2000), for a determination of the appropriate built in gains discount. The opinion gives no guidance on the calculation.
7. **Blockage Discount.** In general, blockage discounts have been decreasing over many years because of the increased volume. The appropriate blockage discount to apply to 2.2% of the common stock of Applied Power, Inc. was before the Tax Court in **Estate of Dorothy B. Foote v. Commissioner**, T.C. Memo. 1999-37. The taxpayer’s expert argued for a 22.5% discount and the IRS’ expert for a 2.3% discount.

The court accepted the IRS’ expert’s opinion. The IRS’ expert determined that there were 8 days in 1993, after the date of death, where more than 50,000 shares of Applied Power stock were traded and that the largest decrease on one of those trading days was 2.5% stock all for one of the largest trading volume days there was an increase in value of 1.5%. In contrast, the taxpayer’s expert had concluded the stock could best be disposed of in 7,000 shares per day increments over a period of 40 days.

Of particular interest is the court’s discussion of post-death events:

We are mindful that as a general rule only facts known at the valuation date are considered in determining the property’s value. However, subsequent market activities may provide helpful comparable sales. See **Estate of Newhouse v. Commissioner**, 94 T.C. 193, 218 n.15 (1990). Here, we believe the three sales by the Trust within 3-1/2 months of decedent's death to be relevant and reasonably proximate to the valuation date. This 3-1/2-month period was, in our opinion, a reasonable period of time following the valuation date.

Petitioner failed to show that the market price of the stock on the valuation date was an inaccurate reflection of the true value of the Trust's block of stock. The relative size of the block of stock at issue in relation to the amount of Applied Power stock outstanding, plus the monthly and yearly trading volumes for the stock of Applied Power, plus the fact that the entire block of stock was sold within an acceptable period of time after the valuation date (and on 3 trading days) suggest that only a minimal blockage discount is warranted. In our opinion, the depressing effect on the market of the Trust's sale of its stock is not commensurate with the 22.5- percent blockage discount estimate of Mr. Kleeman [taxpayer’s expert].

8. **Real Estate Corporation.** The tax court relied primarily on a discounted cash flow analysis, allowing for market absorption discounts, to conclude that the fair market value of the decedent’s one-third interest in a closely-held corporation involved in real estate development was approximately book value. **Estate of Lynn M. Rodgers v. Commissioner**, T.C. Memo. 1999-129.

9. **Actuarial Factors.** Section 7520 provides that the value of an annuity, life interest, interest for a term of years, and remainder and reversionary interests, for transfers after April 30, 1989, are to be determined using a discount rate, rounded to the nearest 2/10ths of one percent, equal to 120% of the applicable federal mid-term rate in effect under section 1274(d)(1) for the month in which the transfer occurs. Section 7520(c)(3) directed the Secretary of the Treasury to issue tables not later than December 31, 1989, using the then most recent mortality experience and to revise the table with respect to mortality experience not less frequently than every 10 years. T.D. 8819, REG-103851-99 contains the new tables for the most recent mortality experience available and is effective as of May 1, 1999. The new mortality tables are referred to as Life Table 90CM. The mortality tables indicate that for the most part individuals are living longer, except in the very oldest ages where life expectancies have actually declined since the 1980 tables.
10. **Comparison With Public Companies.** In *Estate of Brookshire v. Commissioner*, 76 T.C.M. 659 (1998) the Tax Court accepted the taxpayer's expert valuation of Brookshire Grocery Company, comparing it to certain public companies. The court allowed a 40% discount for lack of marketability.

Valuation of two private held telephone companies was at issue in *Barnes v. Commissioner*, 76 T.C.M. 881 (1998). The Tax Court largely accepted the opinion of the taxpayer's expert who compared the privately held companies that issue in the case to 10 local or regional publicly traded telephone companies with respect to price earnings ratios, dividends, price compared with cash flow, etc. The IRS argued that actual dividend payments were irrelevant and that only dividend paying capacity should be considered but the court disagreed finding that 6 of the 10 guideline companies paid out greater dividends than the privately-held companies. The court noted that the donees of the non-voting stock at issue had no right to participate in any decision related to the company and thus could not force the companies to pay dividends.

The court rejected the argument of taxpayer's expert in one regard, holding that no premium should be allowed in calculating the discount rate used to capitalize the companies to sort earnings. The court held that the taxpayer’s expert did not show that the companies were riskier than other comparably sized companies, primarily because all telephone companies are highly regulated.

The Tax Court also allowed substantial discounts of 40% of lack of marketability for one of the companies and 45% for the other company. The court noted that the donor’s family has controlled the companies for more than half a century and intend to keep control. Interestingly, the court pointed to the fact that a voting trust had been created, and life insurance has been purchased, as part of an estate plan, as indicating the intent to maintain the companies in the family. The court also noted that there had been no outside sales of the companies.

The court also allowed an additional discount for the non-voting stock, even though the voting stock was a minority interest of 3.66% based on the testimony of the taxpayer’s expert.

11 **Valuation of S Corporation Shares.** *Walter L. Gross, Jr., et al. v. Commissioner*, T.C. Memo 1999-254, involved the value of S corporation shares. The court did not allow the taxpayer to reduce the assumed cash-flow of the S corporation as if it were a C corporation. That is, the Court rejected "tax-affecting" the earnings. Arguably this is contrary to the training and audit handbooks of the IRS itself. The court also allowed a 25% marketability discount.

12 **Bank Stock.** At issue in *Estate of James Waldo Hendrickson v. Commissioner*, T.C. Memo 1999-278, was the valuation of stock in a closely-held bank in a small Indiana town. The opinion is a useful review of the application of appraisal factors generally. In particular, however, two findings are interesting.

The decedent owned 1499 shares, of 3000, which is 49.97%. One child owned 85 shares and the decedent’s ex-wife owned 610 shares. There were 29 other shareholders, each with at least 3 shares. The court found that the decedent’s shares should be valued as a control block.

The court applied a 30% lack of marketability discount as well.
13. **Blockage and Fractional Interest Discounts for Real Property.** In *Estate of Eileen K. Brocato v Commissioner*, TC Memo 1999-424, the court allowed an 11% blockage discount and a 20% fractional interest discount, largely accepting the taxpayer’s expert, for 8 apartment complexes of between 12 and 45 units each.

In *Estate of William Busch v. Commissioner*, T.C. Memo. 2000-3 (2000), the court allowed a 10% fractional interest discount for a 50% interest in real estate the highest and best use of which was residential. The court rejected the taxpayer’s expert’s claim of a 40% discount finding that discount to be based on studies of partnerships and REITS. The court gave no justification for 10% but did note that it would be “more than adequate to accommodate reasonable costs of partition” on the facts of the case.

Pending in the Tax Court is *Estate of Eileen Kerr Stevens v. Commissioner*, No. 22643-97, in which the IRS, on brief, cites its expert in ceding between a 10% and 20% discount for fractional interests in commercially leased real estate. The brief states that the costs of partition are one factor the expert relied on.

14. **Majority of Operating Company.** In *Estate of Beatrice Ellen Jones Dunn v. Commissioner*, T.C. Memo. 2000-12, the court valued a 62.96% interest in a heavy equipment rental business. The court applied a 5% discount for built-in capital gains, without useful discussion, and a 15% discount for lack of marketability, agreed to by the experts for the taxpayer and IRS. Under Texas law a shareholder cannot compel liquidation of a corporation without 66.67% of the vote. The IRS conceded a discount of 7.5% for lack of a super-majority.

15. **Closely-Held Company With an ESOP.** In *Estate of Sam Homer Marmaduke v. Commissioner*, T.C.Memo. 1999-342, the decedent died owning 22% of Hastings Books, Music & Video, Inc., a retailer. The decedent’s family owned 57% and an ESOP owned 21%. By general agreement, the value of the whole company was $100,000,000 on the date of death. Within a year of death there were a number of transactions involving small blocks of stock that used a value of $47 per shares, about a 20% discount.

Judge Swift determined that a discount below $47 per share was warranted, and valued the stock at $41.51 per shares, a 30% discount.

16. **Tax Court Values Decedent’s Stock in Two Nonpublicly Traded Corporations.** The value of one-third of a farm corporation and 12% of a family owned bank were at issue in *Estate of Helen J. Smith v. Commissioner*, T.C. Memo 1999-368. The case was mostly a taxpayer victory because Judge Gale was more persuaded by the taxpayer’s experts. One point is especially instructive. In valuing the farm corporation the court accepted an expert’s opinion that the valuation would be based 70% on assets and 30% on earnings.

17. **Value of Partnership with Pre-2703 Options.** Estate of Fred O. Godley v. Commissioner, T.C. memo 2000-242 involved the valuation of five 50% interests in housing partnerships owned by a decedent who died in May, 1990. The estate valued the interests at $10,000 each because the decedent’s son, Fred, Jr., could purchase the interests at that price. The Tax Court disregarded the options:

It is well settled that an option agreement may fix the value of a business interest for Federal estate tax purposes if the following conditions are met: (i) The price must be fixed and determinable under the agreement; (ii) the agreement must be binding on the parties both during life and after death; and (iii) the agreement must
have a bona fide business purpose and must not be a substitute for a testamentary disposition. See Estate of Bischoff v. Commissioner, 69 T.C. 32, 39 (1977); see also sec. 20.2031-2(h), Estate Tax Regs. Respondent does not dispute that petitioner meets the first two conditions but challenges whether the option provision had a bona fide business purpose and whether it was a substitute for testamentary disposition. According to petitioner, the option provision was inserted in each of the partnership agreements for the purpose of allowing Fred Jr. to maintain control of the businesses without the possibility of interference from other family members. The maintenance of family ownership and control constitutes a bona fide business purpose. See Estate of Bischoff v. Commissioner, supra at 39-40. However, even if we find that the option had a bona fide business purpose, it will be disregarded if it served as a device to pass decedent's interest to the natural objects of his bounty and to convey that interest for less than full and adequate consideration. See Bommer Revocable Trust v. Commissioner, T.C. Memo. 1997-380; Estate of Lauder v. Commissioner, T.C. Memo. 1992-736; see also sec. 20.2031-2(h), Estate Tax Regs. We find that the option provision in each of the partnership agreements represents a testamentary device to convey decedent's interest to his son for less than full and adequate consideration, and therefore we disregard it in determining the value of those interests.

Petitioner argues that the options were not a testamentary device because they were exchanged for full and adequate consideration. Petitioner claims that the options were granted in exchange for allowing decedent to participate as a 45- or 50-percent partner in the partnerships without a substantial contribution, either of cash or in kind, and that, therefore, decedent's agreement to concede to Fred Jr. all future appreciation exceeding $10,000 was the product of a bona fide, arm's-length transaction. That is, Fred Jr. testified at trial, and petitioner argues on brief, that Fred Jr.'s contribution to the partnerships substantially outweighed decedent's; namely, that Fred Jr. had the original idea of seeking HUD contracts; that Fred Jr. mastered the HUD bureaucracy and regulations encountered in the undertaking; and that, as managing partner, Fred Jr. did the lion's share of the work in developing and managing the housing projects, whereas decedent served merely as a "sounding board". Thus, petitioner's argument goes, decedent's agreement to give the options to Fred Jr. -- in which decedent effectively gave up any future appreciation in the value of his interests exceeding the $10,000 option price and settled for a share of each partnership's current operating income -- was arm's-length and bona fide, given the vastly unequal contributions of father and son.

When both parties to the agreement are members of the same family and circumstances indicate that testamentary considerations influenced the creation of the option agreement, we do not assume that the price as stated in the agreement was a fair one. See Bommer Revocable Trust v. Commissioner, supra; Estate of Lauder v. Commissioner, supra. We first note that the fixed price of the option, without any adjustment mechanism to reflect changing conditions, invites close scrutiny. If decedent and Fred Jr. really engaged in an arm's-length transaction in which it was decided that Fred Jr.'s greater contribution required decedent to give an option, we believe the price of the option would have included an adjustment mechanism to account for future appreciation. See Bommer Revocable Trust v. Commissioner, supra. The fact that the price was set at $10,000, combined with the fact that the agreement was between a father and son, strongly suggests that there was no arm's-length bargain for the option price, but rather that the option was a
testamentary device designed to pass decedent's interest for less than adequate consideration.

Moreover, the foregoing picture of the partners' relative contributions is based almost entirely on Fred Jr.'s self-serving testimony at trial. In contrast to Fred Jr.'s efforts to portray the options in the instant proceeding as the product of an arm's-length bargain, in their sworn testimony in the equitable distribution proceedings, Fred Jr. and decedent both characterized the options as "gifts", suggesting that both thought it was decedent who was giving something of value to Fred Jr., not the other way around. We note also that decedent's second wife provided detailed, credible testimony concerning decedent's frequent trips (on which she accompanied him) to inspect each partnership property and attend to problems thereby discovered; that decedent had an entire career's worth of experience in the construction business; and that Fred Jr.'s brother testified credibly that when decedent entered into a business venture, he was almost always in charge -- all of which tend to rebut Fred Jr.'s characterization of decedent's role in the enterprise as minimal.

On balance, we believe the evidence that the options were a substitute for a testamentary device outweighs any evidence of their bona fide business purpose. In an unusual circumstance, we have the sworn testimony of the grantor-decedent himself as to the options' essentially testamentary purpose, as well as the sworn testimony of the grantee to the same effect, albeit a grantee who now testifies in changed circumstances that the options had a bona fide business purpose.

Presumably in the equitable distribution case between Fred, Jr., the son, and his first wife, it was beneficial for the options to have been gifts.

18. **Use of Capital Asset Pricing Model.** The Tax Court will not accept an expert's use of this method unless a company is going public. In *Estate of Emily F. Klauss v. Commissioner*, T.C.Memo. 2000-191, the court stated:

Fuller [IRS expert] calculated his discount rate using the capital asset pricing model (CAPM). In contrast, Johnson [taxpayer expert] used a discount rate based on the build-up method. We believe that Fuller should not have used the CAPM in this case. Green Light should not be valued by using the CAPM method because Johnson and Fuller agreed that it had little possibility of going public. See *Estate of Maggos v. Commissioner*, T.C. Memo. 2000-120; *Estate of Hendrickson v. Commissioner*, T.C. Memo. 1999-278; *Furman v. Commissioner*, T.C. Memo. 1998-157.

19. **Burden of Proof.** The Ninth Circuit reversed the Tax Court in *Estate of Paul Mitchell v. Commissioner*, 87 AFTR2d Par. 2001-881 (9th Cir. 2001), finding that the testimony of the Internal Revenue Service's own expert at trial about the value of stock of JPMS (a closely-held corporation) in the Estate was sufficient to overcome the presumption of correctness for IRS determinations. The opinion states:

According to the Notice, the Commissioner concluded the value of the JPMS stock at the time of Paul Mitchell's death was $105 million. The Estate had reported the value at $28.5 million in its tax return. Due to the $76.5 million difference in value, the Commissioner asserted that the Estate owed an additional $45,117,089 in estate taxes, not including a total of $8,543,643 in penalties. At trial, Martin Hanan, a
witness for the Commissioner, valued the stock at $81 million — $34 million less than the Commissioner's original valuation. Furthermore, a letter written by the Commissioner's appraiser, AIBE Valuation, dated March 18, 1993, indicates that AIBE Valuation originally appraised Mitchell's interest at $85 million as a minority interest, but increased it to $105 million, at the request of the IRS, to reflect the Estate's interest as a controlling interest. We find that Hanan's testimony and the AIBE letter support the conclusion that the Commissioner's assessment was arbitrary and excessive. United States v. Stonehill, 702 F.2d 1288, 1294 (9th Cir. 1983) (holding that "where the assessment has separable items, . . . error which demonstrates a pattern of arbitrariness or carelessness will destroy the presumption for the entire assessment"); Cohen, 266 F.2d at 11 (holding that when the taxpayer has shown the determination to be arbitrary and excessive, the burden of persuasion shifts to the Commissioner to prove the correct amount of tax owed and the presumption as to the correctness of the Commissioner's determination is out of the case); see also Helvering v. Taylor, 293 U.S. 507, 513-15 (1935).

We conclude that the Tax Court erred in denying the Estate's Motion to Shift the Burden of Persuasion. Consistent with Cohen, because the Commissioner's determination was demonstrated, by its own experts, to be invalid, the Commissioner — and not the Estate — had the "burden of proving whether any deficiency exists and if so the amount." Cohen, 266 F.2d at 11. The Tax Court treated the case as one where the burden of proof made no difference; it did not find that one party failed to carry its burden, but proceeded with its own valuation, "weighing the evidence and choosing from among conflicting inferences and conclusions those which it considers most reasonable." Tax Court Order, Docket No. 21805-93 (July 8, 1998) (citing Comm'r v. Scottish Am. Inv. Co., 323 U.S. 119, 123-24 (1944)). However, in responding to the petitioner's second motion for reconsideration, the Tax Court erroneously stated that valuation was a matter of approximation and judgment "on which the PETITIONER has the burden of proof." (emphasis added). Because the burden of proving the evaluation of the Estate and the commensurate deficiency shifted to the Commissioner, it was error not to put the Commissioner to its proof.

The case was remanded to the Tax Court for a determination of value.

20. **Tax Court Recommends Settlement.** In John E. Wall, et. ux. v. Commissioner, T.C. Memo 2001-75, the taxpayers valued stock on gift tax returns at $221 per share and the IRS claimed $260 per share. During the litigation both sets of experts became more extreme. Judge Beghe upheld the $260 per share value and suggested the parties should have settled.

21. **Discounts, Closely-Held Stock.** In Donald J. Jarida, 181 TCM 1100 (2001) the donor's expert applied a 65.77% discount to minority interest gifts to each of four children in a holding company that owned almost all of a small Nebraska bank. The court applied a 40% discount. The IRS had argued for 20%. the court did not use the quantitative marketability discount model set forth by Z. Christopher Mercer in Quantifying Marketability Discounts (1997).

22. **Discounts, Real Estate.** In Estate of Augusta Porter Forbes, 81 TCM 1399 (2001), the court accepted the 30% discount propounded by the estate's expert. The opinion discusses the issue as follows:
Petitioner presented testimony of two expert witnesses: Mr. James F. Lawton (Lawton) and Mr. Glen A. Hultquist (Hultquist).

Lawton determined that a fractional interest valuation discount is appropriate because the QTIP trust's undivided interests were minority interests and because the market for such interests would be restricted taking into consideration the limited pool of potential buyers, the likely difficulty of securing financing, and the likely costs of partitioning the two separate parcels. Lawton was unable to locate comparable sales, but he determined that in the market in which the subject property is located, real estate brokers had applied fractional interests of 10 percent to 30 percent in liquidating partnerships. Based on this information, and taking into consideration the specific characteristics of the subject property, possible intra-family conflicts, and other factors adversely affecting the marketability of the two undivided interests in the subject property, Lawton concluded that a valuation discount of 30 percent is appropriate.

Hultquist, petitioner's other expert, concluded that the fair market value of the two undivided interests in the subject property as of decedent's date of death was $720,000, based on the correlated present value of net annual income streams that he projected from hypothetical partitions or forced sales of the subject property under various scenarios. Hultquist assumed that the QTIP trust's undivided interests included the value of pecan orchards but not the value of any timber. Because this assumption is contrary to our previous determination that the QTIP trust's undivided interests included no beneficial interest in the pecan orchards, his $720,000 estimate of discounted fair market value is of little utility.

Because Hultquist's $720,000 estimate of the discounted fair market value is approximately 36 percent less than what Hultquist assumed to be the undiscounted fair market value of the undivided interests in the subject property (again assuming that pecan orchards but not timber are included), petitioner argues that a 36 percent discount rate is appropriate. We disagree. We are unconvinced that a discount rate extrapolated from one set of indicated values, under assumptions inapplicable here, would correspond to the discount rate extrapolated from a different set of indicated values if the underlying assumptions were altered. Moreover, even disregarding his faulty assumptions, Hultquist's present value computations are inadequately explained and justified, particularly in regard to the manner in which he derived the projected revenues from his hypothetical partitions or forced sales and the manner in which he derived his chosen 14 percent equity yield for purposes of his present value computations.

Respondent's expert, Mr. Richard Parks (Parks), purported to use a comparable sales approach to determine an appropriate valuation discount for a 42-percent undivided interest in the subject property. Parks indicated that because he was unable to locate minority interest sales in the market where the subject property is located, he had identified three other "appropriate examples" involving: (1) a 1989 sale of an office building in Birmingham, Alabama; (2) a 1961 sale of a 128-acre vacant tract in Jefferson County, Alabama; and (3) a 1981 sale of a 1,600-acre tract known as Bell Plantation (location not specifically identified but apparently somewhere outside of Georgia). These three "comparables" suggested discounts ranging from 25 percent to 64 percent. With little explanation, Parks concludes that based on these examples and "other market oriented research completed by this
appraiser" (not otherwise described by Parks), the appropriate discount rate is 18 percent.

We are unpersuaded that the "examples" on which Parks bases his comparable sales analysis actually represent comparable sales. Even if they did, we find no adequate justification for his selection of an 18-percent discount rate -- a rate that is well below the smallest discount indicated by Parks' own "comparables". Consequently, we do not rely on Parks' report. See Rule I43(f)(1).

We are unsatisfied that any of the parties' experts have adequately justified their recommended discount rates -- a shortcoming that might be attributable in part to a lack of available empirical data. Given that the parties agree that some valuation discount is appropriate, however, and lacking any firm basis on which we might independently derive one, we accept Lawton's recommended 30-percent valuation discount as being the most reasonably justified of the opinions presented to us. This is the same discount rate that petitioner used in reporting the value of the undivided interests for Federal estate tax purposes.

G. SECTION 2032 -- ALTERNATE VALUATION AND SECTION 2032A -- SPECIAL USE VALUATION

1. Protective Election of Alternate Valuation. A protective election under section 2032 was allowed by TAM 9846002. The estate wanted to use the alternate valuation date only if the surviving spouse agreed to an elective share, which she did after the estate tax return was filed. In Estate of Mapes v. Commissioner, 99 T.C. 511 (1992), the Tax Court allowed a protective election that was conditional on section 2032A treatment not being allowed by the IRS.

There are other situations in which a protective election could be desirable. For example, suppose certain assets that have decreased in value may be includable in the gross estate (e.g. because of what could be a power of appointment), but the value of the other assets in the estate has increased.

In PLR 199942025 the estate made a protective election under section 2032 which would become effective only if the date of death value of the decedent's gross estate, and the estate tax and generation skipping tax, is higher than the value of the gross estate determined under section 2032 using the appropriate alternate valuation date. The facts were that the estate included a large block of publicly traded stock all of which was disposed of within the six months after the decedent's death. The estate intended to take a blockage discount which would reduce the value as of the date of death, but which might be disallowed by the IRS on audit.

2. Minority Interest. A minority interest discount may be taken for assets that then qualify for special use valuation. The IRS has acquiesced in Estate of Clara K. Hoover v. Commissioner, 69 F.3d 1044 (10th Cir. 1995). The assets there were a minority interest in a partnership for which a 30% discount was claimed.

3. Use of Comparables. In Estate of Lewis S. Thompson, III v. Commissioner, T.C. Memo. 1998-325 Tax Ct. Dkt. No. 14929-96, the Tax Court held that taxpayer's expert did not meet the regulatory requirements for a valid section 2032A election:

Section 20.2032A-4(b)(2), Estate Tax Regs., describes the documentation required from the executor in order to value property under section 2032A(e)(7)(A). The
regulation states that "The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property" for each of the 5 calendar years preceding the year of the decedent's death. Sec. 20.2032A-4(b)(2)(i) and (iv), Estate Tax Regs.

The determination of whether property is comparable is a factual one and is made according to "generally accepted real property valuation rules". Sec. 20.2032A-4(d), Estate Tax Regs. Factors to be considered in such a determination include, but are not limited to, whether the property is situated in the same locality as the specially valued property; whether the property is segmented or unified; whether the property is subject to flooding; and, in the case of timberlands, the comparability of the timber to the timber located on the property to be specially valued. Sec. 20.2032A-4(d), Estate Tax Regs.

Frazer [taxpayer's expert] utilized 8 timberland properties as comparables in his report. The report identified the lessor and lessee, the location of the property, the initial year of the lease, and the cash consideration paid for each of the 8 properties used as comparables. The report also listed the "Adjusted Net Lease Income/Acre" for the 8 properties and the "Average" thereof ($15). The report indicated no adjustments to any of the 8 properties used as comparables based on the factors set forth in section 20.2032A-4(d), Estate Tax Regs.

For the following reasons, we conclude that the report is completely unreliable as to whether any of the 8 properties were indeed comparable to the subject property. The putative comparables ranged in size from 44 acres to 34,365 acres, yet no adjustment to any of them was made for size even though the substantially disparate sizes of the properties would appear to have some significance in terms of economies of scale. Frazer also did not make any adjustments for location, land quality, or timber type/maturity in his report. Moreover, no description of the properties was contained in the report, from which Frazer appears implausibly to be inferring that they were sufficiently similar so as to warrant none of the above adjustments.

We are also not convinced that the special use valuation of the subject property was based on actual cash rents of the putative comparables as is called for under the regulations. Section 20.2032A-4(b)(2)(iii), Estate Tax Regs., provides that "appraisals or other statements regarding rental value as well as area-wide averages of rentals * * * may not be used under section 2032A(e)(7) because they are not true measures of the ACTUAL CASH RENTAL VALUE OF COMPARABLE PROPERTY in the same locality as the specially valued property." (Emphasis added.)

Although in effect for the 5 years preceding decedent's death in 1992, the 8 timberland leases were entered into over the 27-year period from 1957 through 1984. For those leases which did not contain rent escalation clauses, Frazer claimed to have applied the "Producer Price Index" (PPI) to the consideration stated therein in an effort to calculate the market rental value of those properties for the 5-year period preceding decedent's death. The result was termed the "Adjusted Net Lease Income/Acre" in his report.

In Estate of Carolyn J. Rogers v. Commissioner, T.C.M. 2000-133, the court reached a different conclusion from that of Thompson.

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In Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, we concluded that the taxpayer had failed to identify comparable real properties and cash rentals within the meaning of section 2032A(e)(7), where the expert's adjusted net lease income per acre figures were more akin to an appraisal, which is expressly prohibited by section 20.2032A-4(b)(2)(iii), Estate Tax Regs., rather than an accurate calculation of actual cash rents.

In Estate of Thompson we concluded that the expert's report was completely unreliable as to whether any of eight properties were indeed comparable to the subject property for the following reasons. First, the alleged comparable properties ranged in size from 44 acres to 34,365 acres, compared to the subject property of 2,929 acres. In addition, the expert made no adjustments due to differences in location, land quality, or timber type/maturity. Moreover, no description of the properties was contained in the expert's report.

In decedent's estate here, five out of seven tracts share nine out of the nine applicable features set forth in section 20.2032-4(d), Estate Tax Regs. For decedent's estate, the range in size of comparables is much tighter: comparables of 261 to 1,665.28 acres (for subject properties ranging from 65-1670 acres). Furthermore, Dr. Haney excluded potential comparables because of differences in location, land quality, and timber type/maturity. Dr. Haney excluded the potential comparable in Fayette County because of location; he excluded a Pickens County tract with somewhat different slope and soil. Further, Dr. Haney proposed a 10-percent reduction to four of the subject properties, because of the superior quality of timber on the five leased tracts. As noted previously, however, such a reduction is inappropriate as appraisals are not true measures of the actual cash rental value of comparable property. Moreover, petitioner provided detailed descriptions of the subject properties and the leased properties in the original estate tax return; more detailed descriptions of the leased properties are provided in the leases and Dr. Haney's reports.

The eight leases in Estate of Thompson were entered into over a 27-year period, some with no rent escalation clause. For those leases with no rent escalation clause, the expert claimed to have applied the "Producer Price Index" (PPI) in an effort to calculate the market rental value of those properties for the 5-year period preceding decedent's death. Petitioner requested that we take judicial notice of Report 807, Escalation and Producer Price Indexes: A Guide for Contracting Parties issued by the U.S. Department of Labor, Bureau of Labor Statistics in September 1991 for the purpose of establishing that the PPI can be applied to contract rents to calculate accurately fair market rents for future years in the absence of escalation clauses, as the expert claimed to have done. We determined in Estate of Thompson that:

Report 807 does not support the proposition that market rents for the relevant period can be accurately calculated from contract rents entered into several decades beforehand via the application of the PPI for purposes of section 2032A(e)(7)(A) for those leases which do not themselves contain rent escalation clauses. Rather, Report 807 provides guidance to contracting parties with respect to the use of price adjustment clauses at the time the contract is entered into. * * *
In Estate of Thompson the average gross cash rental for the 5 years preceding the
decedent's death was determined by the expert on the basis of his "personal
knowledge * * * what I thought would be the indicated market rent for what I knew
about the whole business, and that's it." Furthermore, the expert testified that he
validated his estimate of the cash rental rate for the timberland by reference to the
prevailing rate for cropland during the relevant period, of which there was no
evidence.

In decedent's estate here, the special use valuation of the five estate tracts is based
exclusively on actual cash rents from the five leased tracts for the 5 years preceding
decedent's death. All five leases for the five leased tracts contain rent escalation
clauses; as escalated, the leases constituted the prevailing rents during the statutory
period on that type of land. Both the actual rents and State and local property taxes
were explained and are fully substantiated with original source data. There is no
adjustment to rents because petitioner used only actual current rents during the
statutory period.

Respondent also asserts that the five estate tracts and the five leased tracts are not
comparable in any manner in regard to the rental values. Respondent contends that
the regulations require that "generally accepted real property valuation rules" be
applied to determine comparability of the property. Sec. 20.2032A-4(d), Estate Tax
Regs. Respondent asserts that the maximum period allowed under real estate
valuation rules is 5 years prior to the valuation date. On brief, respondent states this
argument as follows:

Leases that establish the applicable rents are leases that would have been
negotiated and entered into during the five-year period. Leases that were
negotiated more than five years prior to the date of death do not accurately
reflect the economic conditions at the date of death and the current rental
values of comparable lands. Comparability must be based on numerous
factors, no one of which is determinative. See sec. 20.2032A-4(d), Estate
Tax Regs. All factors generally considered in real estate valuation are to
be considered in determining comparability under section 2032A. See id.
However, respondent seeks to exclude the comparable land on the basis
of one factor and one factor only (the age of the leases -- which is not
even one of the factors enumerated in the regulations).

Neither the statute nor the regulations support respondent's position in that respect.
In this case, the parties stipulated that the typical timber lease in effect in western
Alabama between 1987 and 1991 was entered into in the 1950's, 1960's, and early
1970's and was a long-term timber lease. Respondent's argument would exclude
every lease executed before August 19, 1987, which would effectively operate to
prevent estates in Alabama from using section 2032A(e)(7) to value timberland
since the typical timber lease in effect in western Alabama between 1987 and 1991
was entered into in the 1950's, 1960's, and early 1970's.

Respondent has submitted an original and two rebuttal reports from his expert,
Richard Maloy. Mr. Maloy contends that, "Comparable leases must have been
negotiated under recent (5-year period of analysis) dates to ensure comparability
of economic conditions." Mr. Maloy is simply parroting respondent's primary legal
argument that would inject an arbitrary requirement for application of section
2032A(e)(7) -- that is, as a matter of law no lease can be considered unless it was
executed within 5 years of the date of death. We have stated before, in Alumax v. Commissioner, 109 T.C. 133, 171 (1997): "We shall disregard any opinion of an expert that constitutes nothing more than that expert's legal opinion or conclusion about a particular matter."

Mr. Maloy further states the following: "Lease comparability under section 2032A(e)(7) would require recent leases, foreseeable within the 5-year average. This is relatively easy in row crop valuation, but generally eliminates the use of this section in timber land valuation."

Two consecutive paragraphs establish that the protection afforded farms by section 2032A was intended to apply to timberland. Section 2032A(e)(7) sets forth the "Method of valuing farms." Section 2032A(e)(4) and (5) leaves no doubt that timber operations are included under section 2032A(e)(7) and (8). Furthermore, factor (7) under section 20.2032A-4(d), Estate Tax Regs., obviously contemplates that rented timberland may be comparable property.

As stipulated, the leases represented the typical timber leases in effect in western Alabama during the 5-year statutory period. Moreover, the inflation-adjusted rents paid under these leases constituted the prevailing rents in effect during the statutory period. All of the leases on the five leased tracts have escalation clauses. Moreover, in contrast to the fatal "judgment call" as to the annual rents in Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, the parties have stipulated the precise, actual annual gross rents for the statutory period. Consequently, with their escalation clauses, the stipulated rents constitute the prevailing rents actually paid on comparable land in western Alabama under the typical/standard lease in effect during the statutory period. Once the unleased and the leased land are determined to be comparable (as we have found), section 2032A(e)(7) permits petitioner to use for valuation purposes the average annual gross cash rents for the 5 calendar years preceding decedent's death.

4. **Grant of Development Easement is a Disposition.** In Estate of James C. Gibbs, Sr. v. United States, 82 AFTR2d ¶ 98-5557 (3rd Cir. 1998) the court held that granting a development easement to the state of New Jersey was a disposition of qualified farm property that triggered recapture of estate tax under section 2032A(c)(1). The court’s rationale was that the heir benefitted from the property’s “highest and best use” through the grant of the easement. Stated differently, the court viewed the land as a bundle of two rights — the land’s agricultural use, plus non-agricultural development rights. In order to obtain special use valuation the estate had to warrant that only agricultural use would be made during the 10-year recapture. By granting the easement the owner benefitted from the development value of the land.

5. **Time to Make Election.** In Estate of Eddy v. Commissioner, 115 T.C. No. 10 (2000) the estate tax return was filed more than 18 months after it was due. Section 2032(d) provides that the election must be made not later than one year after the due date, including extensions, of the estate tax return. Thus, the election was denied.

H. **SECTIONS 2035-2038 -- RETAINED INTERESTS**

1. **Requirement that Trustees Pay Grantor’s Income Taxes.** PLR 199922062 dealt with an interesting issue. A grantor intended to create a foreign trust that would be a grantor trust for income tax purposes. The
trust would require the trustee to pay, on behalf of the grantor, to the IRS or to a state revenue authority, income or principal to satisfy the grantor's income tax liability attributable to the trust. The issue presented in the ruling was whether such requirement constituted a retained interest under section 2036. The Service concluded that such direction would not be a retained interest; however, if the trustee were required to make distributions to reimburse to grantor for any tax liabilities not attributable to the trust the grantor would have retained section 2036 power. The ruling did not state why the payments would not be made to the grantor directly, but presumably the ruling would have been the same had the payments been so made. The payment provision itself was a direction to the trustee to distribute an amount by which the personal income tax liability of the grantor exceeded what the grantor's personal income tax liability would be if he were not the owner of any portion of the trust.

2. **Sale of Remainder Interest.** Section 2702 does not apply to residences. Where a client has a long life expectancy the sale of remainder interest in a residence may be more attractive than a qualified personal residence trust. This transaction will be effective, however, only if section 2036 does not apply to the sale of a remainder interest. In *Estate of Cyril I. Magnin*, 184 F.3d 1074 (9th. Cir. 1999) the court followed *D'Ambrosio v. Commissioner*, 101 F.3d 309 (3rd. Cir. 1996) and *Wheeler v. United States*, 116 F.3d 7489 (5th Cir. 1997) to hold that the term “adequate and full consideration” under section 2036(a) refers only to the amount of the remainder interest of the transferred property. The Service's position was that in order for adequate and full consideration to be present the sale must be for the value of the entire property rather than just the value of the remainder interest. The policy arguments supporting the court's decision were that the purpose of section 2036(a) is to prevent depletion of a decedent's estate and the true fair market value of a remainder interest must track the value of a life interest in order to be consistent under the Internal Revenue Code.

The Circuit Court remanded the case to the Tax Court for determination from the value of the consideration in the case. The Tax Court held that the decedent (Cyril) did not receive adequate and full consideration for the remainder interest he agreed to transfer at death to his children pursuant to a 1951 agreement. That agreement required Joseph Magnin, Cyril's father, to give shares in two companies to Cyril which gave him control, and obligated Cyril to transfer the shares to his children at death. The opinion states:

> Before analyzing the positions of each party, we note the facts that: (1) Cyril had a higher percentage of voting control in JM than Joseph prior to the 1951 Agreement, and Cyril's total shares were worth more outright under either party's valuation standards; (2) Cyril received only a life estate in one-half of Joseph's shares, although he obtained voting control of all of Joseph's shares; (3) Cyril was required to transfer his shares to his children on his death and could not dispose of the shares during his lifetime for his own personal gain; and (4) under the 1951 Agreement, Joseph agreed to will his shares to Cyril's children and those shares, coupled with the shares Cyril was required to leave to his children under the 1951 Agreement, represented voting control of JM.

Respondent employed a fair market value approach and determined the value of the interests transferred and received by Cyril under a hypothetical willing buyer and willing seller standard. Fair market value for Federal estate and gift tax purposes
is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U.S. 546, 551 (1973); Snyder v. Commissioner, 93 T.C. 529, 539 (1989); sec. 20.2031-1(b), Estate Tax Regs; sec. 25.2512-1, Gift Tax Regs. The standard is objective; it uses a hypothetical willing buyer and willing seller. See Propstra v. United States, 680 F.2d 1248, 1251-1252 (9th Cir. 1982); Estate of Newhouse v. Commissioner, supra at 218. The willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage, and the views of each hypothetical person must be taken into account. See Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Kolom v. Commissioner, 644 F.2d 1282, 1288 (9th Cir. 1981), affg. 71 T.C. 235 (1978); Estate of Newhouse v. Commissioner, supra at 218; Estate of Kaufman v. Commissioner, T.C. Memo. 1999-119. The individual characteristics of the hypothetical buyer and seller are not necessarily the same as the individual characteristics of the actual buyer or actual seller. See Estate of Simplot v. Commissioner, supra at 152. However, "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect the value of the stock". Estate of Andrews v. Commissioner, supra at 956.

In valuing the interests transferred and received by Cyril, the estate assumes that the hypothetical buyer is a person in the same position as Cyril. The estate then applies a control premium to Joseph's minority block of shares because they will allow the hypothetical buyer in the same position as Cyril to obtain majority voting control of JM. This is not the proper application of the willing buyer and willing seller standard as set forth in the estate and gift tax regulatory provisions and as interpreted by case law because the willing buyer cannot be the actual buyer, he must be a hypothetical person. See Propstra v. United States, supra at 1251-1252; Estate of Bright v. United States, supra at 1005-1006; Furman v. Commissioner, T.C. Memo. 1998-157. The willing buyer and willing seller standard renders irrelevant the actual buyer and actual seller; however, the other stockholders are not irrelevant under the standard. See Estate of Bright v. United States, supra at 1007.

The estate relies on Estate of Winkler v. Commissioner, T.C. Memo. 1989-231, in arguing that Joseph's shares have "swing vote characteristics" because when combined with the shares of a hypothetical shareholder in the position of Cyril, that person would have majority voting control. The estate's reliance on Estate of Winkler v. Commissioner, supra, is misplaced. In that case, there were three shareholders with stock interests of 50 percent, 40 percent, and 10 percent, respectively. The main issue for decision was whether a minority discount applied for estate tax purposes of valuing the 10-percent interest. We held that the 10-percent interest possessed "swing vote characteristics" because a hypothetical buyer would be able to combine with one of the two remaining shareholders to either effect or block control of the company. We based our analysis on a hypothetical buyer, not one holding either the 40- percent or 50-percent interest. We concluded that the no minority discount should apply to the 10-percent interest. The instant case is distinguishable from Estate of Winkler v. Commissioner, supra. Cyril held 33.73 percent and Joseph held 28.26 percent of the voting stock of JM; collectively their shares represented 61.99 percent of the voting power. The evidence in the record does not establish the share ownership of the remainder of the stock of JM. It has not been established that a hypothetical buyer would be able to combine with another shareholder to effectuate control; thus, Joseph's stock has not been
demonstrated to have the "swing vote characteristics" described in Estate of Winkler v. Commissioner, supra.

1. VALUE OF CONSIDERATION RECEIVED BY CYRIL

No calculations were presented by the estate as to the values of the interests if a hypothetical buyer would not gain control as a result of the transfer by Joseph. Accordingly, the estate has failed to present sufficient evidence to establish that the values it assigns to the interests at issue are reliable and accurate under the willing buyer and willing seller standard set forth in the estate and gift tax regulatory provisions.

Although it claims to have used the hypothetical willing buyer and willing seller standard, in reality, the estate applied an actual buyer and actual seller standard because it based its valuation on parties in identical positions as Joseph and Cyril. It chose to look at the actual transaction and the logical inference that Cyril would have paid more for Joseph's minority-interest-voting rights because they would give Cyril voting control when added to his existing minority-interest-voting rights. In applying such a standard, the estate determined that the value of the consideration received by Cyril was approximately $58,000, of which approximately $44,000 consisted of control value received by Cyril.

The estate argues that a control premium must be applied in this circumstance because an actual, bargained-for transaction occurred in which Cyril obtained control of JM. But even if we were to accept the estate's argument, its application of its own "actual buyer-seller" test is flawed. First, the control premium and control value analysis, even if appropriate, were incorrectly applied. Mr. Browning applied the control value to the combined total of Cyril's share ownership after the 1951 Agreement. Thus, Mr. Browning took into account shares already owned by Cyril in valuing control. If Mr. Browning had applied his control value analysis to the percentage of shares owned only by Joseph, 28.26 percent, and not the combined percentage of the shares of Joseph and Cyril, 61.99 percent, the value of the consideration received by Cyril would have been approximately $29,000 using Mr. Browning's valuation methodology. Also, Mr. Browning's support for the 40-percent control premium is derived from studies of control premiums in the 1980's, and he did not establish that such a reference was reliable for purposes of a transaction occurring in 1951.

The estate also failed to address the issue of control in considering what Cyril transferred in exchange for Joseph's shares. Cyril bound himself to transfer a remainder interest in his shares to his children, and those shares, when combined with the shares transferred at death by Joseph to Cyril's children, constituted voting control of JM. The estate's expert agreed at trial that he might have been inconsistent in his approach. The estate did not consider the fact that Joseph bargained for and received from Cyril the right to dispose of control of JM after Cyril's death. Joseph was ensuring that his grandchildren received control of JM upon Cyril's death. If a control premium applies for purposes of valuing what Cyril received from Joseph, then it follows, in the facts of this case, that a control premium should also apply when valuing the interest Cyril transferred to, or at the direction of, Joseph. The application of a control element on both sides of the transaction would significantly increase the value of the remainder interest transferred by Cyril because a control element would attach to the remainder
interest in Cyril's shares. The number of shares transferred by Cyril was larger than
the number of shares received by Cyril, the full fee-simple interest in the stock was
transferred by Cyril at his death, and Cyril's life estate factor in Joseph's shares and
the remainder factor in the stock he transferred at death were approximately equal.
The estate presented no revised calculations or other evidence establishing that the
value transferred by Cyril, when adjusted for this control element, was less than the
consideration received from Joseph. The estate has failed to present sufficient
evidence to establish that the values it assigns to the interests at issue are reliable
and accurate under an actual buyer and actual seller standard.

The valuation methodology of Mr. Browning was questionable in other areas as well.
In determining the values of JM common stock and Specialty common and
preferred stocks, Mr. Browning applied a lack of marketability and liquidity
discount and a minority interest discount on a combined basis, instead of
individually. For example, Mr. Browning added together the 35-percent
marketability and liquidity discount and the 25-percent minority discount to get a
combined discount of 60 percent, which he then applied to the values before him.
As we noted earlier, discounts for marketability and minority interest are separate
and distinct, and this fact must be taken into account when such discounts are
applied in order to avoid distorting the valuation. While expert reports and the
courts sometimes apply combined discount rates to determine the value of stock,
this is a questionable procedure to use if specific rates are determined for each
discount and then added together to reach the combined rate. See Pratt, et al.,
Valuing a Business: The Analysis and Appraisal of Closely Held Companies 314
(3d ed. 1996). In order to ensure accuracy, the minority interest discount should be
applied first and then the marketability and liquidity discount should be applied to
this figure. Had this been done, the discounts would have yielded a combined
discount rate of 51.25 percent. Mr. Browning also applied a minority discount
to the values based on his market comparable analysis, although he agreed at trial
that traditional appraisers believe that the market approach yields a valuation on a
minority basis because the market approach is based on trading done by minority
stockholders. Mr. Browning testified that he applied a minority discount in this
situation because if he did not then his market approach generally yielded a value
higher than the value determined under his DCF approach. We do not find Mr.
Browning's explanation for applying a minority discount in this situation to be
satisfactory because it is not based on valuation standards, but rather on the fact
that he is adjusting his valuation simply to yield a result closer to that produced
under his DCF approach.

The Court of Appeals for the Ninth Circuit emphasized that, on remand, a
determination of "adequate and full consideration" requires a finding that the
exchanged interests are of "approximately equal value". Estate of Magnin v.
Commissioner, 184 F.3d at 1081 (quoting Estate of Davis v. Commissioner, 440
F.2d 896, 900 (3d Cir. 1968), rev. 51 T.C. 269 (1971)). This Court has not
interpreted the "adequate and full consideration" requirement as necessitating a
dollar-for-dollar matching of consideration paid with the value of the transferred
property. Estate of Carli v. Commissioner, 84 T.C. 649, 661 (1985); Estate of
O'Nan v. Commissioner, 47 T.C. 648, 663 (1967). Cyril transferred a remainder
interest in exchange for a life estate. The value of the remainder interest Cyril
transferred was between $90,000 and $110,000. The value of the life estate Cyril
received was $43,878. In the instant case, the approximately 2-to-1 disparity between the remainder interest transferred by Cyril and the consideration received by Cyril does not support a finding that the two interests were of "approximately equal value". Therefore, we hold that Cyril did not receive "adequate and full consideration" for the remainder interest he transferred to his children. The estate is entitled to an offset of $43,878 under section 2043 for the partial consideration received by Cyril.

3. **Stock Transferred to Partnership is Includable in Gross Estate.** TAM 199938005 is very important in the family limited partnership context. At issue was whether closely-held stock owned by a partnership which the decedent could vote as general partner in the partnership would be included in the decedent’s gross estate under section 2036(b). The IRS described the transaction as follows:

Decedent and his brother each owned a 50 percent interest in Corporation represented by W voting and X nonvoting shares of common stock. In Year 1, in conjunction with the renegotiation of Corporation's revolving credit agreement with Bank, Bank required the shareholders to devise a plan of management and ownership succession.

On Date 1 in Year 1, Decedent and his brother carried out the following transaction. Each transferred 55 percent of his stock to a family limited partnership (Partnership) (Y shares of voting and Z shares of nonvoting common) in exchange for 10 general partnership units, 1,000 Class A limited partnership units, 100 Class B limited partnership units, and 100 Class C limited partnership units. Also on Date 1, Decedent transferred 50 Class B units to Child 1, 50 Class B units to Child 2, 50 Class C units to Child 3, 50 Class C units to Child 4, and his remaining partnership units and stock to a revocable trust of which he was trustee (Trust). Under the terms of Trust, at his death, Trust assets passed to his four children.

In a letter dated one month before Date 1, the estate planning attorney for Decedent and his brother states that he has enclosed a draft of a new first Article to the partnership agreement of Partnership and a "draft of a gift trust that could be used to receive the B and C units that are intended to be given to the children at this time." The letter suggests that Decedent and his brother could create identical separate trusts or joint trusts with the end result being a single trust for each child to hold the child's B or C units.

Article 8.3 of the partnership agreement authorized the general partners to vote the shares of Corporation as follows:

Prior to the death of the survivor of [Decedent] and [his brother], the General Partners will have complete discretion regarding the voting of any Controlled Corporation's shares; provided, however, that if the General Partners cannot agree about how the shares of [Corporation] should be voted on any issue, then each General Partner shall vote a number of the Partnership's shares bearing the same proportion to the total shares owned by the Partnership that the number of General Partnership Units held by that Partner bears to the total number of General Partnership Units outstanding.
At his death on Date 2, Trust held Decedent's 10 general partnership units, his 1,000 Class A limited partnership units, and 22.5 percent of the outstanding stock in Corporation. On the federal estate tax return, the estate included in Decedent's gross estate, the date of death value of the 22.5 percent stock interest in Corporation and of the 10 general partnership units and 1,000 Class A limited partnership units.

The IRS concluded:

In this case, in view of the ownership of the Corporation stock by Partnership and Trust, and the decedent's right to vote the stock, Corporation was a controlled corporation for purposes of section 2036(b)(2) with respect to Decedent, between the date of transfer to Partnership and Decedent's date of death.

Further, the transfer of Decedent's Y shares of voting stock to Partnership is properly viewed as a transfer of the stock, for purposes of section 2036(b), for less than adequate consideration. That is, Decedent, in substance, transferred the stock to Partnership in exchange for 10 general partnership units and 1000 Class A limited partnership units. The 100 Class B and 100 Class C units passed to Decedent's children, pursuant to an integrated plan, at the moment Partnership was formed. Thus, these units cannot properly be viewed as received by Decedent in exchange for the transfer of his stock to Partnership. Because Decedent did not receive all of the consideration for his transfer of stock to Partnership, Decedent transferred the stock for less than adequate consideration for purposes of section 2036(b). In addition, it is doubtful that the transfer to the family owned partnership designed to produce an estate freeze could be characterized as a "bona fide" sale.

As a general partner, Decedent retained the right to vote the Y shares. In this regard, the statutory language expressly states that the statute applies where the decedent retains "either directly, or indirectly" the right to vote the stock. The legislative history indicates that the statute applies regardless of the capacity in which the decedent exercises the voting rights. The statute applies where the stock is voted by the decedent indirectly through a fiduciary, and accordingly, would necessarily apply where the decedent holds the voting rights directly, as a fiduciary. Accordingly, Decedent's retention of the right to vote Corporation stock in his capacity as a general partner constitutes the retention of the right to vote the transferred stock for purposes of section 2036(b).

The Service rejected the argument that because the decedent could only vote the stock in conjunction with the other general partner, section 2036(b) would not apply. In part that was because each general partner could vote a proportionate number of shares according to the provisions of the partnership agreement. In addition, the IRS specifically stated that "under section 2036(b), the retained right to vote transferred stock constitutes the retained enjoyment of the stock, and the legislative history indicates that the statute applies regardless of the capacity in which a decedent exercises the voting rights. Thus, we believe the statute applies even if the voting powers only exercisable by decedent in conjunction with another."

The proposed regulations under section 2036 agree with the ruling with respect to the ability vote the stock only in conjunction with someone else. Prop. Reg. § 20.2036-2(c). A transfer of non-voting stock by gift will not be included in a decedent's gross estate merely because the decedent retains voting stock. Prop. Reg. § 20.2036-2(a).
The provisions of 2036 must be examined whenever voting stock is to be given by means of a partnership over which the donor retains control.

4. **Retained Interest in Residence.** Clients often want to make gifts of interests in a residence while continuing to live in the residence. The issue arose in *Estate of Rebecca A. Wineman v. Commissioner*, T.C. Memo. 2000-193. The opinion states:

   The first issue for decision is whether decedent retained a life interest in the partial interests in her homestead property that she gave to her children. Respondent increased decedent's gross estate by the value of a life estate in the aggregate 24-percent interest of her homestead property (parcel 3) that decedent gave to her children. Respondent asserts that the value of that interest is properly includable in decedent's gross estate pursuant to section 2036(a) because she retained a life estate in that interest. Petitioner does not dispute respondent's valuation of the purported life estate but contends that decedent retained no such interest in her homestead property. Petitioner bears the burden of proof. See Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

   In support of its contention that decedent retained no life estate in the children's partial interests, petitioner points out that decedent used much less than 76 percent of parcel 3 and the main house. Petitioner also points to Dean's [one of the decedent's children] testimony to the effect that no agreement existed, implied or otherwise, for decedent to retain the possession and enjoyment of the partial interests at the time she transferred those interests to her children. Respondent argues that Dean's testimony is self-serving and contrary to the objective facts and circumstances. Although Dean's testimony was clearly self-serving, we disagree with the assertion that the testimony was contrary to the objective facts and circumstances, and we ultimately agree with petitioner that decedent did not retain a life estate includable in her gross estate under section 2036.

   A decedent's reservation of a life interest need not be provided for expressly in the instrument of transfer or enforceable under local law to be includable under section 2036. See *Estate of McNichol v. Commissioner*, 29 T.C. 1179 (1958), affd. 265 F.2d 667 (3d Cir. 1959). An implied agreement at the time of transfer for the decedent to continue possession or enjoyment of the property is sufficient and may be inferred from all the circumstances surrounding the transfer. See *Guynn v. United States*, 437 F.2d 1148, 1150 (4th Cir. 1971). In determining whether an implied agreement existed, "all facts and circumstances surrounding the transfer and subsequent use of the property must be considered." *Estate of Rapelje v. Commissioner*, 73 T.C. 82, 86 (1979); sec. 20.2036-1(a), Estate Tax Regs.

   Decedent gave her children, collectively, a 24-percent interest in parcel 3. Parcel 3 consisted of just over 10 acres and had two houses, two large barns, a small barn, a granary, a farm shop, cattle scales and corrals, two garages, and a small orchard. Pursuant to its leases of decedent's properties, Coastal Ranches stored hay in the barns, used the corrals and farm shop, and kept vehicles in a garage and one of the big barns. Decedent occupied the larger house, although Dean kept his desk and bookkeeping papers in one of the bedrooms and used it as an office. Another bedroom was used primarily by Marian when she visited from Montana. Coastal Ranches used an office in the main house. Dean resided in the smaller house on the
homestead property. Other than the main house, decedent's personal use of parcel 3 was limited to the garden and small orchard next to the main house.

Decedent's limited personal use of the property does not prove the absence of an implied agreement. In fact, the record is silent as to whether decedent could designate who might enjoy the property. See sec. 2036(a)(2); see also United States v. Byrum, 408 U.S. 125, 145 (1972) (possession and enjoyment are synonymous with substantial present economic benefit). The fact that decedent personally used less than all of the property does not demonstrate that she did not possess and enjoy the entire property.

In contrast, where a decedent continues exclusive possession and continues to pay taxes and other property expenses after the transfer and the owner of record title neither charges rent nor takes possession of the property, these facts are highly indicative of an implied agreement. See Guynn v. United States, supra at 1150; Estate of Rapelje v. Commissioner, supra at 87. Here, however, decedent shared the property with Dean and his wife and rented the property at a below-market rent (discussed in more detail infra sec. II) to Coastal Ranches. Pursuant to its leases, Coastal Ranches paid the taxes and other property expenses associated with parcel 3. These facts do not of themselves prove the absence of an implied agreement.

On balance, the objective facts convince us that an implied agreement giving decedent continuing possession and enjoyment of the entire homestead property did not exist. Unlike the authority that has been cited in respondent's brief, this case involves a transfer of less than a fee simple interest in property. The majority owner's continued use and possession of real property following transfer of a minority interest is not unusual. Cf. Gutches v. Commissioner, 46 T.C. 554, 557 (1966) (where a husband transferred his entire interest in a homestead property to his wife, who then allowed him to live in the house without charge, the donor's continued use and enjoyment is a natural use which does not diminish the wife's enjoyment and possession). In this case, decedent's continued use and possession of parcel 3, of which she owned a controlling interest, is natural in light of the children's minority ownership. It is not surprising that the children did not seek to partition the property, since they also used the property regularly and they had only a minority interest in the property.

In addition to the objective facts, our decision rests heavily on Dean's testimony that there was no understanding between decedent and her children. While his testimony was clearly self-serving, Dean's testimony was straightforward, unequivocal, and credible. Respondent's counsel chose not to cross-examine him on this point. Because we credit his testimony, we hold that petitioner has carried its burden of proving that there was no implied agreement. Cf. Hendry v. Commissioner, 62 T.C. 861, 872 (1974).

In general, it remains prudent to avoid gifts and sales of partial interests in residences.

I. SECTION 2040 — JOINT INTERESTS
No Developments.

J. SECTIONS 2041 AND 2514 — GENERAL POWERS OF APPOINTMENT
1. Power of Appointment Among Descendants. PLR 199938024 solved a significant drafting problem for a taxpayer. A decedent's son was given the power to appoint by Will among the "Grantor's issue and the spouses
of such issue.” The issue before the Service was whether the son had a general power of appointment. The Service determined that because the power was testamentary, the son could not appoint to the son or the son’s creditors during the son’s life and the son’s estate and the creditors of the son’s estate were not within the class of permissible appointees. Some states mandate the same result under applicable state law (e.g., Maryland). On the other hand, a broader power, might be a general power even if testamentary. See e.g. Dickinson v. Wilmington Trust Co., 734 A.2d 605 (Del. Cha. 1999) (A testamentary power to appoint to “such person or persons” as the power holder designated would be general).

A similar issue arose in TAM 200014002:

In the instant case, Decedent was a life income beneficiary and a co-trustee of the trust created under Item Seven of Spouse's will. The will directed the trustees to pay to Decedent all of the trust income for her comfort and support and for the comfort, education, and support of the children of Spouse and Decedent. The will further provided that should the income payable to Decedent be insufficient for her comfort and support and for the comfort, education, and support of the children of Spouse and Decedent, the trustees were authorized to encroach upon the trust corpus in such amounts as they deemed necessary, in their discretion.

However, as was the case in Rev. Rut. 54-153, under Mo. Ann. Stat. section 456.540.4, at the time of her death, Decedent, as both beneficiary and co-trustee, was prohibited from exercising her trustee powers to make discretionary distributions of trust principal to herself. Consequently, under Missouri law, as co-trustee and life beneficiary, Decedent held no power to invade trust principal for her own benefit. Thus, as provided in Rev. Rut. 54-153, Decedent was prohibited by the Missouri statute from participating in decisions to distribute trust corpus to herself. Accordingly, because Decedent did not have a power to appoint corpus to herself, or for her benefit, (whether or not limited by an ascertainable standard) no part of the value of the trust created under Spouse's will is includible in Decedent's gross estate under section 2041.

K. SECTIONS 83, 2042 AND 7872 - LIFE INSURANCE

1. Interim Guidance on Split-Dollar Life Insurance. TAM 9604001 stated that if the cash surrender value of a policy exceeded the premiums paid by the employer, section 83 would cause the excess to be treated as income. Following much consternation, nothing else was heard from the IRS for five years on this issue until IRS Notice 2001-10. The Notice itself is unclear and arguably internally inconsistent; nonetheless, the IRS has made it clear that guidance is coming that will likely reduce the aggressive planning opportunities that have been seen previously.

First, the Notice reviews existing authority:

II. BACKGROUND

Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12, addressed the Federal income tax treatment of split-dollar arrangements under which an employer and employee join in the purchase of a life insurance contract on the life of the employee subject to a contractual allocation of policy benefits between the employer and employee. The rulings described two contractual forms:
(1) the endorsement method, under which the employer is formally designated as
the owner of the contract, and the employer endorses the contract to specify the
portion of the proceeds payable to the employee's beneficiary; and (2) the collateral
assignment method, under which the employee is formally designated as the owner
of the contract, the employer's premium payments are characterized as loans from
the employer to the employee, and the employer's interest in the proceeds of the
contract is designated as collateral security for its loans.

These rulings conclude that all economic benefits conferred on an employee under
such an arrangement, excluding economic benefits attributable to the employee's
own premium payments, constitute gross income to the employee. See also
Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S.
177 (1945). Under the rationale of these rulings, the determination of an employee's
gross income is unaffected by whether the endorsement method or the collateral
assignment method is used.

Under the specific split-dollar arrangement addressed in Rev. Rul. 64-328, all
amounts credited to the cash surrender value of the life insurance contract inured
to the benefit of the employer. Thus, the only economic benefit inuring to the
employee was the value of the insurance protection attributable to the portion of the
contract's death benefit payable to the employee's beneficiary. Rev. Rul. 64-328
holds that, in such a case, the employee's gross income in any year includes the
value of the life insurance protection provided to the employee in that year, less any
amount actually paid by the employee.

Rev. Rul. 66-110 amplified Rev. Rul. 64-328 by holding that the value of any
economic benefits in addition to current insurance protection that are provided to
an employee under a split-dollar arrangement are also includible in the employee's
gross income. More specifically, Rev. Rul. 66-110 held that an employee has
additional gross income equal to the amount of any policyholder dividends
distributed to the employee or applied to provide additional insurance for the
exclusive benefit of the employee. Thus, where the employer has no interest in the
dividend applied to provide paid-up additional insurance, the taxable economic
benefit is the dividend itself, not the value of the insurance protection resulting
from the dividend.

Rev. Rul. 64-328 and Rev. Rul. 66-110 each addressed a situation in which the
employer possessed all beneficial interest in the cash surrender value of the life
insurance contract (exclusive of any separate cash surrender value of paid-up
additions attributable to dividends 1), and the employee was entitled only to certain
other economic benefits generated by the employer's investment in the contract,
specifically, current insurance protection or dividends. Consistent with that, Rev.
Rul. 64-328 revoked Rev. Rul. 55-713, 1955-2 C.B. 23, which had treated a split-
dollar arrangement similar to that addressed in Rev. Rul. 64-328 as a secured loan
from the employer to the employee. In rejecting the loan characterization, Rev. Rul.
64-328 stated that the substance of the split-dollar arrangement differed from that
of a loan because the employee was not expected to make repayment except out of
the cash surrender value or proceeds of the life insurance contract. But see,
Commissioner, 331 U.S. 1 (1947)] to have approved the Commissioner's decision
to treat a nonrecourse loan in this context as a true loan.

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Rev. Rul. 64-328 held that the table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, commonly referred to as the "P.S. 58" rates, may be used to determine the value of the current life insurance protection provided to an employee under a split-dollar arrangement. Rev. Rul. 66-110 amplified Rev. Rul. 64-328 in this respect by holding that the insurer's published premium rates for one-year term insurance may be used to measure the value of the current insurance protection if those rates are lower than the P.S. 58 rates and available to all standard risks. Rev. Rul. 67-154, 1967-1 C.B. 11, modified Rev. Rul. 66-110 by holding that an insurer's published term rates must be available for initial issue insurance (as distinguished from rates for dividend options) in order to be substituted for the P.S. 58 rates set forth in Rev. Rul. 55-747.

Similarly, the IRS has ruled that the economic benefit inuring to a third-party donee under an employer-employee split-dollar arrangement or to a shareholder under a corporation-shareholder split-dollar arrangement is to be determined under the principles and valuation methods set forth in Rev. Rul. 64-328, as amplified by Rev. Rul. 66-110. See Rev. Rul. 78-420, 1978-2 C.B. 67; Rev. Rul. 79-50, 1979-1 C.B. 138. Also, the same premium rate alternatives may be relied upon to measure the value of current life insurance protection provided to an employee under a qualified retirement plan. See Rev. Rul. 55-747, supra.

III. NEED FOR UPDATED GUIDANCE

A. EQUITY SPLIT-DOLLAR

None of the published rulings relating to split-dollar life insurance has directly addressed the forms of equity split-dollar arrangements that have been widely used in recent years. In contrast with the split-dollar arrangements described in Rev. Rul. 64-328 and Rev. Rul. 66-110, an employee's economic interest in a life insurance contract purchased under an equity split-dollar arrangement includes an agreed upon portion of the cash surrender value. Under the most common form of equity split-dollar arrangement, the employer's interest in the cash surrender value of the contract is limited to the aggregate amount of its premium payments, exclusive of any earnings component. In such cases, the employee derives the entire economic benefit of any positive return on the employer's investment in the life insurance contract.

Under such an equity split-dollar arrangement, the employee derives a valuable economic benefit from the employer's premium payments beyond the current life insurance protection addressed in Rev. Rul. 64-328. As held in Rev. Rul. 66-110, an employee who receives economic benefits beyond the value of current life insurance protection is taxable on the value of those additional benefits. Therefore, under the general principles followed in Rev. Rul. 64-328 and Rev. Rul. 66-110, it is necessary to account for the employee's rights in the cash surrender value under an equity split-dollar arrangement in a manner consistent with the substance of the parties' contractual positions.

Under section 83, which was enacted in 1969 and generally governs the income tax treatment of property transferred in connection with the performance of services, a life insurance contract is considered to be property to the extent of its cash surrender value. See section 1.83-3(e) of the Income Tax Regulations. Therefore, if the substance of an equity split-dollar arrangement involves the transfer of a
beneficial interest in the cash surrender value of a life insurance contract from an employer to an employee, that economic benefit is properly includible in the employee's gross income under section 83. For purposes of section 83, a split-dollar arrangement could, depending on the facts, involve a series of property transfers or a single transfer of property.

However, whether an equity split-dollar arrangement involves a transfer of property within the meaning of section 83 depends on the substance of the arrangement. See section 1.83-3(a) of the regulations. If the employee is the beneficial owner of the life insurance contract from the inception of the arrangement, there is no transfer of property under section 83. For example, assuming there is a reasonable and bona fide expectation that the employer will receive repayment of its share of the premiums at a fixed or determinable future date, then the arrangement may in certain circumstances be properly treated as an acquisition of a life insurance contract by the employee with the proceeds of a loan or series of loans from the employer to the employee secured by the life insurance contract, rather than as an arrangement whereby the employer acquires ownership of the life insurance contract and provides economic benefits to the employee thereunder.

Section 7872 of the Code, which was enacted in 1984, sets forth rules for determining the tax treatment of certain direct and indirect below-market loans. In general, section 7872 recharacterizes a below-market loan (a loan in which the interest rate charged is less than the applicable Federal rate, or "AFR") as an arm's-length transaction in which the lender makes a loan to the borrower at the AFR, coupled with a payment or payments to the borrower sufficient to fund all or part of the interest that the borrower is treated as paying on that loan. The amount, timing, and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender and whether the loan is characterized as a demand loan or a term loan. In the case of a compensation-related below-market loan within the meaning of section 7872(c)(1)(B), the imputed payments to the borrower are treated as compensation income.

The legislative history of section 7872 states that the term "loan" is to be interpreted broadly for purposes of section 7872, potentially encompassing "any transfer of money that provides the transferor with a right to repayment." H.R. Rep. 98-861, 98th Cong., 2d Sess. 1018 (1984). Treasury and the IRS believe that Congress generally intended that section 7872 would govern the determination of compensation income resulting from an arrangement the substance of which is a loan from an employer to an employee, and that there was no congressional intent to make section 7872 inapplicable to split-dollar arrangements if such arrangements are, in substance, loans.

The Notice then states:

IV. INTERIM GUIDANCE

A. CHARACTERIZATION OF SPLIT-DOLLAR ARRANGEMENTS

In light of the rationale set forth in Rev. Rul. 64-328 and the fact that no published guidance has addressed the potential applicability of section 7872 to split-dollar arrangements, Treasury and the IRS recognize that taxpayers have not generally treated employer payments under equity split-dollar arrangements as loans, and that
the below-market loan rules of section 7872 have not generally been applied to impute compensation income to employees from such arrangements. It is also recognized that, without further guidance, it may be difficult for taxpayers to determine whether an employer's payments under a split-dollar arrangement are properly characterized as loans for Federal tax purposes or whether the employer should instead be treated as having acquired a beneficial ownership interest in the life insurance contract through its premium payments and having provided economic benefits to the employee thereunder. Accordingly, pending consideration of public comments and the publication of further guidance, the characterization and income tax treatment of equity and other split-dollar arrangements will generally be determined under the following guidelines:

1. The IRS will generally accept the parties' characterization of the employer's payments under a split-dollar arrangement, provided that (i) such characterization is not clearly inconsistent with the substance of the arrangement, (ii) such characterization has been consistently followed by the parties from the inception of the arrangement, and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.

2. The IRS will permit an employer's payments under a split-dollar arrangement to be characterized as loans for tax purposes, provided that all of the conditions set forth in paragraph 1 are satisfied. In such cases, the tax consequences of the payments treated as loans will be determined under section 7872, the employee will not have additional compensation income for the value of the insurance protection provided under the life insurance contract, and the cash surrender value of the contract will not represent property that has been transferred to the employee for purposes of section 83. However, the employee ordinarily would have additional gross income if the employer's advances were not repaid in accordance with the terms of the arrangement. Moreover, the employee could have gross income under section 72 for distributions actually received under the life insurance contract.

3. In any case in which an employer's payments under a split-dollar arrangement have not been consistently treated as loans in accordance with paragraph 1, the parties will be treated as having adopted a non-loan characterization of the arrangement, and the parties must fully account for all of the economic benefits that the employee derives from the arrangement in a manner consistent with that characterization and with Rev. Rul. 64-328, Rev. Rul. 66-110, and the general tax principles upon which those rulings are based. In general, this means that (i) the employer will be treated as having acquired beneficial ownership of the life insurance contract through its share of the premium payments, (ii) the employee will have compensation income under section 61 equal to the value of the life insurance protection provided to the employee each year that the arrangement remains in effect, reduced by any payments made by the employee for such life insurance protection, (iii) the employee will have compensation income under section 61 equal to any dividends or similar distributions made to the employee under the life insurance contract (including any dividends described in Rev. Rul. 66-110 applied to provide additional policy benefits), and (iv) the employee will have compensation income under section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life
insurance contract, reduced under section 83(a)(2) by any consideration paid by the
employee for such interest in the cash surrender value.

4. Pending the publication of further guidance, the IRS will not treat an
employer as having made a transfer of a portion of the cash surrender value of a
life insurance contract to an employee for purposes of section 83 solely because the
interest or other earnings credited to the cash surrender value of the contract cause
the cash surrender value to exceed the portion thereof payable to the employer on
termination of the split-dollar arrangement. If future guidance provides that such
earnings increments are to be treated as transfers of property for purposes of
section 83, it will apply prospectively.

5. In any case in which the employer's payments under a split-dollar
arrangement have not been consistently treated as loans, then for so long as the
arrangement remains in effect, the IRS will treat the employee as continuing to
have gross income under section 61 for any current life insurance protection
provided to the employee under the arrangement, except to the extent allocable to
premium payments made by the employee (or included in the employee's gross
income under paragraph 6) or to any portion of the cash surrender value of the
contract that has been treated as a substantially vested transfer of property to the
employee under section 83. When such an allocation is required, the IRS will
accept a pro rata or other reasonable method for determining that portion of the
depth benefit allocable to cash surrender value beneficially owned by the employer
and that portion allocable to cash surrender value transferred to or purchased by the
employee.

6. If an employer makes a premium or other payment for the benefit of an
employee under a split-dollar arrangement, and the employer neither acquires a
beneficial ownership interest in the life insurance contract through such payment
nor has a reasonable expectation of receiving repayment of that amount through
policy proceeds or otherwise, such payment will be treated as compensation income
to the employee under section 61. See Reg. section 1.61-2(d)(2)(ii)(a); Frost v.

In sum, therefore, any payment made by an employer under a split-dollar
arrangement must be accounted for as a loan (see paragraph 2), as an investment
in the contract for the employer's own account (see paragraph 3), or as a payment
of compensation (see paragraph 6).

Essentially, the IRS wants the value to the employee to be accounted for, either as income, under section 83,
or as a loan under section 7872. The Notice does not discuss private (or intra-family) split-dollar; arguably, the same
policy arguments apply except that perhaps the choice is between a gift and a loan.

The most complicated aspect of the Notice deals with section 83. The Notices states:

However, whether an equity split-dollar arrangement involves a transfer of property
within the meaning of section 83 depends on the substance of the arrangement. See
section 1.83-3(a) of the regulations. If the employee is the beneficial owner of the
life insurance contract from the inception of the arrangement, there is no transfer
of property under section 83. For example, assuming there is a reasonable and bona
fide expectation that the employer will receive repayment of its share of the
premiums at a fixed or determinable future date, then the arrangement may in
certain circumstances be properly treated as an acquisition of a life insurance
contract by the employee with the proceeds of a loan or series of loans from the
employer to the employee secured by the life insurance contract, rather than as an
arrangement whereby the employer acquires ownership of the life insurance
contract and provides economic benefits to the employee thereunder.

The highlighted sentence is an important planning point.

Another important question unaddressed by the Notice is its application to existing split-dollar arrangements.

The life insurance industry has argued vigorously for grandfathering. Would grandfathering protect new premium
payments or only existing cash values?

The Notice also abolishes the use of the P.S. 58 Tables:

B. Revised Standards for Valuing Current Life Insurance Protection

Pending the consideration of comments and publication of further guidance, the
following interim guidance is provided on the valuation of current life insurance
protection:

1. Rev. Rul. 55-747 is hereby revoked, and the IRS will no longer treat or
accept the P.S. 58 rates set forth therein as a proper measure of the value of current
life insurance protection for Federal tax purposes. Nonetheless, for taxable years
ending on or before December 31, 2001, taxpayers may continue to use the P.S. 58
rates set forth in Rev. Rul. 55-747 for purposes of determining the value of current
life insurance protection provided to an employee under a split-dollar arrangement
or a qualified retirement plan.

2. Taxpayers may use the premium rate table set forth at the end of this
notice, captioned as Table 2001, to determine the value of current life insurance
protection on a single life provided under a split-dollar arrangement or qualified
retirement plan for taxable years ending after the date of issuance of this notice.

Table 2001 is based on the mortality experience reflected in the table of uniform
premiums promulgated under section 79(c) of the Code (see section 1.79-3(d)(2)
of the regulations), with extensions for ages below 25 and above 70, and the
elimination of the five-year age brackets. With the revocation of Rev. Rul. 55-
747, the rates set forth in Table 2001 are provided as an interim substitute for the
P.S. 58 rates that taxpayers may rely upon pending further consideration of how the
value of current life insurance protection should be determined for these Federal
tax purposes in the future. The premium rates set forth in Table 2001 are materially
lower than the P.S. 58 rates at all ages.

3. Taxpayers may continue to determine the value of current life insurance
protection by using the insurer's lower published premium rates that are available
to all standard risks for initial issue one- year term insurance as set forth in Rev.
Rul. 66-110, subject to the following additional limitations. First, for periods after
December 31, 2003, the IRS will not consider an insurer's published premium rates
to be available to all standard risks who apply for term insurance unless (i) the
insurer generally makes the availability of such rates known to persons who apply
for term insurance coverage from the insurer, (ii) the insurer regularly sells term
insurance at such rates to individuals who apply for term insurance coverage
through the insurer's normal distribution channels, and (iii) the insurer does not
more commonly sell term insurance at higher premium rates to individuals that the insurer classifies as standard risks under the definition of standard risk most commonly used by that insurer for the issuance of term insurance. Second, with respect to a life insurance contract (or individual certificate) issued after March 1, 2001, no assurance is provided that such published premium rates may be used to determine the value of life insurance protection for periods after the later of December 31, 2003, or December 31 of the year in which further guidance relating to the valuation of current life insurance protection is published.

L. **SECTION 2053 and 2054 - DEBTS AND ADMINISTRATION EXPENSES**

1. **Deduction for An Uncertain Amount.** In *Estate of McMorris v. Commissioner*, T.C. Memo 1999-82, the court determined that where a decedent took an estate tax deduction for income taxes which were owed, and subsequent developments produced an income tax refund, the estate tax deduction must also be reduced. In April 1990, Donn McMorris died and a few months later Evelyn McMorris received a partial distribution of certain closely-held stock from his estate which was redeemed in September, 1990. Evelyn McMorris died in March, 1991 and a deduction was taken on her estate tax return for a significant income tax. A significant part of the income was gain resulting from the redemption of stock because it was redeemed at considerably more than the value placed on it in Donn McMorris’ estate. Subsequently, the Donn McMorris estate and the IRS reached a settlement which increased the value of the stock in his estate, which in turn increased the basis of Evelyn McMorris in the stock and eliminated the income. Whereupon, she filed a claim for an income tax refund.

The issue was whether the original estate tax deduction in the Evelyn McMorris estate should be adjusted. The court determined that it should be because:

- a claim that is valid and enforceable at the date of a decedent’s death must remain enforceable in order for the estate to deduct the claim. Technical claims that disappear in the light of subsequent circumstances should not be allowed. Thus, postdeath events must be taken into consideration in determining the enforceability of a claim that a creditor fails to make and preserve within the time allowed by local law.

The court distinguished *Estate of Sachs v. Commissioner*, 88 T.C. 769 (1987), rev’d, 856 F.2d 1158 (8th Cir. 1988), which dealt with a post-death, retroactive, change in the tax laws.

The case was appealed and the question before the Tenth Circuit in *Estate of Evelyn M. McMorris*, 87 AFTR2d Par. 2001-668 (2001), was whether the section 2053 deduction in Evelyn’s estate should be reduced. The Tax Court said yes. The opinion relies on *Ithaca Trust*:

Neither section 2053(a)(3) nor the tax regulations clearly indicate whether events that occur after a decedent's death are relevant in calculating a deduction for a claim against the estate. The statute is silent on this issue. The regulations, on the other hand, contain language which arguably supports the positions of both parties. For instance, one regulation cited by the estate provides: "The amounts that may be deducted as claims against a decedent's estate are such only as represent personal obligations of the decedent existing at the time of his death." Treas. Reg. section 20.2053-4. But, another regulation relied upon by the Commissioner permits estates to deduct a decedent's tax liabilities as a claim against the estate even if the exact amount is not known, as long as the deduction "is ascertainable.
with reasonable certainty, and will be paid." Treas. Reg. section 20.2053-1(b)(3).

In light of these apparent inconsistencies, the most we can discern "from these Regulations is that the situation we now face is not expressly contemplated." Estate of Smith v. Comm'r, 198 F.3d 515, 521 (5th Cir. 1999).

We therefore begin our analysis with the leading case on this issue, Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). In Ithaca Trust, the decedent left the residue of his estate to his wife for life, with the remainder to certain charities. To ascertain the amount of the charitable deduction for estate tax purposes, the wife's residual was calculated with a mortality table and subtracted from the principal of the estate. However, the wife died much sooner than expected. The question for the Court was whether the value of the estate's deduction should be calculated according to the wife's life expectancy as of the date of the testator's death or by applying the wife's actual date of death. In a unanimous opinion, the Court adopted a date-of-death valuation rule: "The estate so far as may be is settled as of the date of the testator's death." Id. at 155. The Court acknowledged that "[t]he first impression is that it is absurd to resort to statistical probabilities when you know the fact," but it stated that "the value of the thing to be taxed must be estimated as of the time when the act is done," i.e., the passing of the decedent's estate at death. Id. The Court therefore concluded by stating that, as "[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done." Id.

Several courts have relied on the date-of-death valuation rule announced in Ithaca Trust to hold that events occurring after a decedent's death are irrelevant in valuing an estate's deduction under section 2053(a)(3). See Estate of Smith, 198 F.3d at 520-26 (allowing estate to deduct date-of-death value of claim against it even though estate later settled for lesser amount); Propstra v. United States, 680 F.2d 1248, 1253-56 (9th Cir. 1982) (same); Estate of Van Horne v. Comm'r, 78 T.C. 728, 732-39 (1982) (same), aff'd, 720 F.2d 1114 (9th Cir. 1983); Greene v. United States, 447 F. Supp. 885, 892-95 (N.D. Ill. 1978) (declining to consider creditor's failure to comply with statute of limitations for filing claim after decedent's death in allowing estate's deduction for claim); Russell v. United States, 260 F. Supp. 493, 499-500 (N.D. Ill. 1966) (same); Winer v. United States, 153 F. Supp. 941, 943-44 (S.D.N.Y. 1957) (same). While most of these courts acknowledged that Ithaca Trust involved a different section of the federal estate tax statute, i.e., charitable bequest deductions under the precursor to 26 U.S.C. section 2055, they interpreted the opinion as announcing a broad principle that the value of a taxable estate should be determined as closely as possible to the date of the decedent's death.

Other courts, however, have refused to extend the principle of Ithaca Trust beyond charitable bequest deductions, holding that postmortem events may properly be considered in calculating the value of a claim against the estate deduction. See Estate of Sachs v. Comm'r, 856 F.2d 1158, 1160-63 (8th Cir. 1988) (holding that Commissioner could rely on retroactive tax forgiveness legislation enacted four years after decedent's death in disallowing estate deduction for paying those taxes); Comm'r v. Estate of Shively, 276 F.2d 372, 373-75 (2d Cir. 1960) (holding that decedent's estate could not deduct full date-of-death value of spousal support obligations because ex-wife re-married before estate filed return); Jacobs, 34 F.2d at 235-36 (holding that husband's estate could not deduct amount of claim against it arising from antenuptial agreement as a result of wife's waiver of claim after
husband's death); Estate of Kyle v. Comm'r, 94 T.C. 829, 848-51 (1990) (disallowing estate's deduction for date-of-death value of litigation claim against it because case was resolved in estate's favor six years after decedent's death); Estate of Hagmann v. Comm'r, 60 T.C. 465, 466-69 (1973) (refusing to allow estate to deduct valid claims against it because creditors never filed those claims after decedent's death), aff'd per curiam, 492 F.2d 796 (5th Cir. 1974). 11 Although these courts have offered a variety of reasons why Ithaca Trust should be limited to charitable bequests, three recurring themes emerge.

One explanation for not extending Ithaca Trust to claims against the estate is that the congressional purpose underlying that deduction is different from that of deductions for charitable bequests. According to this rationale, the date-of-death valuation rule does not apply to section 2053(a)(3) because the purpose of that deduction is to appraise the decedent's actual net worth at death, while the purpose of section 2055 is to encourage charitable bequests by ensuring that if a testator makes a charitable gift in a prescribed form, a deduction will be allowed in a specified amount. See, e.g., Sachs, 856 F.2d at 1162 ("there is no legislative interest behind the section 2053(a)(3) deduction in encouraging claims against the estate in the same way that date-of-death valuation encourages charitable bequests").

Another justification for not applying Ithaca Trust to section 2053(a)(3) is based on the other deductions in the section. This approach places heavy reliance on the fact that section 2053(a) allows a deduction not only for claims against the estate but also for funeral and estate administration expenses. Under this view, since these expenses are calculated after death, Congress must also have intended that claims against the estate be ascertained by post-mortem events. See, e.g., Jacobs, 34 F.2d at 236 ("funeral expenses, administration expenses, and claims against the estate, under this paragraph, were intended by Congress to be determined in the course of an orderly administration of the estate").

Sound policy reasons support our adoption of the date-of-death valuation principle for section 2053(a)(3) deductions. Specifically, this principle provides a bright line rule which alleviates the uncertainty and delay in estate administration which may result if events occurring months or even years after a decedent's death could be considered in valuing a claim against the estate. See Appellant's Opening Br. at 22 ("This uncertainty would make estate administrators -- who are personally liable for the estate tax -- more reluctant to satisfy estate obligations and distribute estate assets."); Robert C. Jones, Note, Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death, 22 U.C.L.A. L. Rev. 654, 680 (1975) ("A large part of the delay involved in the probate of estates is attributable to a final determination of tax liabilities.... [A]llowing postmortem events occurring during the administration of the estate to govern, contributes to probate delay."). Our holding resolves these problems by bringing more certainty to estate administration, an ideal which has long been promoted by judge and commentator alike. See Shively, 276 F.2d at 376 (Moore, J., dissenting) ("In the field of estate tax law it is particularly important that there be as much certainty as possible."); Jones, Estate and Income Tax, supra, at 681 ("the current approach to timing the valuation of claims must be made more certain and consistent").
IRS has non-acquiesced in Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999), rev'g, 108 T.C. 412 (1997), cited above in McMorris, and distinguished. The conflict in the circuits may require a Supreme Court resolution. The IRS notice states:

Decedent died on November 16, 1990. At her death, Exxon had a claim against the estate that was being adjudicated in a United States District Court. In February 1991, the court ruled in favor of Exxon and referred the case to a Special Master to determine the amount of the liability. In April 1991, Exxon presented to the estate its $2,482,719 damages calculation. The executors deducted that amount on the estate tax return, which was filed in July 1991. On February 10, 1992, the estate settled the claim for $681,840 and paid this amount on or about March 10, 1992. The Commissioner determined that the estate was only entitled to a deduction for the amount actually paid, and the estate filed a petition in the United States Tax Court.

The Tax Court upheld the Commissioner's determination that the claim against the estate should be limited to the amount actually paid. The Tax Court held that, "[w]here a claim is disputed, contingent, or uncertain as of the date of the decedent's death, the estate is not entitled to a deduction until the claim is resolved and it is determined what amount, if any, will be paid. It is this latter amount that is allowed as a deduction." 108 T.C. at 419.

The United States Court of Appeals for the Fifth Circuit reversed, holding that the amount deductible was the fair market value of the claim on the date of death, rather than the amount paid to settle the claim as argued by the government, or the full amount of the claim as argued by the estate. The Fifth Circuit relied on the decision in Ithaca Trust v. United States, 279 U.S. 151, 155 (1929). In that case, the Supreme Court concluded that a post-death event (the premature death of the life tenant of a charitable remainder trust) should not be taken into account in determining the amount of the charitable deduction allowable under the predecessor to section 2055. The Fifth Circuit remanded the case to the Tax Court to determine the value of the claim at the date of death with the instruction that the court was "neither to admit nor consider evidence of post-death occurrences when determining the date-of-death value of Exxon's claim." 198 F.3d at 526.

We disagree with the Fifth Circuit's reasoning and conclusion. Because the section 2055 deduction involves different concerns, we do not believe that Ithaca Trust precludes consideration of post-death events in determining the amount deductible under section 2053 for claims against the estate. The Fifth Circuit's reliance on Propstra v. United States, 680 F.2d 1248, (9th Cir. 1982), and Estate of Van Horne v. Commissioner, 720 F.2d 1114 (9th Cir. 1983), aff'd, 78 T.C. 728, 734 (1982), cert. denied, 466 U.S. 980 (1984) was also misplaced. Propstra and Van Horne involved claims that were certain and enforceable at death, and in both cases, the Ninth Circuit limited its holding to "certain and enforceable" claims, noting that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims." Propstra, 680 F.2d at 1253.
Every court, except the Fifth Circuit, that has addressed the section 2053(a)(3) issue where the claim is contested, contingent, or unenforceable on the date of death, has considered post-death events in determining the allowable deduction. Gowetz v. Commissioner, 320 F.2d 874 (1st Cir. 1963), aff'd sub nom., Taylor v. Commissioner, 39 T.C. 371 (1962); Estate of Jacobs v. Commissioner, 34 F.2d 233 (8th Cir.), cert. denied, 280 U.S. 603 (1929); Estate of Courtney v. Commissioner, 62 T.C. 317 (1974); Estate of Cafaro v. Commissioner, T.C. Memo. 1989-348. See also Estate of Van Home, 720 F.2d 1114 and Propstra, 680 F.2d 1248. But cf., Commissioner v. Strauss, 77 F.2d 401 (7th Cir. 1935).

2. **Deduction for Interest.** Section 2053(c)(1)(B) provides that for decedents dying after December 31, 1997, no deduction is allowable for any interest payable under section 6601 on any unpaid portion of the federal estate tax for the period during which an extension of time for payment is in effect under section 6166. What if an estate does not elect section 6166 but merely arranges for a loan to pay the estate tax? Is that interest deductible?

Revenue Ruling 84-75, 1984-1 C.B. 193, states that if a loan is reasonably and necessarily incurred in administering the estate (e.g., to avoid a forced sale of estate assets) then the interest is deductible as an expense of administration under section 2053(a)(2). However, if the amount of interest the estate might pay is uncertain, because, for example, the estate’s obligation to make payments could be accelerated either through pre-payment or through default, the ruling concludes that the interest is deductible by the estate only after it accrues and any future estimated accrual is not deductible. This presents a significant problem with loans that last for longer than the applicable statute of limitations.

PLR 199903038 considered an estate in which the estate proposed to borrow, with appropriate court approval as required by applicable state law, from a bank. The loan would provide for an annual payment of both interest and principal over a specified term of years not to exceed seven at a fixed rate of interest. The note would also provide that neither principal nor interest could be prepaid and that in the event of default the entire interest that would have been paid under the full term of the note would be accelerated. Stated differently, the loan was designed to set forth a strictly ascertainable amount of interest that would be paid. PLR 200020011 approved a commercial loan to pay interest owed under section 6166 was reasonable and necessary under section 2053(a)(2). The estate represented as follows:

The represented facts are as follows: Decedent died on Date 1. Decedent's niece (Niece), also Decedent's conservator, is the principal beneficiary of Decedent's estate. Decedent's estate was initially administered by Bank. After the filing of the Estate (and Generation-Skipping Transfer) Tax Return on Form 706 and prior to the issuance of the closing letter dated Date 2, Bank resigned and Niece succeeded Bank as the personal representative of Decedent's estate.

Decedent's federal estate tax return reported a gross estate of a. Of the total gross estate, b represented the value of real estate, including a closely-held business interest in the form of a commercial shopping center. The shopping center was valued for federal estate tax purposes at c and thus comprised approximately w percent of the value of Decedent's gross estate. This percentage of business assets met the percentage requirements for purposes of the election under section 6166. Decedent's estate elected under section 6166(a), therefore, to defer payment of the federal estate tax attributable to the value of the shopping center and to pay the
estate tax in installments together with annual payments of interest on the unpaid portion of the federal estate tax liability during the deferral period. To date, the estate has made the required payments.

It has been represented that Niece, the personal representative and principal beneficiary of Decedent's estate, received approximately x percent of Decedent's estate. It has been further represented that Niece holds a y percent direct interest in the commercial shopping center and, as well, currently operates the shopping center. The remaining z percent is held in a trust for the benefit of Niece's daughter.

Decedent's estate represents that it has had difficulty obtaining operational lines of credit because of the federal tax lien resulting from the election under section 6166 and that the future payments required under section 6166 would cause a strain on the cash flow of the commercial shopping center. Decedent's estate further represents that the majority of other gross estate assets have been liquidated to pay estate taxes. Accordingly, Decedent's estate has determined that it is in the best interests of the closely-held business to obtain a commercial loan for the purpose of paying off the deferred estate taxes in full. To date, such a loan has been secured and the deferred estate taxes have been paid in full.

It has been represented that a loan has been secured and the deferred estate taxes have been paid in full. Inasmuch as the applicable loan documents contain a prepayment option, however, it has been further represented that the loan documents will be amended to provide that the loan may not be prepaid, and upon default all interest that would have been owed throughout the loan term must be paid in full at the time of default. Decedent's estate represents that it will not deduct the interest attributable to the loan as an administration expense until the loan documents have been amended to remove any possibility of prepayment.

The IRS determined that the interest was deductible prior to payment relying on Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, which dealt with a similar situation except that the lender was the decedent's closely-held corporation. The IRS noted that whether the expense was necessarily incurred was a factual determination. As such it was not part of the ruling.

Suppose an estate includes only limited partnership interests. The Executor requests that the general partner distribute funds to the estate for payment of tax. The partnership declines to do so but is willing to make a loan to the estate. If that loan is structured properly the interest should be deductible. Such would be desirable because of a spread between income tax rates and estate tax rates.

3. Environmental Claims. In Estate of Robert L. Snyder v. United States, 84 AFTR2d Par. 99-5255, the decedent owned contaminated property in this revocable trust at death. The estate, after considerable negotiation, settled with the EPA for $750,000 and wanted to deduct that amount under section 2053. The IRS originally denied a deduction because the claim was speculative but after it become fixed, because of the settlement, raised the argument that no deduction in excess of the probate estate could be taken. The court gave the argument short shrift:

The term "property subject to claims," as used in section 2053(c)(2), does not make a distinction between a probate versus a non-probate asset. Rather, it expressly provides that "the term 'property subject to claims' means property INCLUDABLE in the gross estate of the decedent WHICH, or the avails of which, would BEAR
THE BURDEN OF THE PAYMENT OF SUCH DEDUCTIONS in the final adjustment and settlement of the estate . . . .” 26 U.S.C. section 2053(c)(2) (emphasis added). The Revocable Trust’s assets are subject to and bear the burden of the payment of the EPA claims under Ohio law. Thus, the plain language of the statute dictates that the Revocable Trust’s assets fall within the definition of “property subject to claims.”

The government argues that “in the final adjustment and settlement of the estate” means “in the probate estate.” Thus precluding plaintiff from deducting the EPA settlement from the Revocable Trust. It states that the “property subject to claims” must be within the jurisdiction of a state probate court, surrogate court, orphans’ court, or other court which exercises jurisdiction over the final adjustment and settlement of a decedent’s estate. We find this interpretation overly narrow.

The government cites a third circuit case, Wilson v. United States, 372 F.2d 232 (3rd Cir. 1963) to support this proposition. However, under the Pennsylvania law applicable in Wilson, no part of the spendthrift trust in question could have been seized for the payment of the debts of the deceased. In the instant case, the value of the trust has been reduced by the EPA liability.

M. SECTIONS 2056, 2056A AND 2519- MARITAL DEDUCTION

1. Coordination With Tax Payment Clause. The Eighth Circuit has reversed the District Court in Patterson, et al v. United States, 83 A.F.T.R.2d 99-2476 (8th Cir. 1999). The estate poured into a revocable trust. The decedent’s Will directed the executor to pay from the residue all death taxes but also provided that if there were a trust in existence at the decedent’s death, any part of the death taxes could be paid from the trust assets in the trustee’s discretion. The trust provided that 10% of the trust assets, unreduced by any death taxes, were to be set aside in a QTIP trust.

The IRS claimed that 10% of the probate assets which the estate had qualified for the marital deduction were not in fact eligible for the marital deduction because they would not have existed if the trustee had not paid the estate taxes. Stated differently, the IRS contention was that the wording of the tax payment clauses was not sufficient to protect the marital deduction with respect to the estate assets. The Ninth Circuit rejected that position, holding, in essence, that if the assets actually pass to the QTIP trust that is sufficient, relying on Estate of Spencer v. Commissioner, 43 F.3d 226 (6th Cir. 1995); Estate of Robertson v. Commissioner, 15 F.3d 779 (8th Cir. 1994); Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992).

The case underscores the importance of coordinated tax clauses when a Will and a revocable trust are involved.

The facts in Richard Salyer, et al v. United States, 84 AFTR2d Par. 99-5477, No. 98-6243 (November 4, 1999), decided by the Sixth Circuit on appeal from the Eastern District of Kentucky, were interesting. Life insurance was paid to an irrevocable trust that did not qualify for the marital deduction, but which was included in the gross estate of the decedent because it was transferred to the trust within 3 years of the decedent’s death. The decedent’s revocable trust contained the following funding clause:

3.01. a. Share Number One shall be an amount equal to the maximum value of gross estate which when subjected to the federal Estate Tax will result in no tax liability
for the year in which Donor's death occurs. The maximum value of the total gross estate which will not result in a federal Estate Tax may be determined by reference to IRC Section 2010, which provides the amount of the unified credit, and to IRC Section 6018, which describes the maximum gross estate which may exist before a federal Estate Tax return is required to be filed. This amount is also known as the "Exemption Equivalent" and currently equals $600,000.00. The amount so set apart shall be a pecuniary amount and shall not participate in any appreciation or depreciation in the value of Donor's estate during the administration thereof. To the extent other property is available, this share shall not be reduced by the payment of debts, taxes and administrative expenses applicable to and payable from, or by, Donor's estate.

3.01.b. Share Number Two shall be an amount equal to the remaining assets of Donor's estate, which may also be referred to as the rest residue and remainder of the assets in the hands of my Executor/Trustee. However, this subsection shall not be applicable to any property which passes to or becomes a part of Share Number Three pursuant to a disclaimer or renunciation.

3.01.c. Share Number Three shall be those assets for which a proper disclaimer or renunciation has been executed pursuant to Kentucky law and/or the Internal Revenue Code.

The court agreed with the IRS that the insurance plus the exemption equivalent was taxable. The planning point is clear: have the insurance paid to a marital trust if it is included in the estate.

2. **QTIP Regulations: Effect of Estate Expenses.** Proposed regulations on the effect of administration expenses on the marital deduction were issued, REG-114663-97 (December 15, 1998), and final regulations were issued in T.D. 8846 (December 2, 1999). The regulations distinguish between estate transmission expenses which will reduce the marital deduction, and estate management expenses which will not reduce the marital deduction. For drafting purposes, the marital deduction/exemption equivalent formula clause should be revised to take into consideration estate management expenses that are not taken as income tax deductions. The final regulations are substantially like the proposed regulations with one notable exception:

Many of the comments concerned the special rule of section 20.2056(b)-4(e)(2)(ii) of the proposed regulations. Under the special rule, the value of the deductible property interest is not increased as a result of the decrease in the federal estate tax liability that is attributable to the deduction of estate management expenses as expenses of administration under section 2053 on the federal estate tax return. A similar rule would have applied for purposes of the estate tax charitable deduction.

Several of these commentators argued that the special rule is inconsistent with sections 2056(a) and 2055(c), because the value of the property passing to the surviving spouse or charity should be reduced only by the estate taxes actually paid. Thus, an estate should be permitted the full benefit of deducting management expenses on the federal estate tax return, including an increase to the marital or charitable deduction based on the resultant decrease in tax payable from the marital or charitable share.

Conversely, other commentators asserted that the special rule does not conform with section 2056(b)(9). Section 2056(b)(9) provides that nothing in section 2056
or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent. These commentators pointed out that if estate management expenses paid from the marital or charitable share are deducted on the federal estate tax return, and no reduction is made to the allowable amount of the marital or charitable deduction, then the same property interest is deducted twice in violation of section 2056(b)(9).

After considering these comments, the Treasury and the IRS have eliminated the special rule of the proposed regulations. The final regulations provide that estate management expenses attributable to, and payable from, the property interest passing to the surviving spouse or charity do not reduce the value of the property interest. However, pursuant to section 2056(b)(9), the allowable amount of the marital or charitable deduction is reduced by the amount of these management expenses if they are deducted on the Federal estate tax return.

The regulations provide as follows:

(d) Effect of administration expenses -- (1) Definitions -- (i) Management expenses. Estate management expenses are expenses that are incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration. Examples of these expenses could include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

(ii) Transmission expenses. Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense. Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

(iii) Marital share. The marital share is the property or interest in property that passed from the decedent for which a deduction is allowable under section 2056(a). The marital share includes the income produced by the property or interest in property during the period of administration if the income, under the terms of the governing instrument or applicable local law, is payable to the surviving spouse or is to be added to the principal of the property interest passing to, or for the benefit of, the surviving spouse.

(2) Effect of transmission expenses. For purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate transmission expenses paid from the marital share.

(3) Effect of management expenses attributable to the marital share. For purposes of determining the marital deduction, the value of the marital share shall not be reduced by the amount of the estate management expenses attributable to and paid from the marital share. Pursuant to section 2056(b)(9), however, the amount of the allowable marital deduction shall be reduced by the amount of any such
management expenses that are deducted under section 2053 on the decedent's Federal estate tax return.

(4) Effect of management expenses not attributable to the marital share. For purposes of determining the marital deduction, the value of the marital share shall be reduced by the amount of the estate management expenses paid from the marital share but attributable to a property interest not included in the marital share.

(5) Examples. The following examples illustrate the application of this paragraph (d):

Example 1. The decedent dies after 2006 having made no lifetime gifts. The decedent makes a bequest of shares of ABC Corporation stock to the decedent's child. The bequest provides that the child is to receive the income from the shares from the date of the decedent's death. The value of the bequeathed shares on the decedent's date of death is $3,000,000. The residue of the estate is bequeathed to a trust for which the executor properly makes an election under section 2056(b)(7) to treat as qualified terminable interest property. The value of the residue on the decedent's date of death, before the payment of administration expenses and Federal and State estate taxes, is $6,000,000. Under applicable local law, the executor has the discretion to pay administration expenses from the income or principal of the residuary estate. All estate taxes are to be paid from the residue. The State estate tax equals the State death tax credit available under section 2011. During the period of administration, the estate incurs estate transmission expenses of $400,000, which the executor charges to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the Federal and State estate taxes and by the estate transmission expenses. If the transmission expenses are deducted on the Federal estate tax return, the marital deduction is $3,500,000 ($6,000,000 minus $400,000 transmission expenses and minus $2,100,000 Federal and State estate taxes). If the transmission expenses are deducted on the estate's Federal income tax return rather than on the estate tax return, the marital deduction is $3,011,111 ($6,000,000 minus $400,000 transmission expenses and minus $2,588,889 Federal and State estate taxes).

Example 2. The facts are the same as in Example 1, except that, instead of incurring estate transmission expenses, the estate incurs estate management expenses of $400,000 in connection with the residue property passing for the benefit of the spouse. The executor charges these management expenses to the residue. In determining the value of the residue passing to the spouse for marital deduction purposes, a reduction is made for Federal and State estate taxes payable from the residue but no reduction is made for the estate management expenses. If the management expenses are deducted on the estate's income tax return, the net value of the property passing to the spouse is $3,900,000 ($6,000,000 minus $2,100,000 Federal and State estate taxes). A marital deduction is claimed for that amount, and the taxable estate is $5,100,000.

Example 3. The facts are the same as in Example 1, except that the estate management expenses of $400,000 are incurred in connection with the bequest of ABC Corporation stock to the decedent's child. The executor charges these management expenses to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the Federal and State estate taxes and by the management expenses. The management expenses reduce the value of

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the residue because they are charged to the property passing to the spouse even though they were incurred with respect to stock passing to the child. If the management expenses are deducted on the estate's Federal income tax return, the marital deduction is $3,011,111 ($6,000,000 minus $400,000 management expenses and minus $2,588,889 Federal and State estate taxes). If the management expenses are deducted on the estate's Federal estate tax return, rather than on the estate's Federal income tax return, the marital deduction is $3,500,000 ($6,000,000 minus $400,000 management expenses and minus $2,100,000 in Federal and State estate taxes).

Example 4. The decedent, who dies in 2000, has a gross estate of $3,000,000. Included in the gross estate are proceeds of $150,000 from a policy insuring the decedent's life and payable to the decedent's child as beneficiary. The applicable credit amount against the tax was fully consumed by the decedent's lifetime gifts. Applicable State law requires the child to pay any estate taxes attributable to the life insurance policy. Pursuant to the decedent's will, the rest of the decedent's estate passes outright to the surviving spouse. During the period of administration, the estate incurs estate management expenses of $150,000 in connection with the property passing to the spouse. The value of the property passing to the spouse is $2,850,000 ($3,000,000 less $150,000) and there is a resulting taxable estate of $150,000 ($3,000,000 less a marital deduction of $2,850,000). Suppose, instead, the management expenses of $150,000 are deducted on the estate's estate tax return under section 2053 as expenses of administration. In such a situation, claiming a marital deduction of $2,850,000 would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056 and would shield from estate taxes the $150,000 in insurance proceeds passing to the decedent's child. Therefore, in accordance with section 2056(b)(9), the marital deduction is limited to $2,700,000, and the resulting taxable estate is $150,000.

Example 5. The decedent dies after 2006 having made no lifetime gifts. The value of the decedent's residuary estate on the decedent's date of death is $3,000,000, before the payment of administration expenses and Federal and State estate taxes. The decedent's will provides a formula for dividing the decedent's residuary estate between two trusts to reduce the estate's Federal estate taxes to zero. Under the formula, one trust, for the benefit of the decedent's child, is to be funded with that amount of property equal in value to so much of the applicable exclusion amount under section 2010 that would reduce the estate's Federal estate tax to zero. The other trust, for the benefit of the surviving spouse, satisfies the requirements of section 2056(b)(7) and is to be funded with the remaining property in the estate. The State estate tax equals the State death tax credit available under section 2011. During the period of administration, the estate incurs transmission expenses of $200,000. The transmission expenses of $200,000 reduce the value of the residue to $2,800,000. If the transmission expenses are deducted on the Federal estate tax return, then the formula divides the residue so that the value of the property passing to the child's trust is $1,000,000 and the value of the property passing to the marital trust is $1,800,000. The allowable marital deduction is $1,800,000. The applicable exclusion amount shields from Federal estate tax the entire $1,000,000 passing to the child's trust so that the amount of Federal and State estate taxes is zero. Alternatively, if the transmission expenses are deducted on the estate's Federal
income tax return, the formula divides the residue so that the value of the property passing to the child's trust is $800,000 and the value of the property passing to the marital trust is $2,000,000. The allowable marital deduction remains $1,800,000. The applicable exclusion amount shields from Federal estate tax the entire $800,000 passing to the child's trust and $200,000 of the $2,000,000 passing to the marital trust so that the amount of Federal and State estate taxes remains zero.

Example 6. The facts are the same as in Example 5, except that the decedent’s will provides that the child's trust is to be funded with that amount of property equal in value to the applicable exclusion amount under section 2010 allowable to the decedent's estate. The residue of the estate, after the payment of any debts, expenses, and Federal and State estate taxes, is to pass to the marital trust. The applicable exclusion amount in this case is $1,000,000, so the value of the property passing to the child's trust is $1,000,000. After deducting the $200,000 of transmission expenses, the residue of the estate is $1,800,000 less any estate taxes. If the transmission expenses are deducted on the Federal estate tax return, the allowable marital deduction is $1,800,000, the taxable estate is zero, and the Federal and State estate taxes are zero. Alternatively, if the transmission expenses are deducted on the estate's Federal income tax return, the net value of the property passing to the spouse is $1,657,874 ($1,800,000 minus $142,106 estate taxes). A marital deduction is claimed for that amount, the taxable estate is $1,342,106, and the Federal and State estate taxes total $142,106.

Example 7. The decedent, who dies in 2000, makes an outright pecuniary bequest of $3,000,000 to the decedent's surviving spouse, and the residue of the estate, after the payment of all debts, expenses, and Federal and State estate taxes, passes to the decedent's child. Under the terms of the applicable local law, a beneficiary of a pecuniary bequest is not entitled to any income on the bequest. During the period of administration, the estate pays estate transmission expenses from the income earned by the property that will be distributed to the surviving spouse in satisfaction of the pecuniary bequest. The income earned on this property is not part of the marital share. Therefore, the allowable marital deduction is $3,000,000, unreduced by the amount of the estate transmission expenses.

The effective date is for decedents dying after December 3, 1999.

The most important planning point is that a residuary marital clause allows the estate to benefit from the regulations.

3. **Savings Clause.** The IRS determined in 199932001 that a general marital deduction savings clause “trumped” a provision cutting off distributions to the surviving spouse if such distributions would make the spouse ineligible for government benefits. The Service noted that a savings clause is not decisive but is helpful in ascertaining a decedent’s intent. Here, the spouses’ rights were described as follows:

My Trustees shall pay the entire net income therefrom to my wife [Spouse] for so long as she lives, in quarter annual or more frequent intervals as my Trustees determine in their absolute discretion. In addition, my Trustees may pay to or apply for the benefit of my wife, for so long as she lives, so much (even to the extent of the whole) of the principal of this trust as my Trustees deem advisable, in their sole and absolute discretion. However, any authorization, direction, or other provision contained in this trust which would prevent my wife from being eligible for or result in the loss of government benefits or assistance shall be void to the
extent that such authorization, direction or other provision would have such adverse result. I intend that the trust assets be used to supplement, not supplant, impair or diminish, any benefits or assistance of any federal, state, county, city, or other governmental entity for which my wife may otherwise be eligible or which my wife may be receiving.

4. **Minority Interest Passing to Spouse.** Problems arise when a decedent owns a majority interest in a closely-held business at death but a minority interest passes to the surviving spouse. Such were the facts in *Estate of Frank M. DiSanto, et al. v. Commissioner*, T.C. Memo. 1999-421. The decedent owned 53.5% of Morganton Dyeing & Finishing Corp. The decedent’s wife disclaimed a portion of the stock with the result that she received a minority interest. The court found that a share was worth $23.50 per share as a majority interest and $13.00 per share as a minority interest. The opinion states:

Petitioners contend that we must base the marital deduction on the value of Mr. DiSanto’s controlling interest in MD&F stock. We disagree. An estate may deduct "an amount equal to the value of property which passes or has passed from the decedent to his surviving spouse". Sec. 2056(a). The value of the marital deduction for a devised interest in stock of a closely held corporation equals the value of the interest that passes to the surviving spouse. See sec. 2056(b)(4); sec. 20.2056(b)-4(a), Estate Tax Regs.; *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577, 1588-1589 (1987). Thus, the marital deduction for Mr. DiSanto's estate is based on the value of the interest that passed from Mr. DiSanto's estate to Mrs. DiSanto.

Mrs. DiSanto's disclaimer reduced the value of her interest in Mr. DiSanto's estate, and reduced the amount of the marital deduction for Mr. DiSanto’s estate. See sec. 2518(a). We have decided that the fair market value of each share of MD&F stock that Mrs. DiSanto was entitled to receive from Mr. DiSanto's estate after she made the disclaimer was $13 per share when she died. See paragraph B-3, above. Mr. DiSanto's estate may claim a marital deduction based on that per share stock value.

Petitioners contend that we should disregard Mrs. DiSanto's disclaimer in deciding the amount of the marital deduction for Mr. DiSanto's estate just as we disregard postdeath fluctuations in the values of assets in estates in deciding marital deduction amounts. We disagree. Petitioners cite Rev. Rul. 90-3, 1990-1 C.B. 174. In Rev. Rul. 90-3, 1990-1 C.B. 174, respondent ruled that the value of a residuary bequest to a surviving spouse does not change even if the value of estate assets fluctuates after the decedent dies. Mrs. DiSanto's disclaimer of $1,325,000 worth of Mr. DiSanto's MD&F stock is not a postdeath fluctuation in the value of his stock. Thus, Rev. Rul. 90-3, 1990-1 C.B. 174, does not apply here.

Petitioners contend that, if a surviving spouse executes a disclaimer, the marital deduction is merely reduced by the disclaimed amount, citing *Estate of Nix v. Commissioner*, T.C. Memo. 1996-109. We disagree. In *Estate of Nix*, we held that the disclaimer reduced the surviving spouse's interest in the decedent's estate by the value of disclaimed property. Unlike the facts in *Estate of Nix*, here the qualified disclaimer reduces Mrs. DiSanto's interest in Mr. DiSanto's stock in MD&F from a controlling interest to a minority interest.
Petitioners cite Estate of Jameson v. Commissioner, T.C. Memo. 1999-43, for the proposition that respondent may not use one value for including the MD&F stock in Mr. DiSanto's estate and a lower value for calculating the marital deduction. We disagree. The decedent in Estate of Jameson bequeathed an amount to his children and the residuary to his wife. We held that his estate may not use a lower per share value of closely held stock to increase the number of shares to compute the bequest to his children and a higher per share value of the same stock to compute the marital deduction. Estate of Jameson v. Commissioner, supra, is distinguishable because the decedent's wife did not disclaim part of her interest as Mrs. DiSanto did here.

The disclaimer was apparently entered into because Mrs. DiSanto was in ill health and it was thought desirable for her to be in a minority position. The opinion does not discuss the application of the tax clause. Where should the estate tax due on the gap between the estate value and the marital deduction value fall? In general, state law may "protect" a marital bequest from paying tax if the bequest generates no tax but such is not the case here. If it is not protected, the marital deduction would be reduced further.

5. **Nonqualified Disclaimer of QTIP Income Interest.** PLR 200022031 involves interesting facts. Spouse died leaving assets in a QTIP trust with remainder in part to a private foundation and in part to charitable remainder trusts, one for each of three children. Taxpayer -- the surviving spouse -- proposed to execute a nonqualified disclaimer of his interest in the QTIP trust, with any gift tax being paid by the recipients of the disclaimed property as provided in section 2207A. The ruling states:

In the present case, because Taxpayer's disclaimer is not a qualified disclaimer under section 2518, Taxpayer's relinquishment of the income interest is a gift by Taxpayer of the value of that interest under section 2511. Under section 2502(c), the payment of the tax is the liability of the Taxpayer. However, a condition of the Taxpayer's transfer is the agreement that the gift tax will be paid by the trustees of the Trust. Consequently, under section 2512(b), the value of the gift of Taxpayer's income interest is measured by the fair market value of the income interest minus the amount of gift tax to be paid.

In addition, Taxpayer's relinquishment of his income interest constitutes a disposition of Taxpayer's income interest under section 2519. The amount of the gift made by the Taxpayer under section 2519 will be the value of the corpus of Trust less the value of Taxpayer's qualifying income interest, reduced by the amount of the gift tax paid by the person receiving the property under section 2207A.

6. **Disclaimers Save Marital Deduction.** In Estate of Henry Lassiter v. Commissioner, T.C. Memo. 2000-324, the decedent's Will created the following marital trust:

(b) Said Trustee shall hold and manage said property and shall use such part of the income and/or principal thereof as it may deem necessary to provide for the support in reasonable comfort of my wife, and to provide for the support and education of my children and the descendants of any deceased child of mine. After any child has finished his education, or in normal course should have completed his education, the Trustee shall not be required to make any payment for the support of such child or his descendants unless in the judgment of the Trustee there is ample property to support my wife and educate my children or such child is
unable to support himself. To the extent practicable, however, I desire my Trustee in making encroachment for the benefit of my wife to encroach first on the trust created for my wife in Item IV hereof before encroaching on this trust; but this request shall not apply to the extent it would be necessary to sell property which in the opinion of the Trustee should not be sold in order to encroach first on such trust.

(c) My said wife shall have the power at any time and from time to time by instrument in writing signed by her and delivered to the Trustee, to direct the Trustee to turn over any part of the property in this trust to or among such of my descendants, or spouses of such descendants, and in such manner, in trust or otherwise, as my said wife may in such instrument direct or appoint, provided that she shall have no power to appoint said property to herself, to her estate, to her creditors or to the creditors of her estate.

(d) On the death of my said wife, the property then remaining in this trust shall be distributed to or among such of my descendants, and in such manner, in trust or otherwise as my said wife may by her Last Will and Testament direct or appoint, provided that she shall have no power to appoint said property to herself, to her estate or to the creditors of her estate.

(e) Should my said wife fail to exercise her power of appointment as to all of the property in this trust, or should she predecease me, then on my death or on the death of my said wife, whichever last occurs, the property of this trust as to which she fails to exercise such power of appointment shall be divided into as many separate and equal shares as I have children then living and deceased children with descendants then living.

All descendants disclaimed including unborns leaving the wife as the only beneficiary. She disclaimed her power of appointment and her power as trustee to distribute to the descendants. With respect to the guardian ad litem's authority to disclaim, and to the wife's authority as trustee, the opinion states:

In addition, we decline respondent's invitation to question the validity of these disclaimers on the grounds that those executed by the guardian ad litem failed to protect the best interests of the beneficiaries. The renunciations endeavor to preserve in excess of $14 million in a trust naming Mr. Lassiter's descendants as the ultimate remainder beneficiaries. Given this potential for future benefit, we are unwilling to find a violation of fiduciary duties. For similar reasons, we are equally unwilling to construe Mrs. Lassiter's actions in attempting to obtain the increased deduction as a violation of her fiduciary duties as administrator and trustee. On the record before us, we lack any basis upon which to evaluate or second-guess the Probate Court's acceptance of the actions by the fiduciaries.

Hence, we are satisfied that Mr. Lassiter's descendants effectively disclaimed their right to receive trust income during Mrs. Lassiter's life, and thereby cut off the trustee's discretionary power to make such distributions for their support and education.

The court next looked to a Georgia statute to determine that the wife would receive all the income annually:

Ga. Code Ann. section 53-12-190, upon which the estate relies, provides in relevant part:
53-12-190. Trustee Duties.

(a) The duties contained in this chapter are applicable except as otherwise provided in the trust instrument, and are in addition to and not in limitation of the common law duties of the trustee, except to the extent inconsistent therewith.

* * * * *

(c) The trustee shall distribute all net income derived from the trust at least annually.

Our inquiry thus becomes whether the 1970 will "otherwise provide[s]" within the meaning of the statute. Unfortunately, research has revealed no opinions from courts located within the State of Georgia which address subsection (c) of Ga. Code Ann. section 53-12-190 and its relationship to subsection (a). However, this statute is the successor to Ga. Code Ann. sections 108-445 and 108-446 (Code 1933), which were construed by the U.S. District Court for the Southern District of Georgia in Friedman v. United States, supra. These predecessor laws read:

Where the trust instrument is silent as to the time of distribution of income and the frequency thereof, all trustees of all trusts subject to the laws of this State, whether heretofore or hereafter established, shall distribute all net income derived from the property comprising such trust at least annually, on a calendar or fiscal year basis. [Ga. Code Ann. sec. 108-445.]

In the case of any trust now in existence or hereafter created where the trust instrument expressly directs or permits net income to be distributed less frequently than annually, the express provisions of such instrument shall govern the time and manner of making distributions of income. [Ga. Code Ann. sec. 108-446.]

* * * * *

Friedman v. United States, 364 F. Supp. 484 (1973), reflects that the statutes from which Ga. Code Ann. section 53-12-190 sprang were enacted for the purpose of establishing a default rule by which spousal trusts were able to qualify for the marital deduction absent an unmistakable expression of intent to the contrary. At the same time, no evidence suggests that the Georgia legislature has since sought to weaken this rule and thereby make it easier for a trust to fall short of deductible status. The above-quoted sections addressed in Friedman v. United States, supra, were subsequently recodified verbatim in all material respects as subsections (b) and (c) of Ga. Code Ann. section 53-13-53 (Code 1981). The provisions existed in such form until the comprehensive revision and complete recodification of Georgia trust law which took effect on July 1, 1991, and which enacted Ga. Code Ann. section 53-12-190. An article explaining the new act by the individual who served as Reporter to the Trust Law Revision Committee which drafted the measure indicates that no substantive change was intended. See Emanuel, "The Georgia Trust Act", 28 Ga. St. B.J. 95, 97 (1991). Citing former Ga. Code Ann. section 53-13-53, the article states: "The Act ** * carries forward the Georgia statute directing the trustee to distribute net income at least annually in O.C.G.A.
Here then is the situation with which we are faced in deciding whether Georgia courts would require annual distribution on the facts before us. In terms of the legal context, we are presented with a State statute that, in connection with its interpretive history, clearly demonstrates a bias on the part of Georgia lawmakers toward enabling trusts to qualify for the marital deduction. Moreover, from a practical standpoint, we address a situation where any accumulation of income by the trustee under an ascertainable standard theory would be pointless.

The descendants have disclaimed their right to all income earned by the trust during Mrs. Lassiter's lifetime. Under the State disclaimer law, they are deemed to have predeceased Mrs. Lassiter as to these sums. The amounts thus can neither be distributed to them while Mrs. Lassiter is living nor be added to the remainder interest they will take after her death. The surviving spouse, or her estate, is the only possible beneficiary of this income. The disclaimers have therefore rendered meaningless any discretion on the part of the trustee to accumulate income.

On balance, we believe that where a standard for distribution has so been vitiated of any potential for protecting the interests of any other beneficiary, a Georgia court would deem the subject trust instrument to have been rendered silent as to timing and frequency of payment, such that the default rule of Ga. Code Ann. section 53-12-190(c) would require not less than annual payment of all income to the surviving spouse. We so conclude here.

7. **Joint Revocable Trust.** In a very interesting ruling, PLR 20010102, the Service has determined that a joint revocable trust works to achieve a double basis step-up. The facts were:

The facts and representations submitted are summarized as follows: Grantor A and Grantor B, who are husband and wife, propose to create a joint trust ("Trust"). Grantor A will be the initial trustee of Trust. The Grants will fund Trust with assets that they own as tenants by the entireties having a value of approximately $x.

Under the terms of Trust, during the joint lives of the Grantors, the trustee may apply income and principal of Trust as the trustee deems advisable for the comfort, support, maintenance, health and general welfare of the Grantors. The trustee may also pay additional sums to either or both of the Grantors or to a third person for the benefit of either or both Grantors as Grantor A directs, or if he is not capable of this decision, then as Grantor B directs. While both Grantors are living, either one may terminate Trust by written notice to the other Grantor. If Trust is terminated, the trustee will deliver the trust property to the Grantors in both their names as tenants in common. Either Grantor may also amend the trust while both grantors are living by delivering to the other Grantor the amendment in writing at least 90 days before the effective date of the amendment.

Upon the death of the first Grantor to die, he or she possesses a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of Trust, free of trust, to such deceased Grantor's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as the deceased Grantor may direct in his or her will.
If the first Grantor to die fails to fully exercise his or her testamentary general power of appointment, and providing the surviving Grantor survives the first Grantor to die by at least six months, an amount of Trust property sufficient to equal the largest amount that can pass free of federal estate tax by reason of the unified credit, is to be transferred to an irrevocable Credit Shelter Trust. Any amount in excess of the amount needed to fully fund the Credit Shelter Trust that has not been appointed by the deceased Grantor will pass outright to the surviving Grantor.

The rulings were:

RULING #1. Grantor A and Grantor B propose to transfer property held as tenants by the entireties to Trust. The Grantors will each retain the power to terminate Trust by written notice to the other Grantor. If Trust is terminated, the trustee will deliver the trust property to the Grantors in both their names as tenants in common. We conclude that the initial contribution of assets to Trust as proposed will not constitute a completed gift by either Grantor under section 25.2511-2(c), since each will retain the right, exercisable unilaterally, to revoke their respective transfer, and revest title in themselves.

RULING #2. If either Grantor exercises the right to terminate Trust, each Grantor will receive an undivided 50% interest in the remaining balance of the Trust corpus, as a tenant in common. Therefore, distributions of Trust property to either Grantor during their joint lives will constitute a gift by the other Grantor to the extent of 50% of the value of Trust assets distributed. The gift will qualify for the gift tax marital deduction under section 2523.

RULING #3 AND #4. Upon the death of the first Grantor to die, he or she will possess a testamentary power exercisable alone and in all events, to appoint part or all of the assets of the Trust, free of trust, to such deceased Grantor's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as the deceased Grantor may direct in his or her will.

We conclude that, on the death of the first Grantor to die, the portion of the Trust property attributable to the property the deceased Grantor transferred to Trust will be includible in the deceased Grantor's gross estate under section 2036. The balance of the property attributable to the property the surviving Grantor contributed to Trust will be includible in the deceased Grantor's gross estate under section 2041.

Further, on the death of the first deceasing Grantor, the surviving Grantor is treated as relinquishing his or her dominion and control over the surviving Grantor's one-half interest in Trust. Accordingly, on the death of the first deceasing Grantor, the surviving Grantor will make a completed gift under section 2501 of the surviving Grantor's entire interest in Trust. This gift will qualify for the marital deduction under section 2523.

In addition, section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment. See, H.R. Rept. 97-201, 97th Cong., 1st Sess. (July 24, 1981).
RULINGS #5 AND #6. As discussed above, the surviving Grantor is treated as making a completed gift of his or her interest in Trust on the death of the first deceasing Grantor. Also, as discussed above, a portion of the Trust property will be subject to inclusion in the deceased Grantor's gross estate under section 2038, and a portion will be subject to inclusion under section 2041. Accordingly, to the extent the Credit Shelter Trust is funded, property passing to the trust is treated as passing from the deceased Grantor, and not from the surviving Grantor.

The first ruling is the crucial one — that there was no gift when the trust was funded.

8. **Division of Trust for Section 2519 Purposes.** PLR 200116006 determined that where a spouse renounced the income interest in a part of a QTIP trust that had been divided, the spouse would not be treated as having disposed of an income interest under section 2519 in the other part of the trust. Where section 2519 does apply the IRS ruling position is that the gift tax is calculated on a net gift basis. See, e.g., 200022031.

N. **SECTIONS 2501 TO 2524 - GIFTS**

1. **Gift Tax Disclosure Regulations.** REG. 106177-98 set forth proposed regulations relating to the gift tax statute of limitations which became final regulations in T.D. 8845 (December 2, 1999). The regulations add a new paragraph (f) to section 301.6501(c)-1. If a gift is not adequately disclosed on a timely filed gift tax return, then gift tax may be assessed at any time. With respect to the finality issue, the explanation to the regulations states:

   Under the proposed regulations, if a transfer is adequately disclosed on the gift tax return, and the period for assessment of gift tax has expired, then the IRS is foreclosed from adjusting the value of the gift under section 2504(c) (for purposes of determining the current gift tax liability) and under section 2001(f) (for purposes of determining the estate tax liability). However, the IRS is not precluded from making adjustments involving legal issues, even if the gift was adequately disclosed. This position was based on longstanding regulations applying section 2504(c) and relevant case law.

   Comments suggested that this rule is contrary to Congressional intent in enacting section 2001(f) and amending section 2504(c) to provide a greater degree of finality with respect to the gift and estate tax statutory scheme. In response to these comments, the final regulations preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift.

   Adequate disclosure is described by (f)(2) as follows:

   Adequate disclosure of transfers of property reported as gifts. A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information —

   (i) A description of the transferred property and any consideration received by the transferor;

   (ii) The identity of, and relationship between, the transferor and each transferee;
(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

(iv) Except as provided in section 301.6501-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph (f)(2)(iv). In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest; and

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer (see section 601.601(d)(2) of this chapter).

Appraisals will satisfy these rules in certain circumstances:

Submission of appraisals in lieu of the information required under paragraph (f)(2)(iv) of this section. The requirements of paragraph (f)(2)(iv) of this section will be satisfied if the donor submits an appraisal of the transferred property that meets the following requirements --

(i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:

(A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.
(B) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.

(C) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

(ii) The appraisal contains all of the following:

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

Transactions that are non-gifts were handled in the following way, after much criticism of the proposed regulations:

Under the proposed regulations, a completed transfer that did not constitute a gift would be considered adequately disclosed if the taxpayer submitted the information required for adequate disclosure and an explanation describing why the transfer was not subject to the gift tax. One commentator suggested that the adequate disclosure requirement should be waived if the taxpayer reasonably, in good faith, believes the transfer is not a gift (for example, a salary payment made to a child employed in a family business). Another commentator noted that the standard for adequate disclosure is higher for a "non-gift" than it is for a gift transaction since, in the non-gift situation, the donor must provide all the information required by the regulation and a statement why the transaction is not a gift. Another comment requested more guidance for reporting non-gift business transactions. In response to the comments, the final regulations limit the information required in a non-gift
situation. In addition, the final regulations provide that completed transfers to members of the transferor's family (as defined in section 2032A(c)(2)) in the ordinary course of operating a business are deemed to be adequately disclosed, even if not reported on a gift tax return, if the item is properly reported by all parties for income tax purposes. For example, in the case of a salary payment made to a child of the donor employed in the donor's business, the transaction will be treated as adequately disclosed for gift tax purposes if the salary payment is properly reported by the business and the child on their income tax returns. This exception only applies to transactions conducted in the ordinary course of operating a business. It does not apply, for example, in the case of a sale of property (including a business) by a parent to a child.

Another major issue that arose in response to the proposed regulations was the effective date of the regulations.

The explanation states:

One comment requested clarification of the effective date of section 6501(c)(9), as amended. The Taxpayer Relief Act of 1997 provides that the amendments to section 6501(c)(9) (commencing the running of the period of limitations only if the gift is adequately disclosed) apply to gifts made in calendar years ending after August 5, 1997 (that is, all gifts made in calendar year 1997 and thereafter). However, the underlying legislative history indicates that the amendment to section 6501(c)(9) applies "to gifts made in calendar years after the date of enactment [August 5, 1997]". H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 408 (1997). Notwithstanding this statement in the legislative history, the statutory language is clear that the section as amended applies to all gifts made during the 1997 calendar year, and thereafter. In the final regulations, the statutory effective date language is restated in a manner that makes it clear that section 6501(c)(9) as amended applies to all gifts made after December 31, 1996.

Another comment suggested clarification of the application of the adequate disclosure rules and the interaction between sections 2504(c) and 6501(c)(9) with respect to gifts made between January 1, 1997, and August 6, 1997, since section 2504(c) as amended applies only to gifts made after August 5, 1997, but section 6501(c)(9) as amended applies to all gifts made in 1997. In response to this comment, an example has been added under section 25.2504-2(c) involving a situation where a gift is made prior to August 6, 1997, that is not adequately disclosed on the return filed for 1997. The example clarifies that the period for assessment with respect to the pre-August 6, 1997 gift does not commence to run because the gift is not adequately disclosed. Accordingly, a gift tax may be assessed with respect to the gift at any time, and notwithstanding the effective date for section 2504(c), that 1997 gift can be adjusted as a part of prior taxable gifts in determining subsequent gift tax liability. Further, the 1997 gift can be adjusted as part of taxable gifts under section 2001 in determining estate tax liability.

Finally, in response to another comment, an example has been added illustrating the application of the effective date rules in a similar fact pattern, where the gifts are made in a calendar year prior to 1997. The example illustrates that the IRS may not revalue the gifts, for purposes of determining prior taxable gifts for gift tax purposes, if a gift tax was paid and assessed with respect to the calendar year, and the period for assessment has expired. Since the gifts were made prior to 1997, the rules of section 2504(c) and section 6501 prior to amendment apply. However, the
IRS may adjust the gifts for purposes of determining adjusted taxable gifts for estate tax purposes.

2. **No Annual Exclusion for Gifts to Corporation.** The U. S. District Court for the Northern District of Indiana concluded in *Estate of Stinson v. United States*, 82 A.F.T.R.2d 98-6944 (N.D. Ind. 1998), that a donor’s forgiveness of corporate debt did not qualify as an annual exclusion gift to the corporation’s shareholders because the gifts were not present interests. The court stated that “it is the shareholder’s inability to use, possess, or enjoy any of the corporation’s assets, including the gift, without joint actions by the directors that renders their interest in the gift to the corporation’s ‘future interests.’” The Seventh Circuit affirmed, at 85 AFTR2d §2000-690. Revenue Ruling 71-443, 1971-2 C.B. 337, sets forth the same position relying on *Chanin v. United States*, 183 Ct. Cl. 840, 393 F.2d 972 (1968) (a gift from one closely held corporation made to another closely held corporation would be a future interest gift to the shareholders of the recipient corporation).

3. **Prepaid Tuition Payments.** In TAM 199941013 the National Office dealt with whether prepaid tuition payments by a decedent on behalf of two grandchildren to an educational institution would be qualified transfers under section 2503(e). The transfers were made beginning in 1994 and continuing through 1996 and were intended to fund tuition through the year 2004. The ruling notes that the payments were not subject to refund and would be forfeited if the decedent’s grandchildren ceased to attend the school and thus the payments could only be described as being made directly to an educational organization to be used exclusively for the payment as specified tuition costs for designated individuals. By contrast, Example 2 of Treas. Reg. §25.2503-6(c) determined that the unlimited exclusion under §2503(e) would not apply where a donor transferred assets to a trust which required the trustee to use the trust funds to pay tuition expenses for the donor’s grandchildren. The transfers must be to the educational institution itself.

4. **Stock Options.** PLR 199927002 provides as follows:

   In the present case, Taxpayer proposes to transfer options that he received as an employee of Company, to one or more of his children, or to a trust for the benefit of one or more of his children. The exercise of the options will not be conditioned on continued future employment of Taxpayer at the time of transfer. The transferees may exercise the options and purchase the stock at their discretion after the price appreciation thresholds have been met.

   After the transfers to the individuals or the trust, Taxpayer will retain no interest or reversion in the options or the stock upon exercise and has no right to alter, amend, or revoke the transfer of the options or stock. In addition, Taxpayer holds no general power of appointment over the options or the stock.

   Based on the information submitted, we rule as follows:

   1. The transfer of the stock options to the transferee will not cause the recognition of taxable income or gain to Taxpayer

   2. If the transferee subsequently exercises the stock options, Taxpayer (or, if Taxpayer is not then living, Taxpayer’s estate) will be deemed to receive taxable compensation under section 83 of the Code, and Company will receive a corresponding deduction under section 162 of the Code.
3. If the transferee exercises the stock options, the transferee's basis in the stock so acquired will be its fair market value on the date of exercise which consists of the consideration paid by the transferee and income taxed to Taxpayer (or Taxpayer's estate) under section 83 of the Code.

4. Taxpayer's transfers of his Plan A options and Plan B options to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511 of the Code, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gift incomplete.

5. The proposed transfers of the stock options granted under Plan A and Plan B from Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children will not be subject to sections 2701 and 2703 of the Code.

6. After the transfer of the options by Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children, neither the options nor the shares obtained upon the exercise of the options will be includable in Taxpayer's gross estate.

PLR 199952012 dealt with the transfer of vested stock options. Rev. Rul. 98-21, 1998-18 IRB 7, provides that a complete gift cannot be made of options that are conditioned on the performance of future services. The ruling states:

Because the option cannot be exercised if A fails to perform the services, Rev. Rul. 98-21 provides that, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B, one of A's children, for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. Rev. Rul. 98-21 concludes that the transfer of a nonstatutory stock option by A, the optionee, to B, a family member, for no consideration is a completed gift under section 2511 on the later of (i) the date of the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.

The ruling distinguished these, vested, options:

In the present case, Taxpayer, an employee of Company, holds options to purchase Company common stock under both Plan A and Plan B. Taxpayer is under age fifty and has been employed by Company for less than thirteen years. At the time of this ruling, the options received under Plan A met all of the price appreciation thresholds required by Plan A; however, only a portion of the options received under Plan A satisfied the holding period requirements for vesting. Further, at the time of this ruling, the options received under Plan B had not met all of the price appreciation thresholds required by Plan B, and only a portion of the option received under Plan B satisfied the holding period requirements for vesting.
Although all of the stock price appreciation requirements for the option issued to Taxpayer under Plan A have been met, the option owned by Taxpayer under Plan A is not completely vested. Further, the option owned by Taxpayer under Plan B has not met all of the stock appreciation thresholds, nor is the option owned by Taxpayer under Plan B completely vested. Taxpayer proposes to transfer only the portions of the options granted under Plan A and Plan B that are both vested and exercisable. After the proposed transfers, Taxpayer will have no power or right to determine when the transferred portion of the option is exercised. Because Taxpayer proposes to transfer only portions of the Plan A and Plan B options that are vested and exercisable, we conclude that his proposed transfers of the portions of his Plan A and Plan B options that are vested and exercisable to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gifts incomplete.

The relevance of the "price appreciation requirements" being met or unmet is unclear. The issue was not part of Rev. Rul. 98-21.

Section 83 governs the income taxation of the options:

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, the excess of (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having a beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. Pursuant to section 83(h) of the Code, there is allowed a deduction under section 162 of the Code, to the person for whom were performed the services in connection with which the property was transferred, an amount equal to the amount included under section 83 in the gross income of the person who performed the services. The deduction will be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed the services. Section 1.83-6(a)(3) of the Income Tax Regulations provides an exception to the rule of section 83(h) concerning what taxable year the service recipient is allowed the deduction. There, it is provided that, if property is substantially vested upon transfer, the deduction will be allowed in accordance with the service recipient's method of accounting.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value at the time the option is granted. If section 83(a) does not apply to the grant of the option because
it does not have a readily ascertainable fair market value at the time of the grant, section 83 will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under section 83(a). If the option is sold or otherwise disposed of in an arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as section 83 would apply to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the tests to be applied in determining whether an option has a readily ascertainable fair market value.

Section 1.83-4(b) of the regulations provides in part that, if property to which section 83 applies is acquired by any person (including a person who acquires such property in a subsequent transfer which is not at arm's length), while such property is still substantially nonvested, such person's basis in the property should reflect any amount paid for the property and any amount includible in the gross income of the person who performed the services.

Here, Section 83 will not apply until the options are exercised. The ruling holds:

1. The transfer of the stock options to the transferee will not cause the recognition of taxable income or gain to Taxpayer.

2. If the transferee subsequently exercises the stock options, Taxpayer (or, if Taxpayer is not then living, Taxpayer's estate) will be deemed to receive taxable compensation under section 83 of the Code, and Company will receive a corresponding deduction under section 162 of the Code.

3. If the transferee exercises the stock options, the transferee's basis in the stock so acquired will be its fair market value on the date of exercise which consists of the consideration paid by the transferee and income taxed to Taxpayer (or Taxpayer's estate) under section 83 of the Code.

The Service also determined that sections 2701 and 2703 would not apply to the options and the decedent would have no retained interests.

5. **Reciprocal Gifts and Indirect Transfers.** Gifts by siblings to their own children and their nieces and nephews were collapsed by the Tax Court in *Larry L. Sather, et al. v. Commissioner*, T.C. Memo. 1999-309. The court found that the inclusion of a childless sibling in the scheme did not save it from the reciprocal trust doctrine. The court stated:

Section 2501(a) imposes a tax "on the transfer of property by gift", and section 2511(a) provides that "the tax imposed by section 2501 shall apply ** * * whether the gift is direct or indirect". Section 2503(b) excludes from the definition of "taxable gifts" the first $10,000 of gifts to any person during the year. The simultaneous, circuitous transfers of identical property to the various nieces and nephews constitute gifts by the transferors to their own children. See, e.g., *Furst v. Commissioner*, T.C. Memo. 1962-221. Petitioners' attempt to manufacture exclusions under a taxing statute that reaches both direct and indirect gifts is unavailing.
We are led to the inescapable conclusion that the form in which the transfers were cast, i.e., gifts to the nieces and nephews, had no purpose aside from the tax benefits petitioners sought by way of inflating their exclusion amounts. The substance and purpose of the series of transfers was for each married couple to give to their own children their Sathers stock. After the transfers, each child was left in the same economic position as he or she would have been in had the parents given the stock directly to him or her. Each niece and nephew received an identical amount of stock from his or her aunts and uncles and was left in the same economic position in relation to the others. This was not a coincidence but rather was the result of a plan among the donors to give gifts to their own children in a form that would avoid taxes. We hold the number of exclusions under section 2503 is limited by the number of children in each petitioner's family.

Our conclusion is supported by the doctrine of economic substance as embodied in the reciprocal trust doctrine. In United States v. Estate of Grace, 395 U.S. 316 (1969), the decedent created a trust for the benefit of his wife and, at the same time, his wife created a trust of equal value for his benefit. The trusts had identical terms granting the other spouse a life estate with the remainder to their children. The Supreme Court applied the reciprocal trust doctrine which requires that where two settlors simultaneously create trusts with the same provisions and with similar property for the benefit of each other, each settlor will be considered the creator of the trust that is in form created by the other. See id. The Supreme Court clarified that subjective intent of the settlors is irrelevant and held the doctrine applies if the two trusts: (1) Are interrelated, and (2) leave the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as beneficiaries. See id.; Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977).

This Court and other courts have applied the principles of the reciprocal trust doctrine to gift tax cases under facts similar to those of this case, see, e.g., Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Furst v. Commissioner, supra, and we apply those principles herein. The gifts to the nieces and nephews are interrelated. They are identical in type and amount and were executed at the same time. Indeed, the gifts were all part of a plan designed and carried out by petitioners as a group. It is clear that the purpose of the plan was for each married couple to benefit their own children. It is also clear that the gifts in trust left each beneficiary (the nieces and nephews), to the extent of mutual value, in the same position as they would have been in had their parents given the property directly to them. In relation to one another, the nieces and nephews all were left in the same economic position. The fact that petitioners routed the gifts to their own children through their nieces and nephews is immaterial, and we ignore that routing for tax purposes. We sustain respondent's determinations of gift tax for 1993 relating to Larry, Kathy, John, and Sandra. For the same reasons, we also agree with respondent that Kathy, Sandra, and Diane are each entitled to only three exclusion amounts under section 2503 on their respective gift tax returns for 1992.

Petitioners argue that the entire series of transactions should be respected for tax purposes because Rodney gave property on the same dates in 1992 and 1993, and he received nothing in return. Petitioners argue that application of the step-transaction doctrine mandates this result. That doctrine requires that interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. See Commissioner v. Clark, 489 U.S. 726,
738 (1989). When the step-transaction doctrine is applied, separate steps of a transaction are collapsed into one taxable event if the steps of the series are really prearranged parts of a single transaction. See id.; Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987). As we understand it, petitioners' argument is that all transfers by Larry, Kathy, John, Sandra, Duane, Diane, and Rodney, in each year, were really separate steps of a single transaction. Therefore, petitioners argue, the transaction must be viewed and taxed as a "whole", and Rodney's participation destroys the reciprocal nature of the entire transaction because he received nothing in return for his gifts.

To the extent petitioners suggest that Rodney's unilateral gift giving somehow validates the entire transaction and destroys the reciprocal nature of the gifts, we disagree. Rodney is a separate taxpayer whose gifts have not been challenged. That his gifts may have passed scrutiny does not dictate the result as to the other taxpayers. Rodney's participation in the gift giving in no way lends economic reality to the form in which the other donors structured the transfers, and his participation does not immunize the questioned transfers from application of the doctrine of economic substance or the reciprocal trust doctrine.

A similar case is Estate of Robert V. Schuler, et al., v. Commissioner, T.C. Memo. 2000-392. There two brothers owned two companies and made gifts to their, and each other’s, children and other descendants in order, ostensibly, to transfer one business to each brother’s family. The court described the plan:

Decedent had heart disease, had undergone heart bypass surgery, and had suffered seven heart attacks, most of them before the transfers at issue. Decedent had seven children, his brother has six children, and many of both men's children have children. In discussions with their insurance agent, Dave Middaugh (Mr. Middaugh), decedent and his brother made it clear that they wanted their families to succeed them in the businesses, and that they wanted decedent's family to control Sigco and George's family to control Minn-Kota.

After many discussions, decedent, his brother, and Mr. Middaugh devised a three-step plan to transfer divided ownership of Sigma and Minn-Kota to each other's family and to use section 2503(b) to save estate taxes.

The first step to transfer the Sigco stock was for decedent and his wife to make joint gifts of Sigco stock equal to $20,000 of value to their children and grandchildren during December 1994 and January 1995. The second step was for George and his wife to duplicate the first step; that is, to make joint transfers of Sigco stock equal in value to $20,000 to each of decedent's children and grandchildren. The third step in their scheme was for certain of decedent's children to transfer the shares that they had received to four of their siblings, including to Jay and his children.

The first step to transfer the Minn-Kota stock was for George and his wife to make joint gifts of Minn-Kota stock valued at $20,000 to each of their children and grandchildren in December 1994 and January 1995. The second step was for decedent and his wife to duplicate the first step; that is, to transfer in each year $20,000 of Minn-Kota stock to George and his wife and their children. The third step was for certain of George's children and their spouses to transfer the stock in amounts equal in value to $10,000 to Jody and his wife, Holly, and to their children, George M. Schuler IV (George IV) and William.
The court concluded:

The facts of the instant case prove conclusively that the transfers at issue were reciprocal; that is, decedent's transfers to his brother's family were made in exchange for George's transfers to decedent's family members.

The parties stipulated that the brothers' motivations in making the transfers included the desire to separate ownership of Sigco and Minn-Kota between the two families and to minimize estate taxes. Clearly, as both decedent and his brother owned stock of both corporations, separation of ownership by exchanging the stock through transfers to each other's family members at least implies reciprocity. The estate asserts, however, that the business purpose for exchanging the stock excepts these transactions from the reciprocal transaction doctrine. We disagree.

The estate contends that the business purpose was to divide the companies and place Jay in control of Sigco and Jody in control of Minn-Kota. Separation of the families' ownership of Sigco and Minn-Kota, insofar as it was accomplished, was not the main purpose of the transfers. Before the transfers, decedent's family owned 75 percent of Sigco; after the transfers, it owned almost 80 percent. Thus, the transfers resulted in little of the Sigco ownership shifting from George's family to decedent's family. Moreover, the estate's contention is proved false by the facts that decedent transferred shares of Sigco in 1994 and 1995 to George's son Jody, and other members of George's family, and George transferred more than 1,600 Minn-Kota shares to decedent's son, Jay, after decedent's death.

Finally, before the transfers at issue, decedent owned 25 percent of the Sigco shares outstanding and Jay owned 50 percent; collectively, a 75-percent majority. Therefore, the transfers at issue were not necessary for Jay to acquire control of Sigco. Both before and after the transfers, Jody owned 100 percent of the Minn-Kota voting stock and, therefore, controlled Minn-Kota; acquiring control of Minn-Kota for Jody was not the purpose of the transfers.

A business purpose, if any, was not the primary motivation for making the reciprocal transfers at issue. It is an inescapable conclusion that decedent and his brother made the circuitous transfers for the primary purpose of increasing the number of exclusions under section 2503(b) that otherwise would have been available to them.

In Estate of Marie A. Bies, et al. v. Commissioner, T.C. Memo. 2000-338, the decedent made gifts of funeral home stock (MBI) to her sons and daughters-in-law. The latter immediately transferred their shares to their husbands. This was arranged by Mr. Grayson, the decedent's attorney. The opinion states:

Beginning in 1985, and each year until her death, decedent transferred shares of MBI stock to Albert, Gayle, Gregory, and Loretta. Beginning in 1991, and each year until her death, decedent transferred shares of MBI stock to James and his wife Cheryl. Each transfer was to an individual, and each transfer was the number of shares or fraction of a share calculated by Mr. Grayson to be equal in value to $10,000.

The procedure was the same for each of the 27 transfers at issue: Mr. Grayson would prepare the certificates to transfer MBI shares to Albert, Gayle, Gregory, and Loretta, and at the same time, he would prepare the certificates for the shares.
transferred from Gayle to Albert, and from Loretta to Gregory. After Mr. Grayson had prepared all transfer documents, he would deliver them to the funeral home for endorsement. Albert, as president of MBI, endorsed all the certificates before delivery to the donees, including the shares that would be issued to Albert and Gregory once Gayle and Loretta endorsed the certificates for transfer. Gayle and Loretta transferred the shares received from decedent to their husbands upon receipt. Mr. Grayson would retrieve the documents after they were signed, and the transfers were then recorded in the corporate stock ledger. After their marriage, the transfers of shares from decedent to James and Cheryl, and from Cheryl to James, were made according to this same procedure.

The court held:

As a general rule, we will respect the form of a transaction. We will not apply the substance over form principles unless the circumstances so warrant. See Gregory v. Helvering, 293 U.S. 465 (1935); Estate of Jalkut v. Commissioner, 96 T.C. 675, 686 (1991). Courts have applied the substance over form principles in gift tax cases to determine the real donee and value of the property transferred. See, e.g., Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991); Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149. In these cases, the indirect transfers of the property to the intended donees were the result of a prearranged plan. See, e.g., Heyen v. United States, supra at 361 (donor transferred stock to 29 straws who either did not know they were receiving stock or believed that they were participating in stock transfers or had agreed before receiving the stock to its retransfer, 27 of whom then retransferred the stock to the donor's intended donees); Estate of Cidulka v. Commissioner, supra (father's 14 transfers of stock to daughter-in-law, who, on the same day, transferred the stock to her husband, provided "inference" of an "understanding" between father and daughter-in-law that her shares would be merely a pass-through of shares to her husband).

Section 2511(a) requires consideration of whether decedent made indirect transfers. Accordingly, we must decide whether Gayle, Loretta, and Cheryl were merely intermediate recipients of decedent's indirect transfers of stock to Albert, Gregory, and James, respectively, or were the intended beneficiaries of decedent's bounty. See Heyen v. United States, supra at 362; Estate of Cidulka v. Commissioner, supra.

We consider the objective facts of the transfers and the circumstances under which they were made evidence of decedent's actual intent in making the stock transfers. See United States v. Estate of Grace, 395 U.S. 316, 323 (1969); Heyen v. United States, supra at 362-363; sec. 25.2511-1(g)(1), Gift Tax Regs. The evidence shows that the simultaneous transfers were all part of a prearranged single transaction.

It is clear that decedent arranged to give annually to each recipient the number of MBI shares that would avoid imposition of the gift tax. This fact, by itself, is not evidence of an ulterior purpose in making the stock transfers to Gayle, Loretta, and Cheryl. See Gregory v. Helvering, supra at 469 ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). However, it is also clear from the record that Gayle, Loretta, and Cheryl had preexisting agreements to transfer the shares to their husbands. Mr. Grayson testified that he knew before decedent made the gifts that the wives had agreed to transfer the shares to their husbands. Moreover, decedent was treasurer of MBI and a member of its board of
directors; therefore, it cannot be denied that she knew Gayle, Loretta, and Cheryl made immediate transfers of the shares to Albert, Gregory, and James, respectively.

Decedent executed her will in 1989. The will provided for the bequest of the MBI stock that decedent held at death to her sons, or to the survivor of them. Thus, in the event either of her sons had predeceased decedent, decedent did not intend for the surviving spouse of the deceased son to take any shares. This provision is evidence of decedent's intentions regarding ownership of MBI stock by her daughters-in-law.

Furthermore, decedent made no inter vivos or testamentary transfers of MBI stock to either Joanne or Barbara, because neither daughter was committed to the funeral home business. However, decedent made transfers of stock to Gayle even though she knew that Gayle did not want to be in the funeral home business. This is strong evidence that the stock transfers to the daughters-in-law actually were indirect transfers to her sons.

6. Use of Unified Credit. TAM 199930002 deals with simple, but interesting, facts:

Taxpayer died on Date. During Taxpayer's lifetime, Taxpayer made gifts in Year 2 of Amount 1 that were reported on a timely filed gift tax return. No gift tax was due after application of the unified credit under section 2505. The transfers in Year 2 utilized almost the entire amount of the unified credit available to Taxpayer. The statute of limitations for assessment of tax on the Year 2 gifts has expired. During the course of the estate tax examination, it was discovered that in Year 1, Taxpayer entered into a transaction with his children pursuant to which Taxpayer purportedly sold real estate valued at Amount 2 to his children for adequate consideration in money or money's worth. No gift tax return was filed reporting the transaction in Year 1. It is contended that this transaction is properly characterized as a gift subject to gift tax in Year 1. See, Estate of Maxwell v. Commissioner, 3 F.3d 591 (2d Cir. 1993); Rev. Rut. 77-299, 1977-2 C.B. 343. Taxpayer has not agreed with this characterization.

The Service determined:

In the instant case, under the statutory scheme, Taxpayer is not entitled to a total unified credit for lifetime transfers in excess of the amount provided by section 2505. Provided it is determined, either by a court or as a result of the administrative process, that the Year 1 transaction constituted a gift subject to gift tax in Year 1, Taxpayer was obligated to report the gift and to utilize the unified credit in Year 1. By claiming the unified credit with respect to the Year 2 gifts, Taxpayer represented that Taxpayer had not made any prior gifts and that Taxpayer still had his entire unified credit available. The Service relied on this representation in allowing the use of the unified credit for the Year 2 gifts, with respect to which the statute of limitations has now expired. In allowing the application of the unified credit in Year 2, the Commissioner was not provided with any facts or information by Taxpayer that would disclose the Year 1 transaction. The Commissioner may rely on the correctness of a return or report by Taxpayer that is given to the Commissioner under penalty of perjury. Assuming that it is determined, by a court or otherwise, that Taxpayer made a gift in Year 1, the determination would constitute a contrary representation regarding the Year 2 transaction. Taxpayer is precluded from contradicting the previous representation and it is not necessary that there be a finding of intentional misrepresentation by Taxpayer. Accordingly, Taxpayer would be estopped from now arguing that Taxpayer has available the
entire unified credit allowable for application against the Year 1 gift tax liability. Any other result would conflict with the clear statutory intent of section 2505(a), limiting to $192,800 the total available unified credit that can be claimed with respect to lifetime transfers.

7. Gift of Estate Income. The failure to require payment of income may be a gift. In Estate of Ona E. Hendrickson v. Commissioner, T.C. Memo. 1999-357, the estate of the decedent’s deceased husband received about $2 million in investment income from the period 1979 to 1993 of which the decedent, Ona Hendrickson, was entitled to approximately $913,000. The decedent never took the income. The Estate argued that the income was used to maintain the farm, but the Tax Court determined that the needs of the farm did not exceed approximately $239,000 and the decedent’s spouse’s share of that expense would have been not more than $120,000. That result was a significant gift by the decedent’s spouse.

8. Excess Trustee Fees as Gifts. In TAM 200014004 the IRS assumed that trustee fees paid in a QTIP trust to a widow’s children were excessive under sections 162 and 212. The issue was whether the fees were, therefore, gifts from the widow to the children. The TAM states:

In Estate of Hendrickson v. Commissioner, TCM 1999-357, the surviving spouse was bequeathed a substantial portion of the decedent’s estate. The estate was subject to a prolonged period of administration during which the court determined the spouse was entitled to receive approximately $913,000 in estate income. However, most of this income was diverted to, or expended for the benefit of the other beneficiaries of the estate (the spouse’s children.) The court held that the spouse’s conduct as personal representative of the estate and her acquiescence in the expenditure of estate income that she was otherwise entitled to receive for the benefit of her children, constituted a gift for gift tax purposes.

In the present case, we believe that the fees, to the extent they were excessive, constitute gifts by Spouse to C and D. The trustees’ fees were paid by agreement of Spouse, to her two children, the natural objects of her bounty. There is no evidence of any arm’s length bargaining regarding the setting of the fees, and little evidence of a good faith effort to determine the appropriate fee amount, at least on an ongoing basis. The income tax examiner has determined that there is a substantial disparity between the fees paid and that which would constitute a reasonable fee. Thus, there is no indication that the setting of the trustees’ fees and the subsequent payment should be viewed as a transaction in the ordinary course of business. Spouse is the income beneficiary of Trust B. As was the case in Estate of Hendrickson, cited above, Spouse’s agreement to, and acquiescence in, the payment of excessive fees effectively diverted to her children trust income she was otherwise entitled to receive. We believe the facts (including the substantial disparity between a reasonable fee and the fees actually paid) support the conclusion that the excessive fees were intended by all the parties involved to facilitate Spouse’s estate plan by transferring assets that would otherwise be subject to estate tax in Spouse’s gross estate to Spouse’s children without the payment of transfer tax.

9. Redemption for Less Than Fair Market Value Creates a Gift. The Estate of Mary D. Maggos v. Commissioner, T.C.M. 2000-129, can be read very simply: if a shareholder allows his or her stock to be redeemed
for less than fair market value then the shareholder has made a gift to the other shareholders. But the facts are much more interesting.

The decedent owned 56.7% of Pepsi-Cola Alton Bottling, Inc. ("PCAB") which, in 1987, she allowed to be redeemed for a $3,000,000 note, interest only for 10 years at 8%. As a result the decedent's son, Nikita, owned all of the company. The opinion described the transaction:

Decedent was represented by independent and experienced counsel in the transaction. The redemption transaction was designed to be an "estate freeze". The purpose of an estate freeze, to minimize estate taxes, was explained to decedent by her counsel before the redemption. The redemption price of $3 million was determined in part because Nikita Maggos' attorney believed they could support such a valuation for gift tax purposes. In part, the price was determined by the amount Nikita Maggos thought he could afford. Decedent and Nikita Maggos did not negotiate the redemption price. Neither Nikita Maggos nor decedent sought a formal valuation of the company prior to the redemption. However, in January 1987, Nikita Maggos' accountants wrote to Robert T. Shircliff & Associates, Inc. (Shircliff & Associates), requesting that Shircliff & Associates review the draft financial results of PCAB to October 31, 1986, so that they could advise Nikita on the value of PCAB. The purpose of obtaining the valuation was for estate planning. Shircliff & Associates were in the business of consulting with Pepsi bottlers and acting as business brokers in the purchase and sale of Pepsi bottling franchises. Shircliff & Associates prepared a preliminary valuation of PCAB's business based in part on a complete valuation of the business that Shircliff & Associates had conducted in 1983 and on the recent draft financial information that had been provided. Shircliff & Associates formed the view that the business as a whole could be sold for between $9,764,144 and $13,169,366.

Things changed, as they often do in families:

In 1994, after receiving advice from her daughter, Catherine Adkins, decedent ceased her association with Robert Hite, her attorney of many years, and retained new counsel.

Subsequent to retaining new counsel on May 31, 1994, decedent disinherited her son, Nikita Maggos. Based on advice from new counsel, on August 23, 1994, decedent commenced suit in the U.S. District Court for the District of Hawaii against Nikita Maggos and PCAB (Civil No. 94-00649ACK) (the District Court litigation). On August 17, 1995, decedent commenced suit in the Circuit Court of the First Circuit of Hawaii against Helm, Huber, Ring, Helm & Co., Bezman, and Katten Muchin & Zavis (Civ. No. 95-2973-08). The circuit court litigation was removed to the Federal District Court in Hawaii (Civil No. 95-00784 SPK) and was ultimately consolidated with the District Court litigation. In the District Court litigation, decedent sought both damages and the rescission of the redemption transaction based on a number of claims asserted against Nikita Maggos and PCAB, including common law fraud, breach of fiduciary duty (against Nikita in his capacity as a fiduciary being the president and a director of PCAB and the decedent's son), and breach of the Illinois Business Corporation Act. Decedent also asserted similar claims, as well as professional malpractice claims, against Helm, Huber, Ring, Helm & Co. (her former accountants), Bezman, and Katten Muchin & Zavis (Nikita's, and PCAB's attorneys)
Petitioner's attorneys requested Coopers & Lybrand to determine the fair market value of a 100-percent and a 56.7-percent interest in PCAB. Coopers and Lybrand prepared an expert report for the District Court litigation in support of petitioner's contention that decedent had been defrauded by Nikita Maggos. Coopers & Lybrand concluded that on May 1, 1987, a 100-percent interest in PCAB was worth between $14 million and $18 million and a 56.7-percent interest was worth between $7,144,200 and $9,185,400. That study determined that the appropriate "marketability discount" that should be applied to the value of a 56.7-percent interest was 10 percent. Petitioner filed the Coopers & Lybrand report in the District Court litigation on or about December 10, 1996, in support of decedent's assertion that her interest in PCAB was worth substantially in excess of what she received in the May 1, 1987, redemption. The District Court litigation was settled out of court in early 1998.

Nikita paid $1,400,000 plus real estate of unstated value to his mother's estate.

The taxpayer's estate argued first that she did not really own the redeemed stock (it had been held in a trust) but the court summarily rejected that argument because she had filed the civil action. The taxpayer next argued she was defrauded, also rejected by the court:

In May 1987, decedent and her son, Nikita Maggos, entered into a transaction designed to minimize estate taxes and achieve decedent's testamentary goals. Both decedent and Nikita Maggos were represented by independent and qualified attorneys in the transaction. Nikita was represented by Mr. Bezman. Decedent's attorney at the time of the redemption transaction was Robert Hite. We found Mr. Hite to be a credible, truthful, and disinterested witness. Mr. Hite testified that the purpose of the transaction was an "estate freeze", a legitimate estate planning technique to move an appreciating asset out of decedent's estate. He further testified that Nikita Maggos' attorney, Victor Brezman, had planned the transaction. Mr. Hite did not question the redemption price that decedent and her son, Nikita Maggos, had agreed upon because it satisfied decedent's testamentary plan. Mr. Hite testified that decedent "had promised to leave him [Nikita Maggos] the shares when she died." The conclusion that the redemption transaction was part of an estate plan is corroborated by the fact that as part of the redemption transaction plan, Nikita Maggos' and PCAB's attorneys contacted decedent's attorney and recommended that decedent should be convinced to make a gift to decedent's daughter in 1987 so that the statute of limitations for assessing gift tax would start to run. We find that decedent and her son entered into the redemption transaction to fulfill decedent's estate planning goals and for no other reasons. Decedent was not concerned with and did not negotiate or authorize her attorney to negotiate for the fair market value of her interest in PCAB. The price received was the price that satisfied decedent's needs while she was alive, was the greatest amount her son believed he could pay, and was the lowest price Nikita's lawyers thought could be defended for gift tax purposes. So long as the transaction could be defended for Federal gift tax purposes, the fair market value of the PCAB shares that were redeemed was not of material concern to decedent.

We further find that decedent, after having received competent independent legal advice, gave a fully informed consent to the redemption transaction as an estate planning technique. On the record before us, given the intended nature of the redemption transaction, we can find no credible evidence that would support a finding that decedent was defrauded of her interest in PCAB or that there was any
breach of fiduciary duty by Nikita Maggos which was owed to decedent, thus entitling decedent to rescind the transaction. We therefore reject petitioner's "incomplete gift argument", and for the same reasons, we also reject petitioner's "bad business bargain" or "unilateral mistake" arguments.


The court first concluded that the power could be broadly construed then looked to the facts and circumstances in the case. Many states have no conclusive law on this issue. *Pruitt*, therefore, may serve as a road-map as such. The opinion states:

The parties agree that the three powers of attorney at issue in this case did not expressly authorize Ms. Thompson to make gifts. The parties do not agree, however, whether the power to make gifts can be inferred from the language of the powers of attorney and the circumstances surrounding their execution. Applying Oregon law, we examine the language of the powers of attorney and the facts and circumstances surrounding decedent's execution of the powers of attorney to determine whether the power to make gifts must be inferred in order to give effect to decedent's intent. Our goal is to ascertain whether decedent had the intent to confer gift-giving power upon Ms. Thompson.

The March 12, 1992, No. 2 power, which was prepared by decedent's lawyer, appointed Ms. Thompson as decedent's "agent and attorney in fact" with power and authority to "Convey, sell, mortgage, pledge, consign, lease and in any other manner deal in and with my property, both real and personal." (Emphasis added.) The March 12, 1992, No. 2 power, also authorized Ms. Thompson "to execute and acknowledge any and all instruments necessary or proper to carry out the foregoing powers, hereby releasing all third persons from responsibility for the acts and omissions of my attorney."

The December 22, 1987, power and the March 12, 1992, No. 1 power were prepared on preprinted standard power of attorney forms published by the same company and used identical language in most respects. They appointed Ms. Thompson as decedent's "true and lawful attorney" to exercise certain powers "for me and in my name, place and stead and for my use and benefit". Among those powers was the power to "lease, let, grant, bargain, sell, contract to sell, convey, exchange, remise, release and dispose of" any of decedent's "real or personal property * * * for any price or sum and upon such terms and conditions as to my said attorney may seem proper". The powers of attorney also contained a general grant, giving Ms. Thompson "full power and authority freely to do and perform every act and thing whatsoever requisite and necessary to be done in and about the premises, as fully to all intents and purposes, as I might or could do if personally present".

Our review of the March 12, 1992, No. 2 power in particular leads us to conclude that the grant of power authorizing decedent's attorney-in-fact to transfer decedent's real or personal property was sufficiently broad to encompass the power to make gifts. See sec. 2512(b) ("Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift"). Ms. Thompson was authorized by the terms of the March 12, 1992, No. 2
power not only to sell, mortgage, and pledge decedent's property, but also to convey decedent's property. "Convey" is defined in Black's Law Dictionary 301 (5th ed. 1979) as follows:

To transfer or deliver to another. To pass or transmit the title to property from one to another. To transfer property or the title to property by deed, bill of sale, or instrument under seal. * * *

The authority to convey without any qualification of that authority is broad enough to permit property conveyances for no consideration. Even if the word "convey" is interpreted to mean transfer for consideration, the March 12, 1992, No. 2 power broadly authorized Ms. Thompson to deal with decedent's property "in any other manner" and was not necessarily restricted to transactions for consideration.

In other cases where the applicable State law required us to ascertain the decedent's intent in interpreting a generally worded power of attorney, we have applied a similar analysis. For example, in Estate of Bronston v. Commissioner, T.C. Memo. 1988-510, we examined a power of attorney which granted the attorney-in-fact the authority to convey property without restriction to determine if the power to make gifts could be inferred under New Jersey law. The power of attorney did not restrict conveyances to those for consideration and contained a broad grant of authority to the attorney-in-fact to do whatever the principal could do if personally present. After distinguishing several decisions interpreting powers of attorney decided under New Jersey law, we concluded that the specific language in the power of attorney, which authorized the attorney-in-fact to convey property without any apparent restriction, "could authorize gifts in appropriate circumstances." Id. We examined the facts and circumstances surrounding the execution of the power of attorney and the making of the gifts, noting that the decedent "historically gave gifts to her children" and had expressed her intention to give them gifts in the year the disputed gifts were made, and we concluded that the attorney-in-fact "acted on behalf of decedent, continuing her usual affairs." Id. Based upon our review of the language of the power of attorney and the evidence of the decedent's intent, we held that the power of attorney authorized gifts. See id.; see also Estate of Neff v. Commissioner, T.C. Memo. 1997-186 (applying Oklahoma law, we concluded that Oklahoma had not adopted a flat prohibition against attorneys-in-fact making gifts to themselves or to third parties absent express written authorization, and that the durable power of attorney at issue included the implied authority to make irrevocable gifts during the principal's lifetime).

Because the powers of attorney in this case contain language broad enough to include the power to make gifts and, therefore, could be interpreted to authorize Ms. Thompson to make the 1993 and 1994 gifts, we now must examine the facts and circumstances surrounding the execution of the powers of attorney to ascertain whether decedent intended to confer gift-giving power and, if so, whether the gifts in question were "within the spirit of the power conferred upon" Ms. Thompson. Wade v. Northup, 140 P. at 458; see also Brown v. Laird, 291 P. at 354.

Petitioner offered the following evidence of decedent's intent: A substantial and consistent pattern of annual gifting extending over a period of 13 years prior to the gifts made by Ms. Thompson; a February 26, 1987, handwritten letter from decedent to her children; decedent's awareness of the potential tax liabilities of her
estate; the testimony of decedent's daughter, Ms. Thompson, and decedent's attorney, Mr. Walker; and decedent's last will and testament. We review this evidence for what it shows, if anything, about decedent's intent regarding the interpretation of the powers of attorney in this case.

Beginning in 1980 and continuing annually through 1992, decedent made gifts to the natural objects of her bounty. Decedent gave her daughters annual gifts in amounts that increased over time. In 1987, decedent expanded her gifting program to include her sons-in-law and her grandchildren. When decedent executed the first of her three powers of attorney in 1987, the gifting program was well established and steadily growing, and she already had made her annual gifts for 1987. The power of attorney was executed in connection with estate planning by decedent and her husband which was designed to minimize, to the fullest extent possible, the estate and gift tax liability of their estates and to maximize the assets passing to their family. After the execution of the December 22, 1987, power, decedent continued to make annual gifts of her property, periodically increasing the amount of the gifts and the number of donees. In February 1992, decedent again made substantial gifts to her daughters, their husbands, and her grandchildren. We believe this pattern of making annual gifts covering a period of 13 years demonstrates, and is consistent with, decedent's intention to make annual gifts of her property until her death in order to take full advantage of the annual per-donee gift tax exclusion, thereby reducing the amount of estate tax her estate would owe upon her death.

Decedent's intention to make annual gifts to her children in order to minimize her estate tax liability is demonstrated further by her February 26, 1987, letter to her children in which she stated: "It is better, to give to you now, instead of from a will. Then most of it would be consumed by old Uncle Sam, who is always hungry. We want you to enjoy it." Decedent's intention, shown by annual gifts beginning in 1980 and stated clearly in her 1987 letter to her daughters, was to minimize the potential tax liabilities of her estate by giving annual gifts to her family.

The testimony of decedent's daughter also reinforces petitioner's argument that decedent intended to grant the power to make gifts to her attorney-in-fact. Ms. Thompson testified that she discussed the "gifting program" on numerous occasions with her parents, who were concerned about the size of their estates. Ms. Thompson also testified that when decedent delivered the powers of attorney to her, decedent never indicated that Ms. Thompson was prohibited from taking certain acts and decedent gave no specific instructions to Ms. Thompson. Since decedent was told by her attorney, Mr. Walker, that such powers of attorney authorized Ms. Thompson to do whatever decedent could do with her own property, and since each of the powers of attorney contained a general grant of power that would appear to a nonlawyer to be consistent with Mr. Walker's statement to decedent, we do not find it surprising that decedent did not discuss specifically with Ms. Thompson whether Ms. Thompson had the power to continue the annual gifts to decedent's family.

The testimony of decedent's attorney, Mr. Walker, lends support to petitioner's argument. Mr. Walker testified that, when the December 22, 1987, power was executed, "my words were to her that 'this will allow your daughter to do anything that you can do.'" With respect to the March 12, 1992, powers, Mr. Walker testified: "The intent was that the agent under [the power] could do anything that
[decedent] could do." Mr. Walker further testified that when he presented the March 12, 1992, powers to decedent for execution, he recalled "using the words 'this will allow your daughter to do anything that you can do.'" When Mr. Walker was asked on cross-examination whether decedent ever told him whether she specifically wanted to include the power to make gifts in the powers of attorney, Mr. Walker responded: "I think it might have been the other way around. I said that 'this will allow your daughter to do anything that you could do,' and we specifically talked about the gifting." The record amply demonstrates that decedent relied upon Mr. Walker's advice and acted upon it. Decedent understood from conversations she had had with Mr. Walker that lifetime gifts were an important estate planning tool and that her powers of attorney authorized her daughter to do anything decedent could do. It is reasonable, therefore, for us to conclude on this record that decedent intended the powers of attorney to include the power to make gifts.

Finally, a review of decedent's will confirms that the 1993 and 1994 gifts were to the same individuals who would have inherited the properties under the terms of decedent's will. In her will, decedent bequeathed all her real and personal property to her three daughters if she was not survived by her husband (decedent's husband died in November 1993).

* * * * *

Without an explicit ruling by the Supreme Court of Oregon or a statute enacted by its legislature, we cannot decide this case based on a bright-line rule that an agent lacks authority to make gifts of the principal's property unless the agent is expressly given that power in the power of attorney. We must rely instead upon Oregon law which requires us to consider both "the strict letter" and "the spirit of the power" conferred upon the agent. Wade v. Northup, 140 P. 451, 458 (Or. 1914). We recognize the potential for "self-dealing" that exists when an agent acting pursuant to a durable power of attorney has the power to make gifts, especially after the principal becomes incapacitated, and we agree that we must be wary when asked to infer from a power of attorney a power to make gifts when the attorney-in-fact has made the gifts in question to herself and to individuals related to her. See Wilkinson v. Commissioner, T.C. Memo. 1993-336. Acknowledging, as we must, that a decision inferring a power to make gifts from the general language of a durable power of attorney must be made with great caution, we nevertheless must decide this case based on the best information available to us and our careful review of applicable State law. After carefully reviewing Oregon law and examining the decisions of the Supreme Court of Oregon, this Court, and other courts for guidance, we are convinced that a decision to infer the power to make gifts from the general language of a durable power of attorney is warranted in this case because (1) there is no case law or statute in the controlling jurisdiction prohibiting an inferred power to make gifts, (2) the controlling jurisdiction considers the principal's intention in interpreting the power of attorney, (3) there is a substantial pattern of gifting by the principal preceding the gifts made by the attorney-in-fact, (4) the gifts made by the attorney-in-fact are consistent with the principal's prior gifting, (5) the gifts do not deplete the principal's assets to the principal's detriment, and (6) it is clear there has been no fraud or abuse by the agent.

In Estate of Swanson v. United States, 46 Fed. Ct. 388 (2000), the court looked to a specific California statutes and accumulated case law to conclude the opposite. Washington has a similar statute. In Estate of Floy M. Christensen,
et al. v. Commissioner, T.C. Memo. 2000-368, the decedent’s estate attempted to get around the fact that the decedent’s attorneys-in-fact did not have the power to make gifts by arguing that they could write checks to various donees from a joint bank account.

11. **Relation-Back Doesn’t Apply to Non-Charitable Gifts.** In Robert Rosano v. United States, 87 AFTR2d Par. 2001-766 (2d Cir. 2001), the Second Circuit affirmed the district court and held that the relation-back doctrine does not apply to non-charitable gifts:

Other courts have refused to apply the doctrine when the decedent died prior to payment of a non-charitable gift. McCarthy v. United States, 806 F.2d 129, 131-33 (7th Cir. 1986); Newman v. Commissioner, 111 T.C. 81 (1998). In McCarthy, the court offered two reasons for its refusal to extend the doctrine of relation-back. First, a rationale for applying the doctrine in the charitable context was not present in the non-charitable context. Checks delivered by the decedent to a charity but not paid until after the decedent's death, if included in the estate, would generate a deduction for the estate. This deduction would result in a "wash" for estate tax purposes, meaning that the estate would obtain the benefit of the charitable deduction whether or not the doctrine of relation-back was applied. For practical purposes, it makes more sense to consider the checks as outside the estate. "No such practical consideration extends to non-charitable gifts. No offsetting deduction exists for gifts made to noncharitable donees." McCarthy, 806 F.2d at 132. Second, the court thought that extending the doctrine would allow for improper tax avoidance: "By issuing a check to a noncharitable donee with the understanding that it not be cashed until after his death, a decedent may effectively bequest up to $10,000 per donee, thus avoiding the estate tax consequences normally attending such transactions." Id. Accord Metzger, 38 F.3d at 122.

We agree with the policy concerns expressed by the McCarthy and Metzger courts. Thus, we will not apply the doctrine where gifts are made to a non-charitable donee and the donor died prior to the date of payment. We express no opinion as to whether we would apply the doctrine where there is a non-charitable donee and the donor is alive on the date of payment.

O. **SECTION 2518 - DISCLAIMERS**

1. **Reasonable Time.** In PLR 199934011 the Service allowed a disclaimer in an unusual situation. Father created a trust for the benefit of son, son’s descendants, and son’s wife. Son died and son’s wife became aware of her interest and wanted to disclaim it. The ruling states

As discussed above, section 25.2511-1(c)(2) governs the effectiveness of a disclaimer with respect to an interest created in a “taxable transfer” prior to 1977. In the instant case, under the terms of Trust, Taxpayer was a contingent beneficiary of Trust, in the event she survived Son. Under Jewett and Ordway, the “taxable transfer” creating Taxpayer’s interest in Trust occurred on Date 3, when Decedent died. Therefore, section 25.2511-1(c)(2) applied in determining the effectiveness of Taxpayer’s disclaimer for federal transfer tax purposes.

As discussed above, under section 25.2511-1(c)(2), the disclaimer will not be subject to the gift tax if it is made within a reasonable time after the disclaimant obtains knowledge of the transfer creating the interest. The question of what
constitutes a reasonable time is dependent on federal, rather than state, criteria and is generally dependent on the facts and circumstances presented.

We note that a disclaimer made within nine months of the disclaimant learning of the existence of the transfer creating the interest would generally satisfy the reasonable time requirement of the regulations, in the absence of facts indicating a contrary result is warranted. Accordingly, Taxpayer's disclaimer within nine months of learning the existence of the transfer creating the interest would be timely for purposes of section 25.2511-1(c)(2). We express or imply no opinion as to when Taxpayer first obtained the requisite knowledge of the transfer creating the interest.

Presumably there would have been a different result for a post 1976 power.

P. SECTIONS 2601-2654 - GENERATION-SKIPPING TRANSFER TAX

1. Final Regulations Discuss Modification to Grandfathered Trusts. On December 20, 2000, the IRS issued final regulations dealing with trust modifications that will not affect a trust’s exempt status for GST purposes. T.D. 8912. They differ significantly from the proposed regulations.

The explanation states:

1. The Regulatory Approach

In general, under the effective date rules accompanying the GST statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99-514 (100 Stat. 2085, 2731), 1986-3 (Vol. 1) C.B. 1, 634. Such trusts are hereinafter referred to as exempt trusts for GST tax purposes. The proposed regulations provide a number of safe harbors with respect to changes that can be made to the terms of an exempt trust that will not result in the loss of exempt status.

Commentators argued that the approach set forth in the proposed regulations is inconsistent with the statutory effective date provisions. They contend that, under the TRA, with the exception of additions to principal, modifications or other actions with respect to a trust should not affect the trust's exempt status. Rather, any change should have GST tax consequences only if the change subjects the trust principal to a current gift tax. In that case, the individual making the gift will be treated, to the extent of the gift, as the transferor of the trust for GST tax purposes and the trust, to the extent of the gift, will be subject to the GST tax regime.

This approach was not adopted. The statutory effective date provision protects generation-skipping trusts that were irrevocable before the GST tax was enacted and presumably could not be changed to avoid the imposition of the tax. The Treasury Department and the IRS believe that the approach adopted in the regulations is consistent with Congressional intent to protect these trusts and that most of the modifications that will not affect the exempt status of a trust will be covered by the safe harbors in the final regulations.

2. Trustee Discretionary Actions

Under the proposed regulations, where there is a distribution of trust principal from an exempt trust to a new trust, the new trust will be an exempt trust if the terms of
the governing instrument of the old trust authorize the trustee to make distributions to the new trust without the consent or approval of any beneficiary or court and the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust beyond the applicable perpetuities period.

In response to comments, the final regulations clarify that the retention of property in a continuing trust, as well as the distribution of property to a new trust, will not cause loss of exempt status, assuming the requirements of the regulations are satisfied.

In response to comments, the final regulations provide that distribution to a new trust or retention in a continuing trust will not cause the loss of exempt status, even if the governing instrument does not specifically authorize the action, if state law, at the time the exempt trust became irrevocable, permitted such distribution or retention in a continuing trust.

One comment suggested that the final regulations provide that a discretionary distribution that otherwise satisfies the regulatory requirements should not cause the trust to lose exempt status if the trustee, although not required to do so, seeks approval of a court or the trust beneficiaries before taking action. This change was deemed unnecessary. An action that satisfies the requirements of the regulations will not cause loss of exempt status even if, for whatever reason, the trustee seeks a court's or a beneficiary's approval of such action.

Comments suggested that the period for measuring the appropriate perpetuities period for the new trust should be the date the original trust became irrevocable under local law. The comments noted that the perpetuities period is properly measured from the date the trust becomes irrevocable, which is not always the date the trust was created (the date referenced in the proposed regulations). The regulations have been revised accordingly.

3. Settlements and Judicial Constructions

Under the proposed regulations, a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the trust will not cause the trust to lose exempt status if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law. A judicial construction of a governing instrument resolving an ambiguity in the terms of the instrument or correcting a scrivener's error will not cause loss of exempt status if the judicial action involves a bona fide issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

One comment suggested that the standard applicable for recognition of settlement agreements should also apply for court decrees, such that one standard would govern both actions. Thus, the commentator suggested that a settlement agreement or court decree should be binding on the Service (and not cause loss of exempt status) if the result is within the range of reasonable outcomes and the agreement or court decision is the product of adversarial proceedings. The suggestion was not adopted. The standard applied in the regulations for court decrees was enunciated by the Supreme Court in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967),
and has been continuously and repeatedly applied by the IRS and the courts. The adoption of a different standard at this time is not appropriate.

Another comment addressing the rule for settlements stated that the requirement that the settlement fall within the range of reasonable outcomes under the governing instrument and state law could be read to deny protection to a settlement that reaches a result that a court could not reach. However, the purpose of this rule is not to restrict safe harbor protection to only those settlements that reach the result a court could reach if the issue was litigated. Rather, the rule is intended to afford the parties a greater degree of latitude to settle a case than would be available if a court had to decide the issue. Thus, a settlement "within the range of reasonable outcomes" would include a compromise that reflects the parties' assessment of their relative rights and the strengths and weaknesses of their respective positions. The settlement need not (and it is anticipated that in most cases it would not) resolve the issue in the same manner as a court decision on the merits. Language has been added to the final regulations emphasizing this point. On the other hand, as illustrated in the preamble to the proposed regulations, a settlement that, for example, creates beneficial interests that did not exist under a reasonable interpretation of the instrument will not satisfy the regulations.

One comment suggested that the scope of the judicial construction rule should be expanded to cover not only ambiguities and scrivener's error, but any request for court instructions or any similar proceedings such as requests to modernize the trust instrument, or adapt the instrument to unforeseen changed circumstances. This suggestion was not adopted. The Treasury Department and the IRS believe that these and similar actions are properly addressed under the safe-harbor "shift in beneficial interest" rule provided in the regulations, and a separate category to address these items is not needed.

4. Other Changes

Under the proposed regulations, a modification that does not satisfy the regulatory rules for trustee distributions, settlements, and constructions will not cause a trust to lose exempt status, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Comments suggested that the regulations should provide additional guidance on when a modification shifts a beneficial interest in a trust. In response to these comments, the final regulations provide that a modification to an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in an increase in a GST transfer or create a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification.
In conjunction with this change, the final regulations remove Example 7 contained in section 26.2601-1(b)(2)(vii)(B). This example had illustrated the transition rule contained in section 26.2601-1(b)(2) for generation-skipping transfers under wills or revocable trusts executed before October 22, 1986. Under this rule, the GST tax does not apply to transfers made under a will or revocable trust executed before October 22, 1986, if the decedent dies before January 1, 1987, and the instrument is not amended after October 21, 1986, in any respect that results in the creation of, or increase in the amount of, a generation-skipping transfer. In Example 7, trust income is to be distributed equally, for life, to A, B, and C who are skip persons assigned to the same generation. The trust is amended to increase A’s share of the income. The example concludes that the trust is subject to GST tax because the amendment increases the amount of the generation-skipping transfers to be made to A. The amendment to the trust, however, does not increase the amount of a generation-skipping transfer when viewed in the aggregate. The amendment merely shifts an interest from one beneficiary to another beneficiary assigned to the same generation. Example 7 in section 26.2601-1(b)(4)(i)(E) considers a substantially similar fact pattern involving a trust that is irrevocable on or before September 25, 1985, and concludes that the modification will not result in an increase in a generation-skipping transfer.

The standard contained in section 26.2601-1(b)(2) (relating to wills and revocable trusts executed before October 22, 1986) is similar to the standard contained in section 26.2602-1(b)(4)(i)(D) (relating to a modification to a trust that was irrevocable on September 25, 1985). The Treasury Department and the IRS believe that the two provisions should be applied in a consistent manner. Therefore, Example 7 in section 26.2601-1(b)(2)(vii)(B) has been eliminated.

In response to comments, the final regulations specify that changes that are administrative in nature (such as a change in the number of trustees) will not cause the trust to lose its exempt status. An example has been added illustrating this point.

Several comments indicated that many states have adopted, or are considering adopting, section 104 of the Revised Uniform Principal and Income Act. Uniform Principal and Income Act section 104, 7B U.L.A. 141 (1997) (Act). The Act allows a trustee to adjust between principal and income to the extent necessary to produce an equitable result, if the trustee invests and manages trust assets pursuant to the state's prudent investor statute and the trustee is unable to administer the trust fairly and reasonably under the general statutory rules governing the allocation of income and principal. In addition, the comments noted that some state legislatures are contemplating revising their state principal and income act to define trust income as a unitrust amount (a fixed percentage of the trust principal determined annually). The comments suggested that the regulations provide additional safe harbors to the effect that the administration of an exempt trust pursuant to a state statute adopting the Act, or the conversion of an income interest to a unitrust interest pursuant to a court order or a state statute redefining trust income, would not cause the trust to lose exempt status.

A guidance project considering the tax consequences of these state law changes in a broader context is currently under consideration. Accordingly, these regulations do not specifically address this issue. However, two examples have been added to the regulations illustrating circumstances under which a trust will not lose exempt status.
status where an income interest is converted to an interest that pays the greater of trust income or a unitrust amount, and a trust is modified to allow allocation of capital gain to income.

In response to a comment, the facts presented in section 26.2601-1(b)(4)(i)(E) Example 5, have been changed to clarify that after the trusts are partitioned, if either beneficiary should die without descendants surviving, the principal of their partitioned trust will pass to the other partitioned trust.

5. Effective Dates and Other Matters

Comments requested clarification regarding the status of exempt trusts that were modified or subject to other actions (for example, judicial constructions or settlements) prior to the effective date of these regulations, December 20, 2000. The IRS will not challenge the exempt status of a trust that was, prior to December 20, 2000, subject to any trustee action, judicial construction, settlement agreement, modification, or other action, if the action satisfies the requirements of the regulations.

Finally, with respect to the deletion of section 26.2601-1(b)(2)(vii)(B) Example 7, discussed above, the IRS will not follow that example when applying the rule in section 26.2601-1(b)(2).

Certain key areas are illustrated by example.

a. Change in trust situs. Example 4 provides:

Example 4. Change in trust situs. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

What if the change in situs enabled the trust to be administered in a way that benefitted a lower generation by, for instance, allowing less to be distributed to higher generations?
In PLR 199922044 the trust provided that the situs of the trust would be deemed to be at the principal office of the corporate trustee and the trust was to be governed by the laws of the state of the situs and to be administered in accordance with the laws of the state of the situs. The ruling concluded that the primary beneficiary of the trust had the power to replace the corporate trustee according to the governing instrument and thus that the change in situs and applicable law occurred pursuant to the terms of the governing instrument. Thus “the proposed modifications do not confer additional powers or beneficial interest upon any current or new trustee or upon any of the trust beneficiaries. Moreover, these modifications will not create any additional generation-skipping transfers or increase the amount of any generation-skipping transfers.”

b. **Change to unitrust distribution.** Two examples, 8 and 9, deal with this, in a generally favorable way:

Example 8. Conversion of income interest into unitrust interest. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A’s death, the remainder is to pass to A’s issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A’s income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A’s issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 9. Allocation of capital gain to income. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor’s child, A, for life, and upon A’s death, the remainder is to pass to the A’s issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to the income. The modification does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to A, and decreasing the amount distributable to A’s issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Would the result be different in Example 8 if the conversion had been to a pure unitrust?

c. **Effect of state statutes.** Example 2 is slightly different from the regulation. The regulation states:

(4) Retention of trust's exempt status in the case of modifications, etc. — (i)
In general. This paragraph (b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an exempt
trust) will not cause the trust to lose its exempt status. The rules contained in this paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001.

(A) Discretionary powers. The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if --

(1) Either --

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

The example provides:

Example 2. Trustee's power to distribute principal pursuant to state statute. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time, the trust principal will be distributed to A's issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in
favor of a trustee of a trust under an instrument other than that under which the
power to invade is created, or under the same instrument. The trustee may take the
action either with consent of all the persons interested in the trust but without prior
court approval, or with court approval, upon notice to all of the parties. The
exercise of the discretion, however, must not reduce any fixed income interest of
any income beneficiary of the trust and must be in favor of the beneficiaries of the
trust. Under state law prior to the enactment of the state statute, the trustee did not
have the authority to make distributions in trust. In 2002, the trustee distributes
one-half of Trust's principal to a new trust that provides for the payment of trust
income to A for life and further provides that, at A's death, one-half of the trust
remainder will pass to B or B's issue and one-half of the trust will pass to C or C's
issue. Because the state statute was enacted after Trust was created and requires the
consent of all of the parties, the transaction constitutes a modification of Trust.
However, the modification does not shift any beneficial interest in Trust to a
beneficiary or beneficiaries who occupy a lower generation than the person or
persons who held the beneficial interest prior to the modification. In addition, the
modification does not extend the time for vesting of any beneficial interest in Trust
beyond the period provided for in the original trust. The new trust will terminate
at the same date provided under Trust. Therefore, neither Trust nor the new trust
will be subject to the provisions of chapter 13 of the Internal Revenue Code.

2. Effective Date Rule. The Eighth Circuit has issued a very important opinion in John M. Simpson,
et al. v. United States, 84 AFTR2d Par. 99-5089. The facts were simple. Grover Simpson died in 1966 and creates a
general power of appointment marital trust. Mary dies in 1993 having exercised the power of appointment in favor of
her grandchildren. Does the GST apply to the assets passing to the grandchildren?
The court has no trouble answering the questions -- the GST does not apply:
The parties discuss at some length what the purpose of the special effective-date
provision could have been. The effective date of September 25, 1985, is the date
on which the staff of the Joint Committee on Internal Revenue Taxation issued a
summary of proposals for a revision of the then-existing GST tax. (The tax had first
been enacted, in a different form, in 1976.) The premise of such provisions, in
general, is that taxpayers, at least those with a lot at stake, follow closely proposals
pending in Congress to amend the tax laws. Once the taxpayer has notice of a
proposal, it is fair to subject him or her to the tax, even when the tax may be
enacted some months or even years later. (Congress has power, within broad limits,
to make taxing statutes retroactive, but it frequently chooses not to exercise this
power.) So the provision was obviously intended to protect taxpayers who had,
before September 25, 1985, taken certain irrevocable action in reliance upon the
state of the tax law existing at the time of the action. What is the relevant action in
the present case? The government argues that the relevant action was the exercise
of the power of appointment by Mrs. Bryan, an exercise which became effective
only upon her death, approximately eight years after September 25, 1985. The
taxpayer argues, to the contrary, that the relevant action is the date of the creation
of the trust, which occurred when Mr. Simpson died in 1966. When Mr. Simpson
created the trust, there was no GST tax, and he thus had no reason to anticipate that
his wife's exercise of her general testamentary power of appointment would trigger
any kind of a tax over and above the ordinary estate tax consequent upon her
possession of a general power, see 26 U.S.C. section 2041.
Which side is right about the purpose of the statute? The issue is easily resolved, we think, by consulting the most important evidence of a statute's purpose -- that is, its words. Recall the relevant clause: "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985." The government wants us to read the words, in effect, as though "which" modified "transfer." This is not a meaning that the words will bear. The antecedent of "which" is "trust," not "transfer." The relevant action which has to take place before September 25, 1985, is the creation of the trust, or rather its becoming irrevocable, not the occurrence of the generation-skipping transfer. We see no escape from the logic of this reasoning. In the present case, the trust became irrevocable before September 25, 1985. The transfer was made possible by the trust. The transfer was "under" the trust. The fact that the transfer occurred after September 25, 1985, and, indeed, that Mrs. Bryan, the transferor, could have avoided the GST tax by giving the property to someone other than her grandchildren, is not relevant. The point is that when the trust was created and became irrevocable Mrs. Bryan was given the authority, under the law as it then existed, to exercise her general power of appointment in favor of anyone at all, and to do so without subjecting the transfer to a GST tax, such a tax then being far in the future. This is the sort of reliance that the effective-date provision protects.

The IRS thought the issue had been addressed previously in E. Norman Peterson Marital Trust v. Commissioner, 78 F.3d 795 (2d Cir. 1996). The facts there, as recited by the Simpson court were:

In that case, the original settlor, E. Norman Peterson, died in 1974. His will created a trust for the benefit of his wife, Eleanor Peterson. Mrs. Peterson was given a general testamentary power of appointment over the corpus of the trust. If the power was not exercised, the corpus was to be set aside for the Petisons' grandchildren. Mrs. Peterson died in 1987. Because she had a general power of appointment, the remaining value of the trust was then included in her gross estate under 26 U.S.C. section 2041. But in her will, Mrs. Peterson specifically stated that she was not exercising the power, except to the extent necessary to pay the estate tax attributable to the inclusion of the trust property in her estate. The power therefore lapsed, and the property remaining in the trust after payment of the estate taxes was transferred to the grandchildren.

The court distinguished Peterson:

The distinction between Peterson and the present case is obvious. Here, when the power was exercised, it was exercised with respect to the entire remaining corpus. There was no portion of the trust remaining after the exercise. Nor did the power lapse to any extent. There is therefore no way to argue, and the government in fact does not argue, that the transfer at issue here is subject to the GST tax because it was made out of corpus added to the trust after September 25, 1985. Nor is there any regulation, temporary or permanent, that applies to the particular sort of transfer made here -- a transfer of the entire corpus of the trust remaining at the time of the exercise of the power. We have no quarrel with the holding of Peterson, but we cannot agree with the government that it compels or even supports the result contended for in the present case.

Clearly the court was puzzled over why there was any dispute at all:

The entire concept of written law, indeed of all verbal communication, depends on the idea that words have SOME meaning. It is true that the ingenuity of lawyers can usually scrape up some tag end of ambiguity on which to hang a policy hat. But
judges are obliged, unless there is a substantial uncertainty as to the meaning of the words of a statute, to apply the statute as written, unless the words are simply nonsense, or self-contradictory, or something of that kind. This is not such a case. The words of Section 1433(b)(2)(A) are clear, at least to us, and we see no reason not to apply them. The words make it clear that Congress intended to protect the reliance of creators of trusts on the law as it existed at the time the trusts became irrevocable. That Congress could, consistently with the Constitution and with fairness, have selected another effective-date regime is not relevant. We hold that the transfer at issue in this case took place under a trust which was irrevocable on September 25, 1985. The GST tax therefore does not apply.

The final regulations attempt to reverse the result in Simpson. As stated in the Supplementary Information to the proposed regulations:

In Simpson v. United States, 183 F.3d 812 (8th Cir. 1999), the decedent exercised a testamentary general power of appointment granted under a marital trust that was created in 1966. Pursuant to the decedent's exercise of the general power of appointment, the property passed to her grandchildren who were skip persons under section 2612. The court concluded that the transfer to the grandchildren was exempt from the GST tax under section 1433(b)(2)(A) of the TRA, because the transfer was "under a trust" that was irrevocable on September 25, 1985.

The facts in Simpson are similar to those presented in Peterson Marital Trust v. Commissioner, 78 F.3d 795 (2nd Cir. 1996). In Peterson, the decedent had a testamentary general power to appoint property in a pre-September 25, 1985 marital trust created under her husband's will. Rather than appointing the property outright, the taxpayer allowed the power to lapse and the property passed to her husband's grandchildren, who were skip persons under section 2612. The court concluded that the transfer was subject to the GST tax. The court noted that the effective date provisions in section 1433(b)(2) of the TRA were "designed . . . to protect those taxpayers who, on the basis of pre-existing rules, made arrangements from which they could not reasonably escape and which, in retrospect, had become singularly undesirable." Peterson Marital Trust, at 801 (footnote omitted). The court concluded that there was no basis to apply the protection provided in section 1433(b)(2) to the marital trust because the arrangement could have been changed to avoid the GST tax through the exercise of the decedent's general power of appointment.

Treasury and the IRS believe that there is no substantive difference between the situation in Simpson where property passed pursuant to the exercise of a general power of appointment and the situation in Peterson Marital Trust where property passed pursuant to a lapse of a general power of appointment. An individual who has a general power of appointment has the equivalent of outright ownership in the property. Estate of Kruz v. Commissioner, 101 T.C. 44, 50-51, 59-60 (1993). The value of the property subject to the general power is includible in the power holder's gross estate at death under section 2041(a). In either case, the power holder can avoid the consequences of the GST tax by appointing the property to nonskip persons. Therefore, as the court noted in Peterson Marital Trust, there is no basis for exempting such dispositions from the GST tax under the TRA effective date provisions.
Accordingly, the proposed regulations clarify that the transfer of property pursuant to the exercise, release, or lapse of a general power of appointment created in a pre-September 25, 1985 trust is not a transfer under the trust, but rather is a transfer by the power holder occurring when the exercise, release, or lapse of the power becomes effective, for purposes of section 1433(b)(2)(A) of the TRA.

The IRS is correct that there is no substantive difference between the facts of Simons and Peterson. However, the Eighth Circuit in Simpson appeared to be interpreting the statute, not the regulations, in its holding despite the language distinguishing Peterson and referring to the regulation. It should be more difficult for the IRS to reverse a Circuit Court interpretation of the statute itself.

In Robert A. Bachler, et al. v. United States, ______________ (N.D. Cal. 2000), the court was persuaded by Peterson not Simpson. The opinion states:

Peterson does not directly control the analysis of this case, because the facts of that case were different. Peterson dealt with the situation covered by 26 C.F.R. section 26.2601-1(b)(1)(v)(A), where a portion of a trust remains in the trust after the exercise, release, or lapse of a power of appointment. Here, because no part of Trust A was left in the trust after Decedent's exercise of her general power of appointment, the exercise did not constitute a constructive addition under 26 C.F.R. section 26.2601-1(b)(1)(v)(A). Nonetheless, the Court is persuaded by that court's reasoning regarding the purpose of the grandfather clause.

The justification for the grandfather clause is evidenced in the text of the clause itself. Section 1433(b)(2)(A) is one of three grandfathering provisions for the GST tax. Subsection (b)(2)(B) allows extra time for individuals to reform an existing will before the new GST tax would apply to them. Subsection (b)(2)(C) provides that the grandfather clause will apply to the wills of individuals subject to a mental disability who are unable to change their wills after the effective date of the new GST tax. Taken as a whole, the three subsections indicate Congress' intent to protect individuals who are unable to escape from their existing plans, not an intent to exempt certain trusts in perpetuity.

Plaintiff argues that the Court should follow Simpson. While the facts of the instant case are almost identical to those in Simpson, the Court finds Simpson unpersuasive. Simpson analyzed the phrase "under a trust," and justified the application of the grandfather clause to a transfer pursuant to a general power of appointment as follows:

Was the transfer made by Mrs. Simpson "under" this trust? We do not see how an affirmative answer can be avoided. The power of appointment that made the transfer possible was created by the trust. Language has to mean something, and the argument that this particular transfer was not "under" trust A is simply untenable.

Id. at 814. As discussed above, an affirmative answer to the Simpson court's question can be avoided by recognizing that the phrase "under a trust" is ambiguous, and looking to the purposes of the grandfather clause.

Plaintiff claims that "under a trust" is a term of art, and includes decisions and transfers not specified in the trust instrument itself. Plaintiff cites no case law or statutory authority in support of this contention. "Under a trust" is nowhere defined...
in the tax code, and must be given a meaning informed by its context. The context indicates that the grandfather clause of TRA 1986, section 1433(b)(2)(A) was meant to protect donors from a change in the law that they could not avoid. Thus, a transfer "under a trust," within the meaning of the grandfather clause, is a transfer that is required by the terms of an irrevocable trust. Grandfather clauses typically serve such a purpose. See Tataranowicz v. Sullivan, 959 F.2d 268, 277 (D.C. Cir. 1992); Serel v. United States, 684 F.2d 597, 599 (8th Cir. 1982).

Here, it was not inevitable that Trust A would be subject to the GST tax. Settlor's will provided that upon a lapse of Decedent's general power of appointment, the assets of the trust would pass to his children, a transfer that would not have resulted in the imposition of the GST tax. Decedent, like the decedent in Peterson, had the power to appoint the assets in Trust A to whomever she chose. Decedent could have appointed all of Trust A to her children, thus avoiding the GST tax entirely. As the court noted in Peterson, "[t]here is no reason to 'grandfather' such a mutable arrangement, and Congress has given no indication that it wished to do so." Accordingly, the Court holds that TRA 1986, section 1433(b)(2)(A) does not apply to Decedent's transfer to her grandchildren. The GST tax does apply and Plaintiff is not entitled to a refund of it.

3. Substantial Compliance in Allocating GST Exemption. The IRS seems generally willing to rule that donors have substantially complied with the GST exemption allocation requirements even if no notice of allocation is actually filed. See PLRs 200027009 and 200040013 for example.

4. Transfer of CLAT Remainder Does Not Shift Transferor. In an as yet unpublished PLR (dated November 14, 2000) the question was whether the transfer of a remainder interest in a CLAT by a child of the CLAT to the child's children would cause the child to become the transferor. Such a result would be desirable because the interest of the child would be zero, or close to it, upon the transfer. The ruling point out that CLATs have great potential for abuse of the generation skipping tax rules. Thus:

Congress remedied this situation by the enactment of § 2642(e). Under this special rule for charitable lead annuity trusts, the numerator of the applicable fraction is the adjusted GST exemption and the denominator is the value of all property in the trust immediately after termination of the charitable lead interest. The adjusted GST exemption is the GST exemption allocated to the trust increased by the interest rate used in determining the charitable deduction for federal gift or estate tax purposes for the actual period of the charitable lead annuity.

In light of § 2642(e), all generation-skipping transfers made with respect to a charitable lead annuity trust will be subject to the GST tax if no GST exemption is allocated to the trust. Even if GST exemption is allocated to a trust, there is no way to guarantee that it will be sufficient to ensure that the trust is exempt from GST tax.

The series of transactions proposed in the ruling request have the effect of circumventing the rules of § 2642(e) using the same type of leveraging that prompted Congress to enact § 2642(e). The trustees propose to designate Child A as the beneficiary of one-sixth of the remainder interest in Trust. Child A will then assign Child A's one-sixth remainder interest to Child A's children in a transaction that is subject to gift tax.
Based on the above, we conclude that for GST tax purposes, and consistent with the purpose of § 2642(e), there will be two transferors with respect to the trust assets in Trust as of the date of the assignment. Child A will be considered the transferor with respect to the portion of the trust assets equal to the present value of the one-sixth remainder interest on the date of the gift. The Decedent will remain the transferor with respect to the balance of the Trust.

Apparently concerned that the basis of the ruling might be too narrow, the Service goes on to state:

We also note that under the facts presented in the ruling request, the form of the transaction might be disregarded and the series of transactions viewed as the designation by the Trustee of Child A’s children as remainder beneficiaries. Under this analysis, Decedent would be treated as the transferor of the entire Trust estate for GST tax purposes. See Estate of Bles v. Commissioner, T.C. Memo. 200-388; Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149; Griffin v. United States, 42 F.Supp.2d 700 (W.D. Tex. 1998).

separated from the creation of the CLAT by a year so there was a gift? What about a GRAT?

5. Rule Against Perpetuities. A number of states have repealed their rule against perpetuities. Among them are Alaska, Arizona, Delaware, Florida, Idaho, Illinois, Maine, Maryland, New Jersey, Ohio, Rhode Island, South Dakota, and Wisconsin. The Florida statute imposes a 360 year statute. The purpose of the limit, rather than simple repeal, is to avoid the so-called Delaware Tax Trap.

Q. SECTIONS 2701-2704 - SPECIAL VALUATION RULES

1. Application to Family Limited Partnerships. In Blaine P. Kerr, et ux. v. Commissioner, 113 T.C. No. 30 (1999), the Tax Court considered the application of the statute to the transfer of interests in a family partnership to GRATs, KFLP was created under the Texas Revised Limited Partnership Act (TRLPA). The court described the taxpayer’s position:

Petitioners contend that section 2704(b) does not apply to the KFLP interests that they transferred to the GRAT’s trustees because those interests were merely assignee interests under State law. TRLPA section 7.02(a)(2) provides that an assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or exercise the rights or powers of a partner. TRLPA section 7.02(a)(3) and (4) provides that an assignee is allocated the income, gain, loss, deduction, or credit to which the assignor was entitled, and, until the assignee becomes a partner, the assignor continues to be a partner and to have the power to exercise any rights or powers of a partner. TRLPA section 7.04(a) provides that an assignee of a partnership interest may become a limited partner if and to the extent that the partnership agreement provides for such a transition or on the consent of all partners. Relying on the definition of an applicable restriction contained in section 25.2704-2(b), Gift Tax Regs., petitioners maintain that an assignee's inability to force KFLP to liquidate under the KFLP partnership agreement imposes no greater restriction than those imposed upon assignees under TRLPA.

Petitioners' contention that the partnership interests they transferred to the GRAT's trustees were assignee interests as opposed to limited partnership interests is based on a strict construction of the KFLP partnership agreement. In particular, although petitioners made the transfers to themselves as GRAT's trustees, petitioners nonetheless maintain that their children, as KFLP general partners, had to consent
to the admission of the GRAT’s trustees as limited partners pursuant to section 3.06 of the KFLP partnership agreement.

The taxpayer’s argument was rejected because the court found that the interests transferred were limited partnership interests not assignee interests. The opinion states:

Read as a whole, the language used in the "Assignment of Partnership Interest" establishes that petitioners transferred limited partnership interests to themselves as the GRAT’s trustees. Although the documents refer to the GRAT’s trustees as assignees, the description of the assigned interests contained in Schedule I clearly states that the assignees will hold class B limited partnership interests in KFLP. Equally important, the "Assignment of Partnership Interest" states that petitioners had obtained all necessary consents to effect the conveyance. Because the GRAT’s trustees qualified as permitted assignees within the meaning of section 8.03 of the partnership agreement, and petitioners were not required to obtain any consents to transfer an assignee interest to a permitted assignee, the inclusion of the statement that all necessary consents had been obtained also indicates that petitioners were transferring limited partnership interests to the GRAT’s trustees. Further, the statement that all necessary consents had been obtained contradicts the testimony of the Kerr children that petitioners never requested that they consent to the transfers to the GRAT’s trustees.

C. OBJECTIVE ECONOMIC ANALYSIS

The objective economic realities underlying the transfers to the GRAT’s trustees do not support petitioners’ position that the transferred interests should be considered assignee interests. First, and perhaps most importantly, there were no significant differences under the KFLP partnership agreement between the rights of limited partners and assignees. Petitioners were vested with managerial responsibilities for KFLP; neither limited partners nor assignees had any managerial rights. In addition, limited partners and assignees enjoyed equivalent rights to information concerning the partnership's business affairs, and they shared the same interests in the partnership's distributable cash. Finally, while limited partners were permitted to put or sell their interests to the partnership under section 9.02 of the partnership agreement, assignees were given a substantially equivalent right to offer their interests to the partnership under sections 8.04 and 8.21 of the partnership agreement.

The only relevant difference between the rights of limited partners and assignees relates to a limited partner's right to vote on major decisions -- a right not extended to assignees. However, given the rare and extraordinary nature of the matters qualifying as a major decision, such as the filing of a bankruptcy petition or approving an act in contravention of the partnership agreement, we do not consider a limited partner's right to vote on such matters to be significant for purposes of deciding the question presented.

We further note that petitioners retained the right to vote the limited partnership interests and petitioners and the Kerr children had the ability
to convert the purported assignee interests to full limited partnership interests or liquidate the partnership at will. To characterize the interests that petitioners transferred to the GRAT's trustees as assignee interests ignores the objective economic reality that there was no meaningful difference between the transfer of an assignee interest as opposed to a limited partnership interest.

D. TAX MOTIVATION

The record shows that Eastland structured petitioners' transfers to the GRAT's trustees primarily to avoid the special valuation rules set forth in section 2704(b). Eastland's writings on the subject of family limited partnerships disclose his belief that the transfer of an assignee interest from one family member to another would serve to circumvent section 2704(b). Accepting petitioner's testimony that he did not consider whether he was transferring a limited partnership interest as opposed to an assignee interest to his GRAT's, it appears that Eastland made a conscious decision not to raise the subject with his clients.

Consistent with the foregoing, we conclude that petitioners transferred limited partnership interests to the GRAT's trustees in substance as in form.

Having decided that partnership interests were transferred the court determined that section 2704 did not apply:

Section 2704(b)(2)(A) broadly defines an applicable restriction as "any restriction which effectively limits the ability of the corporation or partnership to liquidate". However, section 2704(b)(3)(B) excepts from the definition of an applicable restriction "any restriction on liquidation imposed, or required to be imposed, by any Federal or State law".

In what we view as an expansion of the exception contained in section 2704(b)(3)(B), the Secretary promulgated section 25.2704-2(b), Gift Tax Regs., which states in pertinent part: "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Thus, the question arises whether the partnership agreements involved herein impose greater restrictions on the liquidation of KFLP and KILP than the limitations that generally would apply to the partnerships under State law.

Section 10.01 of the partnership agreements states in pertinent part that the partnerships shall dissolve and liquidate upon the earlier of December 31, 2043, or by agreement of all the partners. Petitioners direct our attention to TRLPA section 8.01, which provides that a Texas limited partnership shall be dissolved on the earlier of: (1) The occurrence of events specified in the partnership agreement to cause dissolution; (2) the written consent of all partners to dissolution; (3) the withdrawal of a general partner; or (4) entry of a decree of judicial dissolution. TRLPA section 8.04 provides that, following the dissolution of a limited partnership, the partnership's affairs shall be wound up (including the liquidation of partnership assets) as soon as reasonably practicable.
On the basis of a comparison of section 10.01 of the partnership agreements and TRLPA section 8.01, we conclude that section 10.01 of the partnership agreements does not contain restrictions on liquidation that constitute applicable restrictions within the meaning of section 2704(b). We reach this conclusion because Texas law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in section 10.01 of the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under Texas law. Consequently, these provisions are excepted from the definition of an applicable restriction pursuant to section 2704(b)(3)(B) and section 25.2704-2(b), Gift Tax Regs.

Kerr was cited favorably in Estate of Morton B. Harper v. Commissioner, T.C. Memo. 2000-202, which held that section 2704(b) did not apply to a California limited partnership.

The Federal District Court for San Antonio has upheld a death-bed family limited partnership involving very difficult facts for the taxpayer, including that the general partner, a corporation, was not actually formed until after the decedent’s death and no assets were titled in the name of the partnership as of the decedent’s death. Elsie J. Church v. United States, 85 A.F.T.R.2d 2000-804 (W.D. Tex., 2000). The Court rejected the application of sections 2703 and 2704, and held that the formation of the general partner and funding of the partnership were ministerial.

In Estate of Reichardt v. Commissioner, 114 T.C. _______ (2000), the Court disregarded a death-bed partnership because, the Court found, the decedent had retained, by implied agreement, use of the partnership units he had given away. The Court determined that the form of the partnership was not respected by the parties. In particular, he continued to live rent-free in a house owned by the partnership and opened no partnership bank accounts.

In three cases between October 26 and November 30, 2000, the Tax Court clarified the rules it sees as applicable to family limited partnerships. The three decisions, each en banc, were J.C. Shepherd v. Commissioner, 115 T.C. No. 30 (2000); Ina F. Knight v. Commissioner, et vir v. Commissioner, 115 T.C. No. 36 (2000); and Estate of Albert Strangi v. Commissioner, 115 T.C. No. 35 (2000). The opinions should be read in their entirety. Three general conclusions follow from all the opinions. First, the most effective attack appears that it might be substance over form, including the step-transaction doctrine. Second, where the Tax Court can find an “understanding” that a partnership will continue for the benefit of a decedent it will be sympathetic to a section 2036 argument. Third, case must be given to avoid a gift on formation.

Shepherd involved the transfer of timberland subject to a lease to a partnership owned 50% by the taxpayer (father) and 25% by each of two sons, followed several weeks later by a gift of bank stock to the same partnership. At issue was whether the gifts were to be valued as gifts of property to one entity -- the partnership, or gifts to two people -- the sons, or gifts of partnership interests. The majority opinion valued the gifts as if they were made to the sons, rather than as gifts of partnership units:

2. DID PETITIONER MAKE DIRECT GIFTS TO HIS SONS?

Petitioner deeded the leased land and bank stock to the partnership. Whatever interests his sons acquired in this property they obtained by virtue of their status as
partners in the partnership. Clearly, then, contrary to one of respondent's alternative arguments, petitioner did not make direct gifts of these properties to his sons. Cf. LeFrak v. Commissioner, supra (transfer by donor-father of buildings to himself and his children as tenants in common, "d.b.a." (doing business as) one of various partnerships formed later the same day to hold the particular building conveyed, represented direct gifts to the children of the father's interest in the buildings).

3. DID PETITIONER MAKE INDIRECT GIFTS TO HIS SONS?

A gift may be direct or indirect. See sec. 25.2511-1(a), Gift Tax Regs. The regulations provide the following example of a transfer that results in an indirect taxable gift, assuming that the transfer is not made for adequate and full consideration: "A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation." Sec. 25.2511-1(h)(1), Gift Tax Regs.

Application of this general rule is well established in case law. For instance, in Kincaid v. United States, 682 F.2d at 1225, the taxpayer transferred her ranch to a newly formed corporation in which she and her two sons owned all the voting stock. In exchange for the ranch, the taxpayer received additional shares of the corporation's stock. The stock was determined to be less valuable than the ranch. The court concluded that the difference between what she gave and what she got represented a gift to the shareholders. Noting that the taxpayer could not make a gift to herself, the court held that she made a gift to each of her sons of one-third of the total gift amount. See also Heringer v. Commissioner, 235 F.2d 149, 151 (9th Cir. 1956) (transfers of farm lands to a family corporation of which donors were 40-percent owners represented gifts to other shareholders of 60 percent of the fair market value of the farm lands), modifying and remanding 21 T.C. 607 (1954); CTUW Georgia Ketteman Hollingsworth v. Commissioner, 86 T.C. 91 (1986) (mother's transfer to closely held corporation of property in exchange for note of lesser value represented gifts to the other five shareholders of five-sixths the difference in values of the property transferred and the note the mother received); Estate of Hitchon v. Commissioner, 45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder-sons); Estate of Bosca v. Commissioner, T.C. Memo. 1998-251 (father's transfer to a family corporation of voting common stock in exchange for nonvoting common stock represented gifts to each of his two shareholder-sons of 50 percent of the difference in the values of the stock the father transferred and of the stock he received); cf. Chanin v. United States, 183 Ct. Cl. 745, 393 F.2d 972 (1968) (two brothers' transfers of stock in their wholly owned corporation to the subsidiary of another family corporation constituted gifts to the other shareholders of the family corporation, reduced by the portion attributable to the brothers' own ownership interests in the family corporation).

Likewise, a transfer to a partnership for less than full and adequate consideration may represent an indirect gift to the other partners. See Gross v. Commissioner, 7 T.C. 837 (1946) (taxpayer's and spouse's transfer of business assets into a newly formed partnership among themselves, their daughter, and son-in-law resulted in taxable gifts to the daughter and son-in-law). Obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly
where the contributing partner's capital account is increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership. In the instant case, however, petitioner's contributions of the leased land and bank stock were allocated to his and his sons' capital accounts according to their respective partnership shares. Under the partnership agreement, each son was entitled to receive distribution of any part of his capital account with prior consent of the other partners (i.e., his father and brother), and was entitled to sell his partnership interest after granting his father and brother the first option to purchase his interest at fair market value. Upon dissolution of the partnership, each son was entitled to receive payment of the balance in his capital account.

In these circumstances, we conclude and hold that petitioner's transfers to the partnership represent indirect gifts to each of his sons, John and William, of undivided 25-percent interests in the leased land and in the bank stock. In reaching this conclusion, we have effectively aggregated petitioner's two separate, same-day transfers to the partnership of undivided 50-percent interests in the leased land to reflect the economic substance of petitioner's conveyance to the partnership of his entire interest in the leased land. We have not, however, aggregated the separate, indirect gifts to his sons, John and William. See Estate of Bosca v. Commissioner, T.C. Memo. 1998-251 (for purposes of the gift tax, each separate gift must be valued separately), and cases cited therein; cf. Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981) (rejecting family attribution in valuing stock for estate tax purposes).

Judge Ruwe and 2 judges would have held that the gift was to the partnership:

I agree with the majority opinion except for its allowance of a 15-percent valuation discount with respect to what the majority describes as "indirect gifts [by petitioner] to each of his sons, John and William, of undivided 25-percent interests in the leased land". Majority op. p. 22. In my opinion, no such discount is appropriate because undivided interests in the leased land were never transferred to petitioner's sons. The transfer in question was a transfer of petitioner's entire interest in the leased land to the partnership. This transfer was to a partnership in which petitioner held a 50-percent interest. Except for enhancing the value of petitioner's 50-percent partnership interest, he received no other consideration for the transfer.

Section 2512(b) provides:

SEC. 2512. Valuation of Gifts.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

The Supreme Court has described previous versions of the gift tax statutes (section 501 imposing the tax on gifts and section 503 which is virtually identical to present section 2512(b)) in the following terms:
Sections 501 and 503 are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress taxed "gifts" simpliciter, it would be appropriate to assume that the term was used in its colloquial sense, and a search for "donative intent" would be indicated. But Congress intended to use the term "gifts" in its broadest and most comprehensive sense. H. Rep. No. 708, 72d Cong., 1st Sess., p.27; S. Rep. No. 665, 72d Cong., 1st Sess., p.39; cf. Smith v. Shaughnessy, 318 U.S. 176; Robinette v. Helvering, 318 U.S. 184. Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent." It formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift..." And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax. [Commissioner v. Wemyss, 324 U.S. 303, 306 (1945); fn. ref. omitted.]

The Supreme Court described the objective of these statutory provisions as follows:

The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. * * * [Id. at 307.]

Under the applicable statutory provisions, it is unnecessary to consider the value of what petitioner's sons received in order to determine the value of the property that was transferred. Indeed, the regulations provide that it is not even necessary to identify the donee. The regulations provide that the gift tax is the primary and personal liability of the donor, that the gift is to be measured by the value of the property passing from the donor, and that the tax applies regardless of the fact that the identity of the donee may not be presently known or ascertainable. See sec. 25.2511-2(a), Gift Tax Regs.

The majority correctly states the formula for valuing transfers of property:

If property is transferred for less than adequate and full consideration, then the excess of the value of the property transferred over the consideration received is generally deemed a gift. See sec. 2512(b). The gift is measured by the value of the property passing from the donor, rather than by the property received by the donee or upon the measure of enrichment to the donee. See sec. 25.2511-2(a), Gift Tax Regs. [Majority op. pp. 11-12.]

This is exactly the formula used in the cases on which the majority relies for the proposition that a gift was made. See Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982); Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956); Ketteman Trust v. Commissioner, 86 T.C. 91 (1986). In each of these cases, property was transferred to a corporation for less than full consideration. All or part of the stock of the transferee corporations was owned by persons other than the transferor. In each case, the value of the gift was found to be the fair market value of the property transferred to the corporation, minus any consideration received by the transferor. None
of these cases allowed a discount based upon a hypothetical assumption that fractionalized interests in the transferred property were given to the individual shareholders of the transferee corporations. Unfortunately, the majority does not follow its own formula, as quoted above, or the above-cited cases.

Presumably Judge Ruwe would have reduced the value of the gift for the father’s 50% interest; whether that reduction would be discounted is not discussed directly but the answer would appear to be no.

Judge Beghe would have applied an estate depletion theory:

With all the woofmg these days about using family partnerships to generate big discounts, the majority opinion provides salutary reminders that the "gift is measured by the value of the property passing from the donor, rather than by the property received by the donee or upon the measure of enrichment of the donee", majority op. pp. 11-12, and that "How petitioner's transfers of the leased land and bank stock may have enhanced the sons' partnership interests is immaterial, for the gift tax is imposed on the value of what the donor transfers, not what the donee receives", majority op. p. 16 (citing section 25.2511-2(a), Gift Tax Regs., Robinette v. Helvering, 318 U.S. 184, 186 (1943), and other cases therein); see also sec. 25.2512-8, Gift Tax Regs.

This is the "estate depletion" theory of the gift tax, given its most cogent expression by the Supreme Court in Commissioner v. Wemyss, 324 U.S. 303, 307-308 (1945):

The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers that are withdrawn from the donor's estate. To allow detriment to the donee to satisfy the requirement of "adequate and full consideration" would violate the purpose of the statute and open wide the door for evasion of the gift tax. See 2 Paul, supra [Federal Estate and Gift Taxation (1942)] at 1114.

The logic and the sense of the estate depletion theory require that a donor's simultaneous or contemporaneous gifts to or for the objects of his bounty be unitized for the purpose of valuing the transfers under section 2511(a). After all, the gift tax was enacted to protect the estate tax, and the two taxes are to be construed in pari materia. See Merrill v. Fahs, 324 U.S. 308, 313 (1945). The estate and gift taxes are different from an inheritance tax, which focuses on what the individual donee-beneficiaries receive; the estate and gift taxes are taxes whose base is measured by the value of what passes from the transferor.

I would hold, contrary to the majority and the approach of Estate of Bosca v. Commissioner, T.C. Memo. 1998-251, that the gross value of what petitioner transferred in the case at hand is to be measured by including the value of his entire interest in the leased land. I would then value the net gifts by subtracting from the gross value so arrived at the value, at the end of the figurative day, of the partnership interest that petitioner received back and retained, sec. 2512(b), not 50 percent of the value of the leased land that he transferred to the partnership.

In Knight a majority of the Tax Court explicitly rejected the IRS argument that the form of the partnership should be disregarded. Judge Beghe dissented as in Shepherd. The facts were:
On December 6, 1994, petitioner opened an investment account at Broadway National Bank in the name of petitioners' family limited partnership, the Herbert D. Knight limited partnership (created on December 28, 1994, as described below), and transferred Treasury notes to it. On December 12, 1994, petitioners opened a checking account for their partnership at Broadway National Bank and transferred $10,000 to it from their personal account. On December 15, 1994, petitioners transferred $558,939.43 worth of a USAA municipal bond fund from their personal investment account to the partnership.

On December 28, 1994, the following occurred:

a. Petitioners signed documents which created the partnership, consisting of 100 units of ownership. The steps followed in the creation of the partnership satisfied all requirements under Texas law to create a limited partnership.

b. Petitioners conveyed the ranch and the real property at 6219 Dilbeck and 14827 Chancey to the partnership.

c. Petitioners created the Knight Management Trust (management trust). The steps followed in the creation of the management trust satisfied all requirements under Texas law to create a trust. The management trust was the partnership's general partner.

d. Petitioners each transferred a one-half unit of the partnership to the management trust. That unit is the only asset held by the management trust. Petitioners each owned a 49.5-percent interest in the partnership as limited partners.

e. Petitioners created trusts for Mary Knight and Douglas Knight (the children's trusts). The documents petitioners executed were sufficient under Texas law to create the children's trusts. Douglas Knight and Mary Knight were each the beneficiary and trustee of the children's trust bearing their name.

f. Petitioners each signed codicils to their wills in which they changed the bequests to their children to bequests to the children's trusts.

g. Petitioners each transferred a 22.3-percent interest in the partnership to each of the children's trusts. After those transfers, petitioners each retained a 4.9-percent interest in the partnership as limited partners.

The opinion states:

Respondent contends that the partnership lacks economic substance and fails to qualify as a partnership under Federal law. See, e.g., Commissioner v. Culbertson, 337 U.S. 733, 740 (1949); Commissioner v. Tower, 327 U.S. 280, 286 (1946); Merryman v. Commissioner, 873 F.2d 879, 882-883 (5th Cir. 1989), affg. T.C. Memo. 1988-72. Petitioners contend that their rights and legal relationships and those of their children changed significantly when petitioners formed the partnership, transferred assets to it, and transferred interests in the partnership to their children's trusts, and that we must recognize the partnership for Federal gift tax valuation purposes. We agree with petitioners.
State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights. See United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985); United States v. Rodgers, 461 U.S. 677, 683 (1983); Aquilino v. United States, 363 U.S. 509, 513 (1960). The parties stipulated that the steps followed in the creation of the partnership satisfied all requirements under Texas law, and that the partnership has been a limited partnership under Texas law since it was created. Thus, the transferred interests are interests in a partnership under Texas law. Petitioners have burdened the partnership with restrictions that apparently are valid and enforceable under Texas law. The amount of tax for Federal estate and gift tax purposes is based on the fair market value of the property transferred. See secs. 2502, 2503. The fair market value of property is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." See sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. We apply the willing buyer, willing seller test to value the interests in the partnership that petitioners transferred under Texas law. We do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.

Respondent relies on several income tax economic substance cases. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 583- 584 (1978); Knetsch v. United States, 364 U.S. 361, 366 (1960); ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 511-516 (D.C. Cir. 2000), affg. T.C. Memo. 1998-305; ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998), affg. in part and revg. in part T.C. Memo. 1997-115; Merryman v. Commissioner, supra; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 278 (1999). We disagree that those cases require that we disregard the partnership here because the issue here is what is the value of the gift. See secs. 2501, 2503; sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512- 1, Gift Tax Regs.

Respondent points out that in several transfer tax cases we and other courts have valued a transfer based on its substance instead of its form. See, e.g., Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991); Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Estate of Murphy v. Commissioner, T.C. Memo. 1990-472; Griffin v. United States, 42 F. Supp. 2d 700, 704 (W.D. Tex. 1998). Our holding is in accord with those cases because we believe the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuation purposes. Respondent agrees that petitioners created and operated a partnership as required under Texas law and gave interests in that partnership to their children's trusts. Those rights are apparently enforceable under Texas law.

The good news were the legal holdings. On the other hand the Tax Court allowed only a 15% discount:

D. PETITIONERS' CONTENTION THAT A PORTFOLIO DISCOUNT AND MINORITY AND LACK OF MARKETABILITY DISCOUNTS TOTALING 44 PERCENT APPLY

Petitioners' expert, Robert K. Conklin (Conklin), estimated that, if we recognize the partnership for Federal tax purposes, a 10-percent portfolio discount and discounts of 10 percent for minority interest and 30 percent for lack of marketability apply, for an aggregate discount of 44 percent.
1. PORTFOLIO DISCOUNT

Conklin concluded that a 10-percent portfolio discount applies based on the assumption that it is unlikely that a buyer could be found who would want to buy all of the Knight family partnership's assets. He provided no evidence to support that assumption, see Rule 143(f)(1); Rose v. Commissioner, 88 T.C. 386, 401 (1987), affd. 868 F.2d 851 (6th Cir. 1989); Compaq Computer Corp. v. Commissioner, T.C. Memo. 1999-220.

To estimate the amount of the portfolio discount, Conklin relied on a report stating that conglomerate public companies tend to sell at a discount of about 10 to 15 percent from their breakup value. However, the Knight family partnership is not a conglomerate public company.

Conklin cites Shannon Pratt's definition of a portfolio discount in estimating the portfolio discount to apply to the assets of the partnership. A portfolio discount applies to a company that owns two or more operations or assets, the combination of which would not be particularly attractive to a buyer. See Estate of Piper v. Commissioner, 72 T.C. 1062, 1082 (1979). The partnership held real estate and marketable securities. Conklin gave no convincing reason why the partnership's mix of assets would be unattractive to a buyer. We apply no portfolio discount to the assets of the partnership.

2. LACK OF CONTROL AND MARKETABILITY DISCOUNTS

Conklin concluded that a lack of control discount applies. He speculated that, because the partnership invested a large part of its assets in bonds, and investors in the bond fund could not influence investment policy, the partnership "could be similar to a closed-end bond fund". He estimated that a lack of control discount of 10 percent applies by evaluating the difference between the trading value and the net asset values on October 21, 1994, of 10 publicly traded closed-end bond funds. The 10 funds that Conklin chose are not comparable to the Knight family partnership. We find unconvincing his use of data from noncomparable entities to increase the discount. However, on this record, we believe some discount is appropriate based on an analogy to a closed-end fund.

Conklin cited seven studies of sales of restricted stocks from 1969 to 1984 to support his estimate that a 30-percent discount for lack of marketability applies. He used a table summarizing initial public offerings of common stock from 1985 to 1993. However, he did not show that the companies in the studies or the table were comparable to the partnership, or explain how he used this data to estimate the discount for lack of marketability. See Tripp v. Commissioner, 337 F.2d 432, 434-435 (7th Cir. 1964), affg. T.C. Memo. 1963-244; Rose v. Commissioner, supra; Chiu v. Commissioner, 84 T.C. 722, 734-735 (1985). He also listed seven reasons why a discount for lack of marketability applies, but he did not explain how those reasons affect the amount of the discount for lack of marketability.

3. CONKLIN'S FACTUAL ASSUMPTIONS

Conklin listed 19 purported business reasons for which he said the partnership was formed. Petitioners claimed to have had only 5 of those 19 reasons. Conklin also said: "The compensation and reimbursement paid to the general partner reduce the
income available to limited partners or assignees." His statement is inapplicable because the general partner received no compensation and incurred no expenses.

We have rejected expert opinion based on conclusions which are unexplained or contrary to the evidence. See Rose v. Commissioner, supra; Compaq Computer Corp. v. Commissioner, supra. An expert fails to assist the trier of fact if he or she assumes the position of advocate. See Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990); Laureys v. Commissioner, 92 T.C. 101, 122-129 (1989). Conklin's erroneous factual assumptions cast doubt on his objectivity.

4. CONCLUSION

The parties stipulated that the net asset value of the partnership was $2,081,323 on December 28, 1994. Each petitioner gave each trust a 22.3-percent interest in the partnership; 44.6 percent of $2,081,323 is $928,270.

We conclude that Conklin was acting as an advocate and that his testimony was not objective. However, despite the flaws in petitioners' expert's testimony, we believe that some discount is proper, in part to take into account material in the record relating to closed-end bond funds. We hold that the fair market value of an interest in the Knight family partnership is the pro rata net asset value of the partnership less a discount totaling 15 percent for minority interest and lack of marketability. Thus, on December 28, 1994, each petitioner made taxable gifts of $789,030 (44.6 percent of $2,081,323, reduced by 15 percent).

The court also commented on an attempt to cap the amount of the gifts:

C. WHETHER THE VALUE OF PETITIONERS' FOUR GIFTS IS LIMITED TO $300,000 EACH

The transfer document through which petitioners made the gifts at issue states that each petitioner transferred to each of their children's trusts the number of limited partnership units which equals $300,000 in value. Petitioners contend that this bars respondent from asserting that the value of each partnership interest exceeds $300,000.

Respondent contends that the transfer document makes a formula gift that is void as against public policy. Respondent relies on Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), and Ward v. Commissioner, 87 T.C. 78, 109-116 (1986). In Procter, the transfer document provided that, if a court decided a value that would cause a part of the transfer to be taxable, that part of the transfer would revert to the donor. The U.S. Court of Appeals for the Fourth Circuit described this provision as a condition subsequent, and held that it was void as against public policy. See Commissioner v. Procter, supra at 827.

We need not decide whether Procter and Ward control here because we disregard the stated $300,000 gift value for other reasons. First, petitioners reported on their gift tax returns that they each gave two 22.3-percent interests in the partnership. Contrary to the transfer document, they did not report that they had given partnership interests worth $300,000. We believe this shows their disregard for the transfer document, and that they intended to give 22.3-percent interests in the partnership.
Second, even though petitioners contend that respondent is limited to the $300,000 amount, i.e., that the gifts were for $300,000 and thus cannot be worth more than $300,000, petitioners contend that the gifts are each worth less than $300,000. In fact, petitioners offered expert testimony to show that each gift was worth only $263,165. We find petitioners' contentions to be at best inconsistent. We treat petitioners' contention and offer of evidence that the gifts were worth less than $300,000 as opening the door to our consideration of respondent's argument that the gifts were worth more than $300,000.

Clearly the court was not sympathetic to the taxpayer but it did not squarely confront this issue.

In *Strangi* the decedent's attorney-in-fact formed the partnership two month's before the decedent's death. The decedent retained a 99% limited interest and a 47% interest in the 1% corporate general partner. The decedent's children paid for the other shares in the general partner. Over 75% of the partnerships' assets were marketable securities.

The Tax Court first determined that the "business purposes" for the partnership were bogus but that the partnership would be respected anyway:

We must decide whether the existence of SFLP [Strangi Family Limited Partnership] will be recognized for Federal estate tax purposes. Respondent argues that, under the business purpose and economic substance doctrines, SFLP should be disregarded in valuing the assets in decedent's estate. Petitioner contends that the business purpose and economic substance doctrines do not apply to transfer tax cases and that SFLP had economic substance and business purpose.

Taxpayers are generally free to structure transactions as they please, even if motivated by tax-avoidance considerations. See Gregory v. Helvering, 293 U.S. 465, 469 (1935); Yosha v. Commissioner, 861 F.2d 494, 497 (7th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986). However, the tax effects of a particular transaction are determined by the substance of the transaction rather than by its form. In *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978), the Supreme Court stated that "a genuine multiple-party transaction with economic substance * * * compelled or encouraged by business or regulatory realities, * * * imbued with tax-independent considerations, and * * * not shaped solely by tax avoidance features" should be respected for tax purposes. "[T]ransactions which have no economic purpose or substance other than the avoidance of taxes will be disregarded." Gregory v. Helvering, supra at 469-470; see also Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989), affg. T.C. Memo. 1988-72.

Family partnerships must be closely scrutinized by the courts because the family relationship "so readily lends itself to paper arrangements having little or no relationship to reality." Kuney v. Frank, 308 F.2d 719, 720 (9th Cir. 1962); accord Frazee v. Commissioner, 98 T.C. 554, 561 (1992); Harwood v. Commissioner, 82 T.C. 239, 258 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Kelley v. Commissioner, 63 T.C. 321, 325 (1974); Estate of Tiffany v. Commissioner, 47 T.C. 491, 499 (1967); see also Helvering v. Clifford, 309 U.S. 331, 336-337 (1940). Family partnerships have long been recognized where there is a bona fide business carried on after the partnership is formed. See, e.g., Drew v. Commissioner, 12 T.C. 5, 12-13 (1949). Mere suspicion and speculation about a decedent's estate planning and testamentary objectives are not sufficient to disregard an agreement in the absence of persuasive evidence that the
agreement is not susceptible of enforcement or would not be enforced by parties to the agreement. Cf. Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989).

The estate contends that there were "clear and compelling" nontax motives for creating SFLP, including the provision of a flexible and efficient means by which to manage and protect decedent's assets. Specifically, the estate argues that its business purposes for forming SFLP were (1) to reduce executor and attorney's fees payable at the death of decedent, (2) to insulate decedent from an anticipated tort claim and the estate from a will contest (by creating another layer through which creditors must go to reach assets conveyed to the partnership), and (3) to provide a joint investment vehicle for management of decedent's assets. We agree with respondent that there are reasons to be skeptical about the nontax motives for forming SFLP.

We also do not believe that a "joint investment vehicle" was the purpose of the partnership. Mr. Gulig [the attorney-in-fact] took over control of decedent's affairs in September 1993, under the 1988 power of attorney, and Mr. Gulig continued to manage decedent's assets through his management responsibilities in Stranco. Petitioner concedes, in disputing respondent's alternative claim of gift tax liability, that "directly or indirectly, the Decedent ended up with 99.47% of the Partnership, having put in essentially 99.47% of the capital."

The formation and subsequent control of SFLP were orchestrated by Mr. Gulig without regard to "joint enterprise". He formed the partnership and the corporation and then invited Mrs. Gulig's siblings, funded by her, to invest in the corporation. The Strangi children shared in managing the assets only after and to the extent that the Merrill Lynch account was fragmented in accordance with their respective beneficial interests.

The nature of the assets that were contributed to SFLP supports the conclusion that management of those assets was not the purpose of SFLP. There were no operating business assets contributed to SFLP. Decedent transferred cash, securities, life insurance policies, annuities, real estate, and partnership interests to SFLP. The cash and securities approximated 75 percent of the value of the assets transferred. No active business was conducted by SFLP following its formation.

SFLP was validly formed under State law. The formalities were followed, and the proverbial "i's were dotted" and "t's were crossed". The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case.

The court then rejected the applicability of section 2703:

Respondent next argues that the term "property" in section 2703(a)(2) means the underlying assets in the partnership and that the partnership form is the restriction that must be disregarded. Unfortunately for
respondent's position, neither the language of the statute nor the language of the regulation supports respondent's interpretation. Absent application of some other provision, the property included in decedent's estate is the limited partnership interest and decedent's interest in Stranco.

In Kerr v. Commissioner, 113 T.C. 449 (1999), the Court dealt with a similar issue with respect to interpretation of section 2704(b). Sections 2703 and 2704 were enacted as part of chapter 14, I.R.C., in 1990. See Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 1388. However, as we indicated in Kerr v. Commissioner, supra at 470-471, and as respondent acknowledges in the portion of his brief quoted above, the new statute was intended to be a targeted substitute for the complexity, breadth, and vagueness of prior section 2036(c); and Congress "wanted to value property interests more accurately when they were transferred, instead of including previously transferred property in the transferor's gross estate."

Treating the partnership assets, rather than decedent's interest in the partnership, as the "property" to which section 2703(a) applies in this case would raise anew the difficulties that Congress sought to avoid by repealing section 2036(c) and replacing it with chapter 14. We conclude that Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest. See also Estate of Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000). Thus, we need not address whether the partnership agreement satisfies the safe harbor provisions of section 2703(b). Respondent did not argue separately that the Stranco shareholders' agreement should be disregarded for lack of economic substance or under section 2703(a).

More interesting is the court's discussion of the gift on formation argument. The court rejects the argument:

Respondent determined in the statutory notice and argues in the alternative that, if the partnership is recognized for estate tax purposes, decedent made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. Using the value reported by petitioner on the estate tax return, if decedent gave up property worth in excess of $10 million and received back a limited partnership interest worth approximately $6.5 million, he appears to have made a gift equal to the loss in value. (Petitioner now claims a greater discount, as discussed below.) In analogous circumstances involving a transfer to a corporation, the Court of Appeals in Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982), held that there was a taxable gift and awarded summary judgment to the Government. The Court of Appeals rejected the discounts claimed by the taxpayer, stating that no business person "would have entered into this transaction, * * * [thus] the 'moving impulse for the * * * transaction was a desire to pass the family fortune on to others'". Id. at 1225 (quoting Robinette v. Helvering, 318 U.S. 184, 187-188 (1943)). The Court of Appeals in Kincaid concluded that, while there may have been business reasons for the taxpayer to transfer land to a family corporation in exchange for stock, "there was no business purpose, only a donative one, for Mrs. Kincaid to accept less value in return than she gave up." Id. at 1226.

In this case, the estate claims that the assets were transferred to SFLP for the business purposes discussed above. Following the formation of SFLP, decedent owned a 99-percent limited partnership interest in SFLP and 47 percent of the corporate general partner, Stranco. Even assuming arguendo that decedent's
asserted business purposes were real, we do not believe that decedent would give up over $3 million in value to achieve those business purposes.

Nonetheless, in this case, because we do not believe that decedent gave up control over the assets, his beneficial interest in them exceeded 99 percent, and his contribution was allocated to his own capital account, the instinctive reaction that there was a gift at the inception of the partnership does not lead to a determination of gift tax liability. In a situation such as that in Kincaid, where other shareholders or partners have a significant interest in an entity that is enhanced as a result of a transfer to the entity, or in a situation such as Shepherd v. Commissioner, 115 T.C. __ (2000) (slip. op. at 21), where contributions of a taxpayer are allocated to the capital accounts of other partners, there is a gift. However, in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest. See Kincaid v. United States, supra at 1224. Realistically, in this case, the discrepancy between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift.

Clearly the court thought another theory should be asserted, but was not -- section 2036:

The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47-percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036. See, e.g., Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000). Section 2036 is not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely. Applying the economic substance doctrine in this case on the basis of decedent's continuing control would be equivalent to applying section 2036(a) and including the transferred assets in decedent's estate. As discussed below, absent application of section 2036, Congress has adopted an alternative approach to perceived valuation abuses.

The IRS expert allowed a 31% discount which the court, reluctantly, accepted:

Both petitioner's expert and respondent's expert determined that a 25-percent lack of marketability discount was appropriate. Only respondent's expert, however, considered decedent's ownership of Stranco stock. We agree with respondent that the relationship between the limited partnership interest and the interest in Stranco cannot be disregarded. The entities were created as a unit and operated as a unit and were functionally inseparable.

In valuing decedent's 99-percent limited partnership interest on the date of death, respondent's expert applied an 8-percent minority interest discount and a 25-percent marketability discount, to reach a combined (rounded) discount of 31 percent. Respondent's expert valued decedent's 47-percent interest in Stranco by applying a 5-percent minority interest discount and a 15-percent marketability discount, to reach a combined (rounded) discount of 19 percent. Petitioner's expert applied a 25-percent minority interest discount and a 25-percent marketability discount, resulting in an effective total discount of 43.75 percent to the partnership. He did not value petitioner's interest in Stranco because he believed that the
relationship was irrelevant. In our view, his result is unreasonable and must be rejected.

Respondent's expert selected the lower minority interest discount after considering the effective control of the limited partnership interest and the interest in Stranco and considering the detailed provisions of the partnership agreement and the shareholders' agreement. He examined closed-end funds, many of which are traded on major exchanges, and determined the range of discounts from net asset value for those funds. He selected a discount toward the lower end of the range. His analysis was well documented and persuasive. As respondent notes, normally a control premium would apply to an interest having effective control of an entity.

Petitioner argues that consideration of the stock interest in Stranco in valuing the limited partnership interest is erroneous because the shareholders' agreement granted the corporation and the other shareholders the right to purchase a selling shareholder's stock. While the shareholders' agreement may be a factor to be considered in determining fair market value, it does not persuade us that a hypothetical seller would not market the interest in the limited partnership and the interest in the corporation as a unit or that a transaction would actually take place in which only the partnership interest or the stock interest was transferred. Under the circumstances, the shareholders' agreement is merely a factor to be taken into account but not to be given conclusive weight. Cf. Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989); Estate of Lauder v. Commissioner, T.C. Memo. 1994-527.

In view of our rejection of respondent's belated attempt to raise section 2036 and respondent's request that we disregard the partnership agreement altogether, we are constrained to accept the evidence concerning discounts applicable to decedent's interest in the partnership and in Stranco as of the date of death. We believe that the result of respondent's expert's discounts may still be overgenerous to petitioner, but that result is the one that we must reach under the evidence and under the applicable statutes.

Again, there were concurrences and dissents, in line with Shepherd and Knight. Judge Ruwe makes the point that a 31% discount ought to mean a gift on formation based on the majority opinion:

This case involves an attempt by a dying man (or his attorney) to transfer property to a partnership in consideration for a 99-percent partnership interest that would be valued at substantially less than the value of the assets transferred to the partnership, while at the same time assuring that 100 percent of the value of the transferred assets would be passed to decedent's beneficiaries. Assuming, as the majority has found, that decedent's partnership interest was worth less than the property he transferred, section 2512(b) should be applied. Pursuant to that section the excess of the value of the property decedent transferred to the partnership over the value of the consideration he received is "deemed a gift" subject to the gift tax. By failing to apply section 2512(b) in this case, the majority thwarts the purpose of section 2512(b) which the Supreme Court described as "the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions". Commissioner v. Wemyss, supra at 306.

The majority's allowance of a 31-percent discount is in stark contrast to its rejection of respondent's gift argument on the ground that decedent did not give up control.
of the assets when he transferred them to the partnership. See majority op. p. 21. While the basis for finding that decedent did not give up control of the assets is not fully explained, it appears not to be based on the literal terms of the partnership agreement which gave control to Stranco, the corporate general partner. Decedent owned only 47 percent of the Stranco stock. Since the majority also rejects respondent's economic substance argument, the only other conceivable basis for concluding that decedent retained control over the assets that he contributed to the partnership is that the partnership arrangement was a factual sham. If that were the case, the partnership arrangement itself would be "mere window dressing" masking the true facts and the terms of the partnership arrangement should be disregarded. In an analogous situation the Court of Appeals for the Tenth Circuit disregarded the written terms of a transfer document as fraudulent. See Heyen v. United States, 945 F.2d 359 (10th Cir. 1991).

Judge Beghe would have applied substance over form to negate the benefit of the transaction:

I support the use of substance over form analysis to decide whether a transaction qualifies for the tax-law defined status its form suggests. A formally correct transaction without a business purpose may not be a "reorganization", and a title holder of property without an economic interest may not be the tax "owner". However, I share the majority's concerns about using substance over form analysis to alter the conclusion about a real-world fact, such as the fair market value of property, which the law tells us is the price at which the property actually could be sold.

Although my approach to the case at hand employs a step-transaction analysis, which is a variant of substance over form, I do not use that analysis to conclude anything about fair market value. Instead, I use it to identify the property whose transfer is subject to tax. Step-transaction analysis has often been used in transfer tax cases to identify the transferor or the property transferred.

The step-transaction doctrine is a judicially created concept that treats a series of formally separate "steps" as a single transaction if those steps are "in substance integrated, interdependent and focused toward a particular end result." Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). The most far-reaching version of the step-transaction doctrine, the end-result test, applies if it appears that a series of formally separate steps are really prearranged parts of a single transaction that are intended from the outset to reach the ultimate result. See Penrod v. Commissioner, 88 T.C. at 1429, 1430 (citing Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); Morgan Manufacturing Co. v. Commissioner, 124 F.2d 602 (4th Cir. 1941); Heintz v. Commissioner, 25 T.C. 132 (1955); Ericsson Screw Machine Prods. Co., v. Commissioner, 14 T.C. 757 (1950); King Enters., Inc. v. United States, 189 Ct. Cl. 466, 475, 418 F.2d 511, 516 (1969)). The end-result test is flexible and grounds tax consequences on what actually happened, not on formalisms chosen by the participants. See Penrod v. Commissioner, supra.

The sole purpose of the transactions orchestrated by Mr. and Mrs. Gulig was to reduce Federal transfer taxes by depressing the value of Mr. Strangi's assets as they passed through his gross estate, to his children, via the partnership. The arrangement merely operated to convey the assets to the same individuals who would have received the assets in any event under Mr. Strangi's will. Nothing of substance was intended to change as a result of the transactions and, indeed, the
transactions did nothing to affect Mr. Strangi's or his children's interests in the underlying assets except to evidence an effort to reduce Federal transfer taxes. The control exercised by Mr. Strangi and his children over the assets did not change at all as a result of the transactions. For instance, shortly after Mr. Strangi's death SFLP made substantial distributions to the children, the Merrill Lynch account was divided into 4 separate accounts to allow each child to control his or her proportionate share of SFLP assets, and distributions were made to the estate to enable it to pay death taxes and post a bond. Mr. Strangi's testamentary objectives are further evidenced by his practical incompetency and failing health at formation and funding of SFLP and Stranco and the short time between the partnership transactions and Mr. Strangi's death.

The estate asserts that property with a stated value of $9,876,929, in the form of cash and securities, when funneled through the partnership, took on a reduced value of $6,560,730. It is inconceivable that Mr. Strangi would have accepted, if dealing at arm's length, a partnership interest purportedly worth only two-thirds of the value of the assets he transferred. This is especially the case given Mr. Strangi's age and health, because it would have been impossible for him ever to recoup this immediate loss.

It is also inconceivable that Mr. Strangi (or his representatives) would transfer the bulk of his liquid assets to a partnership, in exchange for a limited interest (plus a minority interest in the corporate general partner) that would terminate his control over the assets and their income streams, if the other partners had not been family members. See Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121; there the Court found "incredible" the assertion of the executrix that the decedent's transfer of property to a family corporation in exchange for stock was in the ordinary course of business. It is clear that the sole purpose of SFLP was to depress the value of Mr. Strangi's assets artificially for a brief time as the assets passed through his estate to his children. See Estate of Murphy v. Commissioner, T.C. Memo. 1990-472, in which this Court denied decedent's estate a minority discount on a 49.65-percent stock interest because the prior inter vivos transfer of a 1.76-percent interest did "not appreciably affect decedent's beneficial interest except to reduce Federal transfer taxes." Estate of Murphy v. Commissioner, supra, 60 T.C.M. (CCH) 645, 661, 1990 T.C.M. (RIA) par. 90,472, at 90-2261.

Thus, under the end-result test, the formally separate steps of the transaction (the creation and funding of the partnership within 2 months of Mr. Strangi's death, the substantial outright distributions to the estate and to the children, and the carving up of the Merrill Lynch account) that were employed to achieve Mr. Strangi's testamentary objectives should be collapsed and viewed as a single integrated transaction: the transfer at Mr. Strangi's death of the underlying assets.

In many cases courts have collapsed multistep transactions or recast them to identify the parties (usually the donor or donee) or the property to be valued for transfer tax purposes. See, e.g., Estate of Bies v. Commissioner, T.C. Memo. 2000-338 (identifying transferors for purposes of gift tax annual exclusions); Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (donor's gift of minority stock interests to shareholders followed by a redemption of donor's remaining shares treated as single transfer of a controlling interest); Estate of Murphy v. Commissioner, supra (decedent's inter vivos transfer of a minority interest followed by a testamentary transfer of her remaining shares treated as an integrated plan to
transfer control to decedent's children); Griffin v. United States, 42 F. Supp. 2d 700 (W.D. Tex. 1998) (transfer of 45 percent of donor's stock to donor's spouse followed by a transfer by spouse and donor of all their stock to a trust for the benefit of their child treated as one gift by donor of the entire block).

Most recently, the Tax Court has issued Estate of W. W. Jones, II v. Commissioner, 116 T.C. No. 11 (2001). The opinion is favorable to the taxpayer. The court summarized its holding:

D [W.W. Jones, II] formed a family limited partnership (JBLP) with his son and transferred assets including real property, to JBLP in exchange for a 95.5389-percent limited partnership interest. D also formed a family limited partnership (AVLP) with his four daughters and transferred real property to AVLP in exchange for an 88.178-percent limited partnership interest. D's son contributed real property in exchange for general and limited partnership interests in JBLP, and the daughters contributed real property in exchange for general and limited partnership interests in AVLP. All of the contributions were properly reflected in the capital accounts of the contributing partners. Immediately after formation of the partnerships, D transferred by gift an 83.08-percent limited partnership interest in JBLP to his son and a 16.915-percent limited partnership interest in AVLP to each of his daughters.

HELD: The transfers of property to the partnerships were not taxable gifts. See Estate of Strangi v. Commissioner, 115 T.C. 478 (2000).

HELD, FURTHER, sec. 2704(b), I.R.C., does not apply to this transaction. See Kerr v. Commissioner, 113 T.C. 449 (1999).

HELD, FURTHER, the value of D's gift to his son was 83.08-percent of the value of the underlying assets of JBLP, reduced by a lack-of-marketability (8%) discount. The value of D's gift to each of his daughters was 16.915 percent of the value of the underlying assets of AVLP, reduced by secondary market (40%) and lack-of-marketability (8%) discounts.

HELD, FURTHER, the gifts of limited partnership interests are not subject to additional lack-of-marketability discounts for built-in capital gains. Estate of Davis v. Commissioner, 110 T.C. 530 (1998), distinguished.

2. Use of Notes in GRATs. The IRS has confirmed its regulatory position that notes may not be used to make annuity payments from a GRAT. REG-108287-98 (proposed regulations); T.D. 8899 (September 5, 2000)(final regulations). The explanation to the proposed regulations stated:

Accordingly, these proposed regulations amend the regulations under section 2702 to provide that issuance of a note, other debt instrument, option or similar financial arrangement does not constitute payment for purposes of section 2702. A retained interest that can be satisfied with such instruments is not a qualified annuity interest or a qualified unitrust interest. In examining all of these transactions, the Service will apply the step transaction doctrine where more than one step is used to achieve similar results. In addition, a retained interest is not a qualified interest under section 2702, unless the trust instrument expressly prohibits the use of notes, other debt instruments, options or similar financial arrangements that effectively delay

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receipt by the grantor of the annual payment necessary to satisfy the annuity or unitrust interest amount. Under these provisions, in order to satisfy the annuity or unitrust payment obligation under section 2702(b), the annuity or unitrust payment must be made with either cash or other assets held by the trust.

The proposed regulations provide a transition rule for trusts created before September 20, 1999. If a trust created before September 20, 1999, does not prohibit a trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation, the interest will be treated as a qualified interest under section 2702(b) if notes, etc. are not used after September 20, 1999, to satisfy the obligation and any note or notes or other debt instruments issued on or prior to September 20, 1999, to satisfy the annual payment obligation are paid in full by December 31, 1999, and any option or similar financial arrangement is terminated by December 31, 1999, such that the grantor actually receives cash or other trust assets in satisfaction of the payment obligation. For purposes of this section, an option will be considered terminated if the grantor is paid the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Code, or the fair market value of the option.

The Supplementary Information to the final regulations states:

Under the proposed regulations, the use of a note, other debt instrument, option, or similar financial arrangement does not constitute a payment of the annuity or unitrust amount to the grantor as required by section 2702. Further, the proposed regulations provide that a retained interest is not a qualified interest under section 2702, unless the trust instrument expressly prohibits the use of notes, other debt instruments, options, or similar financial arrangements.

Commentators suggested that the regulations should permit the use of short-term notes or notes that bear interest at the section 7520 rate. This suggestion was not adopted. A note issued by the trust, regardless of the term or the interest rate, effectively defers the required payment. Thus, the issuance of a note is not the current payment of the annuity or unitrust amount not less frequently than annually as required by the statute. Under these provisions, in order to satisfy the annuity or unitrust payment obligation under section 2702(b), the annuity or unitrust amount must be paid with either cash or other assets held by the trust.

Commentators also questioned whether the prohibition on the use of notes to make the annuity or unitrust payment applies if the trustee borrows the required funds from an unrelated party. The Treasury Department and the IRS acknowledge that a trustee may borrow from an unrelated party to make the payment. However, the step transaction doctrine will be applied where a series of transactions is used to achieve a result that is inconsistent with the regulations. For example, suppose that the trustee borrows cash from a bank to make the required annuity payment and then borrows cash from the grantor to repay the bank. Similarly, suppose the grantor requests that a bank make a loan to the trust, but as a prerequisite for making the loan, the bank requires the grantor to deposit with the bank an amount equal to the loan. There is no substantive difference between these series of transactions and the situation in which a trustee issues a note for the annuity amount directly to the grantor. The final regulations have added the words "directly or indirectly" to clarify this point.
In response to a comment, the final regulations clarify that a trust instrument provision expressly prohibiting the use of notes to satisfy the annual payments is not required for trusts established before September 20, 1999. However, as provided in the regulations, a retained interest in a trust established before September 20, 1999, will not be treated as a qualified interest if notes are used after September 20, 1999, to satisfy the payment obligation, or any notes issued to satisfy the annual payment obligation on or prior to September 20, 1999, are not paid in full by December 31, 1999.

Proration of First Year's Payment

In response to comments, the regulations clarify the rules covering the period on which the annual payment must be based and the proration of the annuity or unitrust amount in the case of short periods. The final regulations make it clear that the annuity or unitrust amount need not be payable based on the taxable year of the trust. Rather, the annuity or unitrust amount may be payable annually or more frequently, (for example, monthly, quarterly, or semi-annually) based on the anniversary date of the creation of the trust. Thus, a trust providing for an annuity interest created on May 1st need not require that the trustee make payments based on the taxable year of the trust. Instead, the entire annual payment may be made by April 30th of each succeeding year of the trust term. If payment is based on the anniversary date of the trust, proration of the annuity or unitrust amount will be required only if the last period during which such amount is payable to the grantor is a short period. On the other hand, if payment is based on the taxable year of the trust, proration is required for each short taxable year of the trust during the grantor's term.

The provision allowing payments on the anniversary date will be difficult or impossible to meet in almost every circumstance.

Borrowing can have negative income tax consequences. In TAMs 200010010, 200010011, and 200011005, the Service considered GRATs which borrowed money from another trust to pay the annuity. The remainder beneficiaries of both the GRAT (Trust 2) and the lender trust (Trust 3) were the annuitant's nephews. The TAMs conclude that when the GRAT's status as a grantor trust terminated the annuitant/grantor recognized gain. The Service states:

Section 1.1001-2(a) of the Income Tax Regulations provides that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property."

In Rev. Rul. 85-13, 1985-1 C.B. 184, an individual, A created an irrevocable trust, T, and funded T with 100 shares of stock in Corporation Z in 1980. A's basis in the shares was $20x. On December 27, 1981, when the fair market value of the Corporation Z shares was $40x, W, as trustee, transferred the 100 shares to A in exchange for A's unsecured promissory note with a face amount of $40x, bearing
an adequate rate of interest. On January 20, 1984, A sold the 100 shares to an
unrelated party for $50x. The Revenue Ruling concludes that A's acquisition of the
entire corpus of T in exchange for an unsecured note was, in substance, the
economic equivalent of borrowing trust corpus, and therefore A is treated as the
owner of the trust under section 675(3), and is considered to be the owner of the
trust assets for federal income tax purposes. Furthermore, the ruling concludes that
the transfer of trust assets to A was not a sale for federal income tax purposes and
A did not acquire a cost basis in those assets.

Under section 1.1001-2(c) Ex. 5, C, an individual creates T, a grantor trust. C is
treated as the owner of the entire trust. T purchases an interest in P, a partnership.
C, as the owner of T, deducts the distributive share of partnership losses
attributable to the partnership interest held by T. When C renounces the powers
that initially resulted in T being classified as a grantor trust, T ceases to be a
grantor trust and C is no longer considered to be the owner of the trust. Since prior
to the renunciation, C was the owner of the entire trust, C was considered the
owner of all the trust property for federal income tax purposes and C was
considered to be the partner in P during the time T was a grantor trust. When T no
longer qualified as a grantor trust, with the result that C was no longer considered
to be the owner of the trust and trust property, C is considered to have transferred
ownership of the interest in P to T, now a separate taxable entity. At that time C's
share of P's liabilities is $11,000. On the transfer, C's share of partnership liabilities
is considered as money received.

Similarly, in the present case, X has created a grantor trust and is treated as the
owner of the entire trust and the owner of all the trust property. Thus, although X
has nominally transferred a shares of Company stock to Trust 2, X remains the
owner of the trust property for federal income tax purposes. Therefore, when Trust
2 terminates and transfers a shares of Company stock to the remainder trusts for C
and D, X is considered to have disposed of the Company stock to the remainder
trusts, along with the associated liability assumed by the remainder trusts, and X's
amount realized includes the amount of liabilities from which X is discharged as
a result of the disposition.

X argues that this case is distinguishable from Example 5 in 1.1001-2(c) because,
in that example, T purchased an interest in P and C deducted the distributive share
of partnership losses attributable to the partnership interest held by T, while, in the
present case X did not deduct losses attributable to debt incurred by Trust 2.
Therefore, X argues that X should not be considered the owner of all the trust
property for federal income tax purposes, and X should not be considered to have
transferred ownership of the stock, subject to the liability, to the remainder trusts.
X argues that instead, Trust 2 should be treated as the owner of the stock, and Trust
2 should be treated as the transferor of the stock, subject to the liability, to the
remainder trusts. In addition, X argues that the debt is incurred by reason of Trust
2's acquisition of the stock, and since under Rev. Rul. 85-13, the amount of the
debt did not increase Trust 2's basis in the stock, the liability should not be included
in Trust 2's amount realized under section 1.1001-2(a)(3).

However, although X did not deduct losses attributable to debt incurred by Trust
2, X received an annuity payment from Trust 2 that was not includible in X's
income, and thus, X benefitted from the debt incurred by Trust 2. Therefore, we
conclude that the present case is not distinguishable from Example 5 of section
1.1001-2(c). Because X was considered the owner of the stock for federal income tax purposes, the exception in section 1.1001-2(a)(3) does not apply to the present case. X, not Trust 2, is the transferor of the stock on termination of Trust 2 and X did not incur the indebtedness in order to acquire the stock within the meaning of section 1.1001-2(a)(3).

In addition, X argues that the language of section 1.1001-2(a)(3) does not require that the debt be incurred by reason of the transferor's acquisition of the property, but merely be incurred by reason of any acquisition of the property. Therefore, X states that regardless of whether X or Trust 2 is treated as the transferor of the stock to the remainder trusts, the amount of the liability should not be included in X's amount realized because the debt was incurred by reason of Trust 2's acquisition of Company stock. Section 1.1001-2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property." We believe this language can only be reasonably read to refer to the transferor's acquisition of the property. We believe this case is substantially identical to Example 5 in section 1.1001-2(c).

3. **Valuing Annuity Interest in GRAT.** Two Tax Court cases have clarified what are, and are not, qualified interests for purposes of section 2702. In *William A. Cook, et ux. v. Commissioner*, 115 T.C. No. 2 (2000), the Tax Court held that a spousal interest that took effect after the grantor's death was not a qualified interest. The opinion states:

> Respondent agrees that each grantor's retained annuity to the extent it is for a term of years or the grantor's earlier death constitutes a qualified interest. Respondent, however, challenges the provision of each trust which continues the annuity for the spouse, if the spouse survives the grantor, for the remaining term of the trust or until the spouse's earlier death.

> We agree with respondent that as to each trust, the interest retained in favor of the grantor's spouse, whether viewed as an independent interest or as an expansion of the grantor's interest, is not qualified and therefore must be valued at zero. Thus, we reject petitioners' contention that they are entitled to value each grantor's retained interest as an annuity based on two lives.

> We first consider the nature of the spousal interests themselves. In the trusts before us, the spousal interests are contingent upon surviving the grantor, so they may never take effect. We, however, do not believe section 2702 permits a transferor to reduce the value of a remainder interest by the simple expedient of assigning a value to a retained interest which may, in fact, never take effect.

> As indicated above, the regulations provide that "The governing instrument must fix the term of the annuity or unitrust interest." Sec. 25.2702-3(d)(3), Gift Tax Regs. We construe this language to require that the term be fixed and ascertainable at the creation of the trust. The regulations contain two examples which illustrate this requirement, as follows:

> EXAMPLE 5. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the
unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.

EXAMPLE 6. The facts are the same as in Example 5, except that if A dies within the 10-year term the unitrust amount will be paid to A's estate for an additional 35 years. The result is the same as in Example 5, because the 10-year term is the only term that is fixed and ascertainable at the creation of the interest. [Sec. 25.2702-3(e), Example (5) and Example (6), Gift Tax Regs.]

In each of these examples, only the retained interest for the shorter of a term of years or the transferor's life is fixed and ascertainable at the creation of the interest, and is therefore a qualified interest under section 2702. In Example (5) and Example (6) above, the unitrust interests that may be paid to A's estate are both contingent upon A's death before the completion of the 10-year fixed term, and are therefore not qualified interests. In the trusts before us, the spousal interests are not fixed and ascertainable at the creation of the trusts but, rather, are contingent in each case upon the spouse's surviving the grantor. For this reason, the spousal interests are not qualified interests and therefore must be valued as zero under section 2702(a)(2)(A).

Legislative history reflects that Congress was "concerned about potential estate and gift tax valuation abuses", specifically, "undervaluation of gifts valued pursuant to Treasury tables." 136 Cong. Rec. S15629, S15680-S15681 (daily ed. Oct. 18, 1990). As explained by the lawmakers in the context of trusts and term interests in property: "Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of Treasury tables undervalues the transferred interests in the aggregate, more often than not." Id. at S15681. Hence, a statute was enacted which Congress intended would "deter abuse by making unfavorable assumptions regarding certain retained rights." Id. at S15680.

This congressional purpose is advanced by a rule which ensures that only value that is fixed and ascertainable at the creation of the trust, and therefore is not contingent, may reduce the value of the gift of the remainder. In contrast, if gifts in trust may be reduced by the value of spousal interests which are contingent and which in fact never take effect, the retained interests have the potential for overvaluation and the gift of the remainder for undervaluation. We are satisfied that such would be contrary to the intent of section 2702.

Moreover, even if we were to assume that the spousal interests here, standing alone, were qualified, the retained annuities to the extent based on two lives would fail to achieve qualified status for an additional reason. As previously noted, the regulations provide that retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest). See sec. 25.2702-2(a)(5), Gift Tax Regs. In each of the trusts under scrutiny, however, if the interest over which the grantor has retained a power to revoke is treated as an interest retained by the grantor, the requirement of section 25.2702-3(d)(3), Gift Tax Regs., that the term of the annuity must be the lesser of a term of years or the life of the term holder has not been met. Under the trust terms the spousal interests create the possibility that
the retained annuity will extend beyond the life of the term holder; i.e., the grantor. Section 25.2702-3(d)(3), Gift Tax Regs., precludes this result.

The Tax Court followed its decision in Cook in Patricia A. Schott, et al. v. Commissioner, T.C. Memo. 2001-110.

On the other hand, the Tax Court, in a reviewed opinion, has agreed that payments to a decedent's estate are qualified interests. Audrey J. Walton v. Commissioner, 115 T.C. No. 41 (2000). There were two GRATs involved:

According to the provisions of each GRAT, petitioner was to receive an annuity amount equal to 49.35 percent of the initial trust value for the first 12-month period of the trust term and 59.22 percent of such initial value for the second 12-month period of the trust term. In the event that petitioner's death intervened, the annuity amounts were to be paid to her estate. The sums were payable on December 31 of each taxable year but could be paid up through the date by which the Federal income tax return for the trust was required to be filed. The payments were to be made from income and, to the extent income was not sufficient, from principal. Any excess income was to be added to principal.

Upon completion of the 2-year trust term, the remaining balance was to be distributed to the designated remainder beneficiary.

The opinion describes the issue as follows:

Respondent contends that in establishing each GRAT, petitioner created three separate and distinct interests: (1) The annuity payable to her during her lifetime, (2) the "contingent" interest of her estate to receive the annuity payments in the event of her death prior to expiration of the 2-year trust term, and (3) the remainder interest granted to her daughter. Of these three, it is respondent's position that only the first interest, but not the second, constitutes a qualified retained interest within the meaning of section 2702 and the regulations promulgated thereunder. Respondent particularly relies upon section 25.2702-3(e), Example (5), Gift Tax Regs. (hereinafter Example 5), as a valid interpretation of the statute and as governing the issues involved in this case.

Hence, according to respondent, only the value of an annuity payable for the shorter of 2 years or the period ending upon petitioner's death may be subtracted from the fair market value of the stock in calculating the value of the taxable gift made by reason of petitioner's establishment of the GRATs.

Conversely, petitioner maintains that for valuation purposes under section 2702, each GRAT is properly characterized as creating only two separate interests: (1) A retained annuity payable for a fixed term of 2 years, and (2) a remainder interest in favor of her daughter. Petitioner further asserts that the former, in its entirety, is a qualified interest within the meaning of the statute. Accordingly, it is petitioner's position that the retained interest to be subtracted in computing the amount of the taxable gift occasioned by each GRAT is to be valued as a simple 2-year term annuity, without regard to any mortality factor.

The IRS relied on Example 5 for its position; the taxpayer argued that Example 5 was an invalid interpretation of section 2702.
Overturning a regulation is hard. The court described the standard of review in this way:

The regulations at issue here are interpretative regulations promulgated under the general authority vested in the Secretary by section 7805(a). Hence, while entitled to considerable weight, they are accorded less deference than would be legislative regulations issued under a specific grant of authority to address a matter raised by the pertinent statute. See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-844 (1984) (Chevron); United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982). A legislative regulation is to be upheld unless "arbitrary, capricious, or manifestly contrary to the statute." Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., supra at 843-844.

With respect to interpretative regulations, the appropriate standard is whether the provision "implement[s] the congressional mandate in some reasonable manner." United States v. Vogel Fertilizer Co., supra at 24 (quoting United States v. Correll, 389 U.S. 299, 307 (1967)). In applying this test, we look to the following two-part analysis enunciated by the Supreme Court:

When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. [Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., supra at 842-843; fn. refs. omitted.]

A challenged regulation is not considered such a permissible construction or reasonable interpretation unless it harmonizes both with the statutory language and with the statute's origin and purpose. See United States v. Vogel Fertilizer Co., supra at 25-26; National Muffler Dealers Association v. United States, 440 U.S. 472, 477 (1979) (National Muffler).

We pause to note that before the Chevron standard of review was enunciated by the Supreme Court, the traditional standard was simply "whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose", as prescribed by the Supreme Court in National Muffler Dealers Association v. United States, supra at 477. As we have observed in a previous case, the opinion of the Supreme Court in Chevron failed to cite National Muffler and may have established a different formulation of the standard of review. See Central Pa. Sav. Association v. Commissioner, 104 T.C. 384, 390-391 (1995). In the case before us, we conclude that it is unnecessary to parse the semantics of the two tests to discern any substantive difference between them, because the result here would be the same under either.

The IRS argument was that an annuity paid to an estate is essentially a contingent reversion, which is not a qualified interest.
Respondent alleges that Congress sought to curb the then-current practice of bifurcating trusts into numerous interests and selectively retaining interests based on mortality, such as reversions. Respondent points out the common estate planning device of creating a trust, with a term short enough that the grantor's risk of dying during the term would be minimal, in which the grantor retained both an income interest and a contingent reversion in the trust corpus to take effect in the event of his or her death during the term. The value of the gift to the remaindermen would then be calculated by subtracting actuarial amounts for each of these interests, despite the negligible chance that the reversion would become operative.

Respondent then goes on to frame the annuities payable to petitioner's estate as no different in substance from such reversions. Respondent's position is that both represent separate rights to receive property contingent upon the grantor's death during the trust term. Because contingent rights, not fixed or ascertainable at the creation of the trust, do not fall within any of the three forms defined as qualified in section 2702(b), respondent maintains that both are properly valued at zero. On this basis, respondent argues that Example 5 is consistent not only with the purpose of section 2702 but also with other regulations which deal with post-death interests, particularly section 25.2702-3(e), Gift Tax Regs.

Respondent further contends that Congress' reference to a trust consisting only of a fixed-term annuity and a noncontingent remainder was describing a situation different from that of petitioner here. Respondent avers that the scenario contemplated by the lawmakers was one in which the donor transferred the lead annuity to an entity with perpetual life and retained a noncontingent remainder. According to respondent, only in that context is it possible for a donor to create strictly an annuity for a term of years and a noncontingent remainder. Hence, it is only that kind of situation which respondent claims is sanctioned by the mention of an annuity "for a specified term of years" in section 25.2702-3(d)(3), Gift Tax Regs., with the result that there exists no inconsistency between Example 5 and such regulatory section.

The court rejected the IRS argument:

With respect to the text itself, the short answer is that an annuity for a specified term of years is consistent with the section 2702(b) definition of a qualified interest; a contingent reversion is not.

As regards policy, permitting reduction to gift value for reversionary interests was resulting in arbitrary and abusive elimination of value which was intended to, and typically did, pass to the donee. Donors were subtracting the full actuarial value of a reversionary interest in the trust corpus and were not merely treating their retained interests as an annuity for a fixed term of years. Although we acknowledge that, in the case of a reversion, at least the equivalent of the term annuity's value would be payable to the grantor or the grantor's estate in all events, Congress was entitled to require that interests be cast in one of three specified forms to receive the favorable treatment afforded qualified interests. Accordingly, the Commissioner is equally justified in assigning a zero value to reversionary interests outside the scope of the statutory definition and refusing to consider whether such interests can have the practical effect of a different form of interest not chosen by the grantor. See sec. 25.2702-3(e), Example (1), Gift Tax Regs.
In contrast, there exists no rationale for refusing to take into account for valuation purposes a retained interest of which both the form and the effect are consistent with the statute. We further observe that respondent's attempts to equate the estate's rights here with other contingent, post-death interests are premised on the bifurcation of the estate's interest from that of petitioner. Yet, given the historical unity between an individual and his or her estate, we believe such separation is unwarranted where the trust is drafted in the form of a specified interest retained by the grantor, with the estate designated only as the alternate payee of that precise interest. This is the result that would obtain if the governing instrument were simply silent as to the disposition of the annuity in the event of the grantor's death during the trust term. Additionally, any other construction would effectively eliminate the qualified term-of-years annuity, a result not contemplated by Congress.

Moreover, we note in this connection that the Commissioner has defined noncontingent for purposes of determining a qualified remainder interest as follows: "an interest is non-contingent only if it is payable to the beneficiary or the beneficiary's estate in all events." Sec. 25.2702-3(f)(1)(iii), Gift Tax Regs. We are satisfied that this principle is equally applicable in the circumstances at bar. For similar reasons, we decline respondent's invitation to treat term annuities payable to a grantor or the grantor's estate as having two separate "holders" for purposes of the regulatory requirement of section 25.2702-3(b)(1)(i), Gift Tax Regs., that the annuity amount "be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term."

Lastly, we observe that the legislative history indicates section 2702 was to draw upon the rules for valuing split-interest gifts to charity under section 664. Section 664 deals with charitable remainder annuity trusts and unitrusts for which a tax deduction is available. Yet under this statute, respondent apparently acknowledges that an annuity payable for a term of years to an individual or the individual's estate is valued as a fixed-term interest. Section 1.664-2(c), Income Tax Regs., provides that the present value of an annuity is to be computed in accordance with regulations promulgated under section 2031. Such regulations, in turn, contain the following example:

EXAMPLE 4. ANNUITY PAYABLE FOR A TERM OF YEARS.
The decedent, or the decedent's estate, was entitled to receive an annuity of $10,000 a year payable in equal quarterly installments at the end of each quarter throughout a term certain. At the time of the decedent's death, the section 7520 rate was 9.8 percent. A quarterly payment had just been made prior to the decedent's death and payments were to continue for 5 more years. Under Table B in section 20.2031-7(d)(6) for the interest rate of 9.8 percent, the factor for the present value of a remainder interest due after a term of 5 years is .626597. Converting the factor to an annuity factor, as described in paragraph (d)(2)(iv)(A) of this section, the factor for the present value of an annuity for a term of 5 years is 3.8102. The adjustment factor from Table K in section 20.2031-7(d)(6) at an interest rate of 9.8 percent for quarterly annuity payments made at the end of the period is 1.0360. The present value of the annuity is, therefore, $39,473.67 ($10,000 x 3.8102 x 1.0360).
It strikes us as incongruous that respondent is willing to recognize the full value of a term annuity, whether payable to a taxpayer or to the taxpayer's estate, when to do so will reduce the amount of a charitable deduction, but refutes this approach when it will decrease the amount of a taxable gift.

4. **Commuation of GRIT.** TAM 199935003 determined that the commutation of a grantor retained income trust would not remove assets from the grantor’s estate. The GRIT was created in 1988 and the trustee could commute the GRIT by giving the grantor and the remaindermen their respective actuarial interests. The commutation at issue was as follows:

On Date 1, in 1995, the decedent was admitted to the hospital. The Decedent had been diagnosed with terminal cancer.

Eight days later, on Date 2, the trustee wrote the three remaindernen and informed the remaindernen that if Decedent died during the ten-year trust term, then the entire value of the trust would be included in Decedent's gross estate. The letter further stated that, by commuting the Decedent's interest, and, thus avoiding inclusion of the entire trust corpus in the gross estate, a significant amount of estate tax could be saved. The letter then requested the beneficiaries' recommendation regarding commutation. The three remaindernen recommended commutation.

Eleven days later on Date 3, the trust was valued at $6,159,479.05. The trustee distributed $2,247,981.95 to a separate account for the Decedent. The balance of the trust, $3,911,497.20, was distributed to the three remainder beneficiaries (pursuant to authority contained in Article TENTH). The amount distributed to the Decedent was the actuarial value of Decedent's interest on the date of the distribution, determined based on the actuarial tables contained in the regulations.

The Decedent died the following day on Date 4.

The IRS argued that the grantor’s death may have been imminent so the actuarial tables would not apply. However, its primary argument was under section 2035:

In United States v. Allen, 293 F.2d 916 (10th Cir. 1961), the settlor created an irrevocable trust reserving an income interest for her life in a portion of the trust. Subsequently, the settlor sold her income interest in the trust to her son in exchange for an amount equal to the actuarial value of the income interest. The estate acknowledged that if the decedent had gratuitously transferred her income interest in the trust, the trust corpus would be includable under section 811(c)(1)(A) of the 1939 Code, the predecessor to section 2035. However, because the settlor received adequate consideration for the transfer of the income interest, the estate argued that section 811(c)(1)(A) did not apply. The court concluded that in order to remove the trust, property from a decedent's gross estate under the bona fide sale exception to section 811(c)(1)(A), the consideration received for the sale had to be at least equal to the value of the property that would have been included in the gross estate if the interest had been retained. In Allen, since the settlor had reserved an income interest in part of the trust corpus, the portion of the trust associated with the reserved income interest would have been included in the settlor's gross estate upon death.
the settlor's death. Thus, payment equal to the value of the income interest was not adequate and full consideration for purposes of the statute, because the value of the income interest was less than the value of the trust portion that would otherwise be included in the settlor's gross estate if the income interest had been retained until death.

* * * * *

There is little distinction between the sale considered by the court in United States v. Allen and the commutation involved in the instant case. In Allen, the decedent transferred her interest to her son in exchange for cash. In this case, the commutation effectuated a transfer of the decedent's interest to the trust (or the trust remaindermen) in exchange for cash. The amount received by the Decedent for the transfer of her interest did not constitute adequate and full consideration for purposes of the "bona fide sale" exception contained in section 2035, since the amount received was only a fraction of the value of the trust corpus subject to inclusion under section 2036. Further, it is questionable whether the commutation transaction could be characterized as a sale, but in any event, it would clearly not constitute a "bona fide" sale. As the facts indicate, the intra-family transaction was consummated shortly before Decedent's death. The amount received by the Decedent, considering the state of Decedent's health, was wholly inadequate, in view of the right of Decedent's revocable trust to receive the entire trust corpus in the event Decedent died prior to the expiration of the 10 year trust term. The parties were clearly not dealing at arm's length. Accordingly, as was the case in Allen, the entire trust corpus (less the payment received for the income interest) should be included in the gross estate under section 2035.

Taxpayer argues that sections 2035(a) and 2035(d)(2) do not apply to the transaction, because the Decedent did not "transfer" the retained interest. Rather the term "transfer" implies a volitional act. Here taxpayer was required to relinquish her interest pursuant to the terms of the trust authorizing the trustee to commute her interest. However, in this case, the Trustee's actions effectuated a transfer of Decedent's retained interest in the trust for a cash payment. Although the trustee may have initiated the transaction, nonetheless, the transaction resulted in a transfer by the Decedent of her retained interest for purposes of section 2035(d)(2). The Decedent authorized the commutation clause in the trust with the intent and expectation that the trustee would exercise the power in appropriate circumstances, such as a situation where the Decedent's death was imminent. Thus, although the Decedent did not formally initiate the commutation, the exercise of the power by the trustee was consistent with Decedent's intent and was authorized, if not implicitly directed, by the Decedent. Further, the transaction was entirely intra-family between the Decedent and her children, and was consummated solely to reduce the impending estate tax liability. Thus, even assuming that statute requires that an intra-family transaction must be initiated or consented to by the decedent, it is difficult to characterize the transaction in this case as other than a "transfer" within the purview of section 2035, by the Decedent. As the court noted in United States v. Allen, "It does not seem plausible . . . that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates."

5. **Change of Interest Rate in Buy-Sell Does Not Violate Sections 2703 or 2704.** PLR 200015012 confirms that a change in a pre-October 8, 1990 partnership agreement to change the interest rate paid on repurchases
of partnership interests from 5% to the greater of 5% or the section 1274 long-term rate will not violate sections 2703 or 2704.

6. **Joint Purchase of Residence.** PLR 200112023 deals with a trust into which parents contributed enough cash to purchase the life interest in a residence and son contributed the amount of the remainder interest. Parents could live in the residence until the death of the second of them and the residence would not be included in either of their estates.

R. **SECTION 6166 -- EXTENSION OF TIME TO PAY TAX**

1. **Transfer of Sole Proprietorship Assets to LLC.** In PLR 200043030 the Service approved the reorganization of business assets. Specifically approved were:

   (1) The distribution of excess capital held in the name of the Sole Proprietorship to Decedent's estate will not constitute a disposition as defined under section 6166(g).

   (2) The conversion of the Sole Proprietorship into an LLC and the dissolution of the Corporation will not be treated as dispositions under section 6166(g).

   (3) The distribution of farmland from Decedent's estate to Daughter's estate is not a disposition under section 6166(g).

   (4) The farmland leased by Daughter's estate to the LLC remains active, and entering into the lease is not a disposition under section 6166(g).

   (5) The distribution of profits of the LLC and the Quarry LLC to Decedent's estate is not a disposition under section 6166(g).

The third and fifth rulings are interesting:

Section 6166(g)(1)(A)(i) provides that if any portion of an interest in a closely held business which qualifies under section 6166(a)(1) is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such trade or business, and (ii) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawal equals or exceeds 50 percent of the value of such interest, then the extension of time for payment of tax provided in subsection (a) shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

Section 6166(g)(1)(D) provides that section 6166(g)(1)(A)(i) does not apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive the property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent. A similar rule applies in the case of a series of subsequent transfers of the property by reason of death so long as each transfer is to a member of the family (within the meaning of section 267(c)(4)) of the transferor in such transfer.

Section 20.6166A-3(e)(1) provides, in pertinent part, that a transfer by the executor of an interest in a closely held business to a beneficiary or trustee named in the decedent's will, or an heir who is entitled to receive the interest under the
applicable intestacy law, does not constitute a distribution thereof for purposes of
determining whether 50 percent or more of an interest in a closely held business
has been distributed, sold, exchanged, or otherwise disposed of.

In this case, pursuant to Article IV of Decedent's will, the residue of Decedent's
estate (including the farmland) passes outright to Daughter. Accordingly, the
transfer of the farmland by Decedent's estate to Daughter's estate (the estate of the
person entitled by reason of Decedent's death to receive the property under
Decedent's will) in order to limit Decedent's estate's potential liability from third-
parties who could be injured by the continued farming operations will not
constitute a distribution thereof for purposes of determining whether 50 percent or
more of an interest in a closely held business has been distributed, sold, exchanged,
or otherwise disposed of.

According to the terms of Daughter's will, the residue of Daughter's estate passes
to Trust. Therefore, the executor of Daughter's estate will distribute the residue of
Daughter's estate, including the farmland received as part of Decedent's residuary
bequest to Daughter, to Trust.

It is represented that the farming business will be operated through the LLC.
Although the core of the farming operation is conducted through the LLC, the
farmland constitutes a fundamental part of the overall farming operation and will
continue to be utilized in the farming operation. Thus, the transfer of the farmland
by Daughter's estate to Trust pursuant to the terms of Daughter's will not constitute
a distribution thereof for purposes of determining whether 50 percent or more of
an interest in a closely held business has been distributed, sold, exchanged, or
otherwise disposed of.

* * * * *

Section 20.6166A-3(d)(1) provides that in any case where money or other property
is withdrawn from the trade or business and the aggregate withdrawals of money
or other property equal or exceed 50 percent of the value of the trade or business,
the privilege of paying the tax in installments terminates and the whole of the
unpaid portion of the tax which is payable in installments becomes due and shall
be paid upon notice and demand from the District Director. A withdrawal will
trigger this acceleration provision only if the withdrawn money or other property
constitutes "included property" within the meaning of that term as used in section
20.2032-1(d). Section 20.2032-1(d) defines included property as all property
interests existing at the decedent's death which form a part of the gross estate. The
provisions of section 20.6166A-3(d)(1) do not apply to the withdrawal of money
or other property which constitutes "excluded property." Section 20.2032-1(d)
defines excluded property as property earned or accrued after the date of decedent's
death.

The profits earned by the LLC and the Quarry ILLC after the date of Decedent's
death are excluded property under section 20.2032-1(d), and as such, would not
constitute a withdrawal of money or other property from a closely held business
within the meaning of section 6166(g). Accordingly, the withdrawal of current and
future profits from the I LLC and the Quarry LLC will not be considered a
disposition or a withdrawal of funds from the closely held business for purposes
of section 6166(g)(1)(A)(i). However, withdrawal of any included property (as
defined under section 20.2032-1(d)) from the closely held business will be
considered a disposition for purposes of section 6166(g).

PLR 200043031 grants an additional request, that a protective section 2013 election can be made.

S. TAX ADMINISTRATION

1. Attachment of Federal Tax Lien to Disclaimed Property. May a beneficiary who owes federal
taxes avoid the attachment of a federal tax lien to inherited property by disclaiming? The answer appears to depend on
the character of the right to inherited property under applicable state law.

(8th. Cir. 1998). The Supreme Court upheld at 84 AFTR2d ¶ 99-5563. The Court stated:

The Eighth Circuit, with fidelity to the relevant Code provisions and our case law,
determined first what rights state law accorded Drye in his mother's estate. It is
beyond debate, the Court of Appeals observed, that under Arkansas law Drye had,
at his mother's death, a valuable, transferable, legally protected right to the property
at issue. See 152 F.3d, at 895 (although Code does not define "property" or "rights
to property," appellate courts read those terms to encompass "state-law rights or
interests that have pecuniary value and are transferable"). The Court noted, for
example, that a prospective heir may effectively assign his expectancy in an estate
under Arkansas law, and the assignment will be enforced when the expectancy
ripens into a present estate. See id., at 895-896 (citing several Arkansas Supreme
Court decisions, including: Clark v. Rutherford, 227 Ark. 270, 270-271, 298 S.W.2d
327, 330 (1957); Bradley Lumber Co. of Ark. v. Burbridge, 213 Ark. 165, 172,
210 S.W.2d 284, 288 (1948); Leggett v. Martin, 203 Ark. 88, 94, 156 S.W.2d 71,
74-75 (1941)).

Drye emphasizes his undoubted right under Arkansas law to disclaim
the inheritance, see Ark. Code Ann. section 28-2-101 (1987), a right that is indeed
personal and not marketable. See Brief for Petitioners 13 (right to disclaim is not
transferable and has no pecuniary value). But Arkansas law primarily gave Drye
a right of considerable value -- the right either to inherit or to channel the
inheritance to a close family member (the next lineal descendant). That right simply
cannot be written off as a mere "personal right ... to accept or reject [a] gift." Brief
for Petitioners 13.

In pressing the analogy to a rejected gift, Drye overlooks this crucial distinction.
A donee who declines an inter vivos gift generally restores the status quo ante,
leaving the donor to do with the gift what she will. The disclaiming heir or devisee,
in contrast, does not restore the status quo, for the decedent cannot be revived.
Thus the heir inevitably exercises dominion over the property. He determines who
will receive the property -- himself if he does not disclaim, a known other if he
does. See Hirsch, The Problem of the Insolvent Heir, 74 Cornell L. Rev. 587, 607-608 (1989). This power to channel the estate's assets warrants the conclusion that
Drye held "property" or a "right[t] to property" subject to the Government's liens.

* * * *

In sum, in determining whether a federal taxpayer's state- law rights constitute
"property" or "rights to property," "[t]he important consideration is the breadth of
the control the [taxpayer] could exercise over the property." Morgan, 309 U.S., at
83. Drye had the unqualified right to receive the entire value of his mother's estate (less administrative expenses), see National Bank of Commerce, 472 U.S., at 725 (confirming that unqualified "right to receive property is itself a property right" subject to the tax collector's levy), or to channel that value to his daughter. The control rein he held under state law, we hold, rendered the inheritance "property" or "rights to property" belonging to him within the meaning of section 6321, and hence subject to the federal tax liens that sparked this controversy.

2. **Recalculation of State Death Tax Credit.** In TAM 199940005 the National Office held that where a state imposed an estate tax for the amount attributable to the recapture tax under section 2032A(c) the state death tax credit would be redetermined. Presumably, the result will be the same with respect to a recapture tax under section 2057.

3. **Reopening Audit After Erroneous Closing Letter.** In Estate of Eileen K. Brocato v. Commissioner, T.C. Memo. 1999-424, the court allowed the IRS to reopen an audit after a closing letter had been sent by mistake. While the IRS was hiring an appraiser the estate filed a supplemental estate tax return to claim an additional interest deduction. A clerk at the Ogden, Utah Service Center issued the closing letter. The opinion states:

   Petitioner argues that respondent should be estopped from assessing additional estate taxes on two grounds: (1) Respondent's closing letter constituted affirmative misconduct on which petitioner relied to its detriment; and (2) respondent failed to follow the procedures for reopening a case outlined in the Internal Revenue Manual (the Manual) and closing letter.

   There is no doubt that the Ogden Service Center's closing letter was erroneous. It, however, appears from the sparse record on this point that the error occurred because an Ogden Service Center employee neglected to check the estate's transcript which indicated an examination was underway before issuing the closing letter. Respondent never affirmatively concealed the mistake. Once the mistake was discovered, respondent immediately notified petitioner that the audit was still underway. Petitioner has failed to demonstrate how this isolated and careless act amounts to affirmative misconduct going beyond mere negligence.

   As for petitioner's second argument, we do not believe that respondent violated the Manual procedures or the closing letter's description of the circumstances for reopening petitioners' case. Under section 4023.2(1) of the Manual, there are three criteria for reopening petitioners' case. Under section 4023.2(1) of the Manual, there are three criteria for reopening an audit. The third criterion is that an audit may be reopened where "other circumstances exist which indicate failure to reopen would be a serious administrative omission." 1 Audit, Internal Revenue Manual (CCH), sec. 4023.2(1) at 7063-4. Under section 4023.5 of the Manual, a "serious administrative omission" is defined as a closed case where failure to reopen the case could "result in serious criticism of the Service's administration of the tax laws". 1 Audit, Internal Revenue Manual (CCH), sec. 4023.5 at 7065. The closing letter stated: "we will not reopen this return unless * * * other circumstances exist which indicate that a failure to reopen would result in a serious administrative omission." The reopening letter stated that the audit was being reopened because a "serious administrative omission" had occurred and failure to reopen the case "would result in criticism, undesirable precedent, or inconsistent treatment."

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Failure to reopen the audit, herein, would mean that a potential $1,373,797 of estate tax could go uncollected. The loss of such revenue could result in criticism of the IRS' administration of the tax laws and inconsistent treatment among taxpayers. We believe that respondent complied with the Manual's procedures and the closing letter's description of circumstances for reopening an audit. Further, this Court has stated numerous times that procedural rules of this sort are "merely directory, not mandatory, and compliance with them is not essential to the validity of a notice of deficiency."  Collins v. Commissioner, 61 T.C. 693, 701 (1974)(quoting Luhring v. Glotzbach, 304 F.2d 560, 563 (4th Cir. 1962)).

We are also not convinced that the traditional elements of equitable estoppel are satisfied. We doubt whether petitioner's reliance on the closing letter was reasonable. On October 10, 1995, Mr. Samuelson notified petitioner's counsel that the IRS intended to hire an appraiser to value the properties which would take at least 3 months, and Mr. Samuelson would contact petitioners' counsel when the expert was hired. On December 14, 1995, the Ogden Service Center issued the closing letter. Neither petitioner's counsel nor a representative of petitioner contacted Mr. Samuelson to discuss the issuance of the closing letter and the inconsistencies between its issuance and the conversation between petitioner's counsel and Mr. Samuelson just 2 months earlier. We believe that a reasonable and prudent person would have inquired about these inconsistencies.

Additionally, we are skeptical as to petitioner's claim of detriment in this case. Petitioner claims that it wanted to know the precise amount of estate tax owed before formulating its plan to dispose of the Brocato properties and it relied on the closing letter in determining that amount. If petitioner had not received the closing letter, petitioner contends that it would have exercised its section 6166 election and would have waited to sell 2360 Chestnut after the property appreciated.

It is not disputed that petitioner had a valid section 6166 election and could have deferred payment of its estate tax. We, however, question whether petitioner would have actually exercised its section 6166 election. Petitioner paid its estate tax liability on May 22, 1996, approximately 3 years before it was required to pay under section 6166. It is speculative whether petitioner would have continued to take advantage of the section 6166 election had it been told of the increased estate tax liability.

Petitioner also claims that the Chestnut property appreciated in value after its premature sale, and petitioner would have been able to sell it for a higher sum but for the issuance of the closing letter. Again, this involves conjecture. Petitioner has failed to demonstrate that it suffered a detriment as a result of its reliance on the closing letter.

4. **Fiduciary Liability for Unpaid Income Taxes.** William D. Little v. Commissioner, 113 T.C. No. 31, deals with a fiduciary's liability for unpaid income taxes when the fiduciary relies on an attorney's advice that no taxes were owed. The opinion states:

> Respondent argues that under 31 U.S.C. section 3713(b), petitioner is personally liable for the estate's unpaid income tax liabilities. Title 31 U.S.C. section 3713 provides:

> Section 3713. Priority of Government claims
(a)(1) A claim of the United States Government shall be paid first when --

... ... ...

(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

... ... ...

(b) A representative of a person or an estate * * paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

This section appears to impose strict liability on a fiduciary who makes a disbursement which leaves the estate with insufficient funds with which to pay a debt owed to the United States. However, courts have long departed from such a rigid interpretation. "[I]t has long been held that a fiduciary is liable only if it had notice of the claim of the United States before making the distribution." Want v. Commissioner, 280 F.2d 777, 783 (2d Cir. 1960); see also Leigh v. Commissioner, 72 T.C. 1105, 1109 (1979). Whether the fiduciary had notice is determined by whether the executor knew or was chargeable with knowledge of the debt. "The knowledge requirement of 31 U.S.C. sec. 192 [now 31 U.S.C. sec. 3713] may be satisfied by either actual knowledge of the liability or notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States." Leigh v. Commissioner, supra at 1110 (citing Irving Trust Co. v. Commissioner, 36 B.T.A. 146 (1937); Livingston v. Becker, 40 F.2d 673 (E.D. Mo. 1929)). To be chargeable with knowledge of such a debt, the executor must be in possession of such facts as to "put him on inquiry." New v. Commissioner, 48 T.C. 671, 676 (1967). "It is this knowing disregard of the debts due to the United States that imposes liability on the fiduciary." Leigh v. Commissioner, supra at 1109-1110 (citing United States v. Crocker, 313 F.2d 946 (9th Cir. 1963)).

It is clear that petitioner had no actual knowledge of the estate's income tax liabilities at the time that he made disbursements and distributions from the estate. However, respondent argues that petitioner's receipt of Forms W-2 and 1099 and subsequent notices would have put a reasonably prudent person in petitioner's position on inquiry as to the existence of the debts due to the United States for unpaid income taxes.

We agree that the receipt of the tax information forms in January 1990 and 1991 was sufficient to put petitioner on inquiry. However, petitioner, having been put on inquiry, acted in a prudent and reasonable manner consistent with his fiduciary duties. Petitioner forwarded the forms to the estate's attorney, Mr. Lahr, and sought his advice. Mr. Lahr informed petitioner that because of the estate's size, the estate had no income tax liabilities. Mr. Lahr's legal advice was wrong.
Petitioner continued to receive the same advice from Mr. Lahr after giving him other notices from respondent that indicated there might be unpaid income taxes for which the estate might be liable. It was not until the summer of 1993 when Mr. Dilg was brought in and prepared and filed delinquent returns that the tax liabilities in issue were discovered by Mr. Lahr. But almost all the estate's assets had already been distributed by then. As a result, on November 30, 1993, petitioner submitted an Offer in Compromise and sent a check for $17,586.07, the balance of the estate's assets, to respondent. The offer was not accepted, and several months later respondent returned the check to petitioner without explanation. Petitioner immediately informed Mr. Lahr. Thereafter, Mr. Lahr and Mr. Dilg met with representatives of respondent and erroneously concluded that respondent would drop the tax claims against the estate. They informed petitioner of this, and Mr. Lahr advised petitioner to make the final disbursements and to close the estate. Relying on the advice of the estate's attorney and the certified public accountant, petitioner closed the estate.

5. Post-Death Events Relevant to Whether Failure to Pay Estate Tax Was Reasonable. The Fifth Circuit has held in Estate of Willie Mae Sowell v. United States, 84 AFTR2d Par. 99-5583 (1999), that post-death events are relevant. The opinion states:

   The Estate argues that since "reasonable cause" and "willful neglect" are determined as of the date the taxes are due, any events subsequent to that date are irrelevant and unduly prejudicial. We disagree. The post-due date evidence was introduced by the government to rebut the Estate's argument that it used "ordinary care and prudence" in attempting to pay the tax before it was due. For example, the fact that the Estate did not attempt to obtain a loan for the entire four-year period following the due date is certainly relevant to whether its failure to arrange for a loan before the due date was "reasonable." Further, the Estate's failure to appeal the IRS's denial of its request for an extension clearly affects whether the Estate's overall failure to pay on time was "reasonable." Such information is more than merely relevant, it is quite probative of "reasonableness", and outweighs any unduly prejudicial effect it may have had on the estate.

   Under the Estate's rationale, evidence that an executor used estate funds to purchase a fleet of luxury cars and an island in the South Pacific after the date the taxes were due would be inadmissible to prove that the executor's failure to pay the estate taxes on time was unreasonable. This is plainly wrong. Accordingly, the district court did not abuse its discretion in allowing introduction of the post-due date evidence as admissible to prove that the Estate was unreasonable in failing to pay its taxes on the due date.

   The court also found that the trial court could exclude expert testimony on whether the estate acted reasonably.

6. Collateral Estoppel Prevents Estate From Excluding Ranch. In Estate of Theodore C. Chemodurow v. Commissioner, T.C. Memo. 2001-14 (2001), the Tax Court held that the estate was precluded from arguing that a ranch and is equipment had been sold to the decedent's daughter because in two actions in Montana state court this had been determined that the sale was invalid. The applicable law was set forth by the court as follows:
The doctrine of issue preclusion, or collateral estoppel, provides that, once an issue of fact or law is "actually and necessarily determined by a court of competent jurisdiction, that determination is conclusive in subsequent suits based on a different cause of action involving a party to the prior litigation." Montana v. United States, 440 U.S. 147, 153 (1979) (citing Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n.5 (1979)). Issue preclusion is a judicially created equitable doctrine the purposes of which are to protect parties from unnecessary and redundant litigation, to conserve judicial resources, and to foster certainty in and reliance on judicial action. See, e.g., id. at 153-154; United States v. ITT Rayonier, Inc., 627 F.2d 996, 1000 (9th Cir. 1980). In Peck v. Commissioner, 90 T.C. 162, 166-167 (1988), affd. 904 F.2d 525 (9th Cir. 1990), we set forth the following five conditions that must be satisfied prior to application of issue preclusion in the context of a factual dispute (the Peck requirements):

1. The issue in the second suit must be identical in all respects with the one decided in the first suit.

2. There must be a final judgment rendered by a court of competent jurisdiction.

3. Collateral estoppel may be invoked against parties and their privies to the prior judgment.

4. The parties must actually have litigated the issues and the resolution of these issues must have been essential to the prior decision.

5. The controlling facts and applicable legal rules must remain unchanged from those in the prior litigation. [Citations omitted.]

Even if the Peck requirements are satisfied, however, we have broad discretion to determine when issue preclusion should apply, and we may refuse to apply it where, for instance, it is to be applied offensively, and the party against whom it is to be applied had little incentive to defend in the first action or where the second action affords the party procedural opportunities unavailable in the first action that could readily cause a different result. See Parklane Hosiery Co. v. Shore, 439 U.S. 322, 330-331 (1979); see also McQuade v. Commissioner, 84 T.C. 137, 143 (1985).

In considering respondent's position that preclusive effect attaches to the findings of the State court, we inquire whether the courts of Montana would accord such findings preclusive effect. See 28 U.S.C. sec. 1738 (2000) (the records and judicial proceedings of a State shall have the same full faith and credit in every court within the United States as they have in the courts of the State from which they are taken); Kremer v. Chemical Constr. Corp., 456 U.S. 461, 482 (1982) ("Congress has specifically required all federal courts to give preclusive effect to state-court judgments whenever the courts of the State from which the judgments emerged.

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would do so", quoting Allen v. McCurry, 449 U.S. 90, 96 (1980)); Bertoli v. Commissioner, 103 T.C. 501, 508 (1994). The doctrine of collateral estoppel is recognized in the courts of Montana. E.g., Rafanelli v. Dale, 971 P.2d 371, 373 (Mont. 1998) ("The doctrine of collateral estoppel bars a party against whom the claim is asserted or a party in privity with the earlier party, from relitigating an issue which has been decided in a different cause of action."). The Supreme Court of Montana applies a three-part test to determine whether collateral estoppel bars litigation: (1) Was the issue decided in the prior adjudication identical with the one presented in the action in question? (2) Was there a final judgment on the merits? (3) Was the party against whom the plea is asserted a party in privity with a party to the prior litigation? See id. at 373-374. Although the three-part test applied by the Supreme Court of Montana does not specifically recognize the fourth and fifth Peck requirements (actual litigation of an issue whose resolution was essential to prior case and no change in controlling facts and applicable legal rules), we believe that those requirements are inherent in Montana's three-part test. Since the parties have couched their arguments in terms of the Peck requirements, we shall respond accordingly.

7. Refund Suit Under Section 6166. In Hansen v. United States, 87 AFTR2d, 2001-846 (April 2001), the Eighth Circuit held that the district court had no jurisdiction in a refund case if the estate had elected to make payments under section 6166 but was behind in the payments.

T. MISCELLANEOUS

1. Tax Apportionment. Apportionment of estate tax presents on-going issues. One of those was addressed in Estate of Miller v. Commissioner, T.C. Memo. 1998-416: apportionment inside the residue. The decedent's Will provided for all taxes to be paid from the residue. The residue was to be divided, one-half for the decedent's surviving spouse and the other half to a trust that did not qualify for the marital deduction. The applicable apportionment statute, Texas, was summarized by the court:

Generally, in the absence of specific directions in the will regarding the apportionment of estate tax, the State's apportionment statute mandates that estate tax be apportioned among estate beneficiaries according to the taxable value of their respective interests in the estate. Tex. Prob. Code Ann. sec. 322A(b)(1). Apportionment, pursuant to the statute, takes into consideration bequests qualifying for the marital deduction, and no estate tax is apportioned to the surviving spouse with respect to such bequests. Tex. Prob. Code Ann. sec. 322A(c) and (d). The Texas statute, however, allows the decedent to opt out of the general scheme by specifically providing for an alternative plan of apportionment. Tex. Prob. Code Ann. sec. 322A(b)(2).

The court relied on Estate of Fine v. Commissioner, 90 T.C. 1068 (1988), aff'd without published opinion, 885 F.2d 879 (11th Cir. 1989), and Estate of Brunetti v. Commissioner, T.C. Memo. 1988-517, and held that the Will "opted out" of the statute.

A contrary result was reached in Edward McKeon v. United Stated, 82 A.F.T.R.2d 98-5114 (9th Cir.), construing the California apportionment statute.

In Estate of Fagan v. Commissioner, T.C. Memo. 1999-46, the decedent's will provided in pertinent part as follows:
1.01 CLAIMS AGAINST MY ESTATE. I direct my Executor, hereinafter named, to pay out of the general funds of my estate the cost of the administration of my estate, all my legal debts, expenses of last illness, and funeral expenses.

1.02 PAYMENT OF TAXES. I direct my Executor to pay out of my residuary estate, otherwise passing under Article III hereof, and as soon as practical, all inheritance, estate, transfer, and succession taxes payable by reason of my death (including interest and penalties thereon in the discretion of my Executor) assessed on my property or interest included in my gross estate for tax purposes. I direct that my Executor shall not require that any part of such taxes by [sic] recovered from, paid by, or apportioned among the recipients of, or those interested in, such property.

* * * *

ARTICLE III
DISPOSITION OF RESIDUARY ESTATE

All the rest, residue and remainder of my property, real and personal, tangible and intangible, wheresoever situate and howsoever held, including any property over which I may have a power of appointment, herein referred to as my residuary estate, I give, devise, and bequeath to First-Citizens Bank & Trust Company, as Trustee under that certain Trust Agreement dated the 17th day of June, 1988, wherein I am the Grantor and First-Citizens Bank & Trust Company is Trustee, to be held and administered as a part of the trust hereby [sic] created.

The trust provided that the trust assets would be divided into three shares, the last of which was equal to three-fifths of the estate and was to be distributed among various charitable organizations. The trust agreement provided that that share should “not be reduced by any taxes chargeable against the Grantor’s gross estate.”

At issue before the court was whether the charitable share was calculated as a percentage of the entire estate, unreduced by federal estate taxes, or after the payment of federal estate taxes. The court determined that the language of the Will waived any general apportionment statutes under applicable state law (North Carolina) as well as section 2206 (apportionment to life insurance). The court found that the clause in the trust was insufficient to overcome the waiver of apportionment in the Will stating that the “apportionment clause in the trust agreement deals with an allocation of the tax burden on property that the beneficiaries of the trust are entitled to receive from the trust, not what the trust is entitled to receive from the grantor-decedent’s estate.”

In TAM 199915001 the decedent had a Will that provided for the payment of all estate taxes from the residue of the estate without apportionment. The decedent’s estate plan also included a revocable trust and an irrevocable life insurance trust, the insurance proceeds payable to which were included in the decedent’s gross estate. The TAM concludes that the general tax clause waived apportionment under section 2206 and thus the insurance trust would not be required to reimburse the probate estate but that reimbursement under section 2207B was not waived and thus taxes would be apportioned against the revocable trust because it was included in the decedent’s estate under section 2036.

An issue not addressed was whether the revocable trust is also included under section 2038 or instead under section 2038. Section 2207B applies only to section 2036.
Section 2206 gives the executor a right of reimbursement against the beneficiary of life insurance, unless the decedent otherwise directs in his Will. The meaning of “otherwise directs” was before the Supreme Court of Georgia in Emmertz v. Cherry, 271 Ga. 458 (1999). The option states:

The will in issue here in the first sentence of Item IV directs the payment of "all Estate, inheritance, succession or death taxes" from the residuum, but it does not contain language specifically providing for the payment of taxes on the life insurance proceeds from the residual estate. The third sentence of Item IV reflects the testator's knowledge of the estate tax consequences of nonprobate property and his express exclusion from the initial "pay all taxes" provision of those taxes his estate could incur from two specific types of nonprobate property, i.e., QTIP and power of appointment property, pursuant to IRC ss 2207 and 2207A.

We agree with the probate court that there existed adequate proof of the testator's intention in Item IV to include the taxes on the life insurance proceeds in the "pay all taxes" provision in the first sentence by reading that sentence together with the third sentence. In this regard, the third sentence indicated that the testator knew he owned nonprobate property on which taxes would be due and also indicated that the testator believed that the first sentence would encompass taxes on such nonprobate property unless he expressly exempted that property from the "pay all taxes" provision. The testator accomplished this exemption in the third sentence as to QTIP and power of assignment property but deliberately declined to include the life insurance proceeds within the exemption. Accordingly, by omitting life insurance proceeds among those nonprobate properties the taxes on which the executor was specifically instructed in the third sentence to recover, the testator thus indicated that he intended for the taxes on the life insurance proceeds to be included in the "pay all taxes" provision of the first sentence. We thus reject the executor's argument that because the will does not expressly direct the executor not to recover the pro rata share of estate taxes paid on the life insurance proceeds, the testator did not "direct[ ] otherwise" pursuant to s 2206.

2. **Resulting Trust Argument Rejected.** In Estate of Horstmeier v. Commissioner, T.C. Memo. 1999-145, the court held that 100% of the residence titled in the name of the decedent would be included in the decedent's estate and rejected the estate's contention that a resulting trust in favor of the decedent's life partner was valid. The estate claimed that the decedent's life partner had beneficial interest in half of the property based on an understanding and agreement with the decedent that the decedent purchase the residence and would, in effect, transfer the residence over time to the life partner in exchange for services. The tax court found insufficient evidence of a resulting trust.

A somewhat different conclusion was reached in the Kentucky case of Rakhman v. Zusstone, Ky., 957 S.W.2d 241 (1997), in which Zusstone bought the residence and Rakhman contended that the residence was a gift to her on the occasion of the birth of their second child. The parties began living together, unmarried, in 1979, their second child was born in 1985, and the home was used as their residence until their separation in 1992. Any evidence that the residence...
was a gift was in testimony of Rakhman, although the court did find other instances in which Zusstone bought property and had it “held” in someone else’s name.

The Kentucky Supreme Court found first that Rakhman was the natural object of Zusstone’s affection stating “one with whom the donor has shared a home for nearly twelve years, who has been represented to the public as the donor’s spouse, who has adopted the use of the donor’s surname, and who has borne the donor two children and has shared the demands and joys of parenting with the donor, would come within a practical definition of the phrase.” In 1985 when the property was purchased, Zusstone transferred funds into a bank account over which Rakhman had sole control, she wrote and signed the check in payment for the house, and the deed was placed in her name alone. Thus, there was presumption that the gift was made to her.

3. Biological Twins Conceived By In-Vitro Fertilization and Born Eighteen Months After Decedent’s Death Were Heirs at Law of Decedent. In In the Matter of the Estate of William J. Kolacy, 753 A.2d 1257 (N.J. Sup.Ct. 2000), the court stated:

Given that general legislative intent, it seems to me that once we establish, as we have in this case, that a child is indeed the offspring of a decedent, we should routinely grant that child the legal status of being an heir of the decedent, unless doing so would unfairly intrude on the rights of other persons or would cause serious problems in terms of the orderly administration of estates.

I note that after born children who come into existence because of modern reproductive techniques pose special challenges to society and to our legal system. Historically, after born children were conceived and in their mother’s womb at the time of a decedent’s death and they could be counted on to appear no later than approximately nine months after that death. Now they can appear after the death of either a mother or a father and they can appear a number of years after that death. Estates cannot be held open for years simply to allow for the possibility that after born children may come into existence. People alive at the time of a decedent’s death who are entitled to receive property from the decedent’s estate are entitled to receive it reasonably promptly. It would undoubtedly be both fair and constitutional for a Legislature to impose time limits and other situationally described limits on the ability of after born children to take from or through a parent. In the absence of legislative provision in that regard, it would undoubtedly be fair and constitutional for courts to impose limits on the ability of after born children to take in particular cases.

In our present case, there are no estate administration problems involved and there are no competing interests of other persons who were alive at the time of William Kolacy’s death which would be unfairly frustrated by recognizing Amanda and Elyse as his heirs. Even in situations where competing interests such as other children born during the lifetime of the decedent are in existence at the time of his death, it might be possible to accommodate those interests with the interests of after born children. For example, by statutory provision or decisional rule, payments made in the course of routine estate administration before the advent of after born children could be treated as vested and left undisturbed, while distributions made following the birth of after born children could be made to both categories of children.
4. **Ability of Attorney in Fact to Make Gifts.** May an attorney in fact make gifts to himself or herself without express authority in the power of attorney document? In *Wabner v. Black*, Ky. 7 S.W.3rd 379 (2000), the Kentucky Supreme Court answered yes, so long as the attorney in fact acted with the “utmost good faith.” The facts before the court were as follows:

On March 11, 1994, elderly George Tapp executed a durable power of attorney in favor of his niece, Nancy Wabner. He had recently relocated from Evansville, Indiana, to Poole, Kentucky, where he lived with his sister, Leona Poole. According to Ms. Wabner, after her uncle executed the power of attorney (in the presence of Leona Poole and Jimmy Vaughn of Poole Deposit Bank), her uncle instructed her to collect his Evansville bank accounts and certificates of deposit into a local bank account naming her as joint owner with right of survivorship. Leona Poole confirmed that these were Tapp's instructions to Wabner.

Tapp's will, drafted in 1986, expressly provided that any such accounts existing at the time of his death would become the property of the joint owner. His will also passed the family farm to Wabner (whose father had once owned a one-half interest in the farm) and made one-quarter residuary bequests to the Garvinwood Baptist Church, the General Baptist Foundation, Poole, and Wabner.

Pursuant to the power of attorney and allegedly complying with oral instructions from her uncle, who purportedly maintained his mental faculties until his death, Wabner collected assets valued at over $200,000 into joint bank accounts. George Tapp died on April 21, 1994 at the age of 94. At that time, Wabner had collected into the accounts approximately 80% of her uncle's assets other than the farm.

The opinion relies on *Deaton v. Hale*, Ky., 592 S.W.2d 127 (1979):

In Deaton, the attorney in fact (second wife of her principal) was alleged to have made gifts to herself from her principal's estate and to have maintained her principal's cash estate in a joint checking account. This Court refused to adopt a per se restoration rule and instead announced an "utmost good faith" standard by which to judge the transactions made by the attorney in fact. In so holding, the Court stated:

An attorney-in-fact, one acting under a Power of Attorney, must account for any and all property, real or personal, that is received by him from or for his principal. The accounting must be for all property that is received by him while acting in his official capacity or otherwise. We do not mean to say, and we do not hold, that an agent operating in a fiduciary capacity, such as in the instant case, is liable for restoration or reimbursement for all properties received by him from the principal or from whatever source. What we are saying is that the agent does have the responsibility of explaining to the satisfaction of the Court what disposition was made of the properties. The agent is required to go forward with an explanation when proof is introduced showing that the property was in the hands of the agent. The burden of going forward with the proof so as to explain the disposition of any and all properties received by the agent is then with him. The issue thereby presented is one of fact to be decided by the court or by a jury, as the case may be.
The court concluded:

The power of attorney executed by Tapp was unambiguous. It expressly provided in writing that Wabner was to have the full power "to cash any certificates of deposits which I own or to change and redesignate the ownership thereof in his [her] sole discretion." When Wabner changed her uncle's accounts to joint accounts, she did what was expressly authorized by the power of attorney. The only question then was whether Wabner's exercise of the express authority granted by the power of attorney was attended by the utmost good faith. This was a question of fact for the jury.

* * * * *

The "flat rule" announced by the Court of Appeals has the advantage that every per se rule has in that it allows certainty and predictability. We do not believe, however, that this rule of law should be adopted here in light of Deaton and the clear language of the power of attorney authorizing Wabner to make the disputed transactions. The better approach, consistent with firmly established law, is to allow the court or the jury, as it may be, to determine as a matter of fact the propriety of the transactions. Although this Court may not agree with the verdict reached by the jury here, it is not the place of an appellate tribunal to substitute its judgment for that of a fact-finding body. Thus, the jury's verdict must stand.
ADDENDUM A

H.R. 1836

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001
A. **Estate, Gift and Generation-Skipping Tax Provisions That Are Effective Immediately.**

1. **Conservation Easements.** With respect to decedents dying after December 31, 2000 the requirement that land eligible for a qualified conservation easement be within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest is eliminated. Although most areas of the country were already covered, this reduces the complexity of a very useful planning technique.

2. **Generation-Skipping Transfer Tax Rules.** The Act contains a number of "savings" provisions related to the GST. The provisions were advocated primarily by the accounting profession in order to ward off malpractice claims by fixing certain kinds of problems - e.g. failure to allocate exemption on a timely filed form 709 - and by making it possible to fix certain problems after the fact.

   a. **Deemed Allocations.** GST exemption will be deemed allocated to "indirect skips", which are transfers to a "GST trust," to the extent necessary to produce an inclusion ratio of zero, unless the transferor elects not to have the deemed allocation rules apply by gift tax return filed for the period in which the transfer is made or deemed to be made. A GST trust is defined by the statute as a trust that could have a generation-skipping transfer with respect to the transferor unless:

   "(i) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons --

   "(I) before the date that the individual attains age 46,

   "(II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or

   "(III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,

   "(ii) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older
than such individuals,

"(iii) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,

"(iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,

"(v) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or

"(vi) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate. For purposes of this subparagraph, the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

In general it remains more advisable to allocate GST exemption on a timely filed gift tax return to avoid confusion. Allocations should always be made by formula to reduce the chances that insufficient exemption will be allocated and to cover the risk that the automatic allocation rules will have inadvertently used exemption not leaving enough to cover a subsequent transfer.

b. Retroactive Allocations. In certain instances retroactive allocations of GST exemption will be allowed. In general this will occur where a transfer is made to a trust which has a non-skip person as a beneficiary and the non-skip person dies prior to the transferor. The statute provides as follows:

"(1) IN GENERAL. -- If --

"(A) a non-skip person has an interest or a future interest in a trust to which any transfer has been made,

"(B) such person --

"(i) is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse or former spouse, and

"(ii) is assigned to a generation below the generation assignment of the transferor, and

"(C) such person predeceases the transferor,

then the transferor may make an allocation of any of such transferor's unused GST exemption to any previous
transfer or transfers to the trust on a chronological basis.

"(2) SPECIAL RULES. -- If the allocation under paragraph (1) by the transferor is made on a gift tax return filed on or before the date prescribed by section 6075(b) for gifts made within the calendar year within which the non-skip person's death occurred --

"(A) the value of such transfer or transfers for purposes of section 2642(a) shall be determined as if such allocation had been made on a timely filed gift tax return for each calendar year within which each transfer was made,

"(B) such allocation shall be effective immediately before such death, and

"(C) the amount of the transferor's unused GST exemption available to be allocated shall be determined immediately before such death.

"(3) FUTURE INTEREST. -- For purposes of this subsection, a person has a future interest in a trust if the trust may permit income or corpus to be paid to such person on a date or dates in the future.".

The operation of this provision in certain situations is not entirely clear. For instance, suppose a trust has only one beneficiary, a skip person who also has a special power of appointment. The skip person adds a non-skip person as a beneficiary, and the non-skip person dies. Is there a retroactive allocation?

c. Severance Of Trusts With Inclusion Ratios Greater Than Zero. The Act allows trusts with inclusion ratios of other than zero to be severed into two trusts if done on a fractional basis, one with an inclusion ratio of one and the other with an inclusion ratio of zero. The severance must be done under the terms of the governing instrument or under applicable state law. The statute also allows the severance of other trusts as follows:

IN GENERAL. -- The term 'qualified severance' means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if --

"(I) the single trust was divided on a fractional basis, and

"(II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

d. Valuation Rules. New rules are added to say that the value of GST transfers will be the same as determined for gift or estate tax purposes as the case may be as of the time of the transfer or the close of the estate tax inclusion period (if applicable). This is helpful in certain instances, such as the treatment of split-dollar life insurance.

e. Relief from Late Elections and Substantial Compliance. Treasury is directed to issue regulations allowing relief from late elections where there has been substantial

1. Change in Rates and Applicable Credit Amounts. As explained by The Joint Committee on Taxation Summary of the Act:

Under the conference agreement, in 2002, the 5-percent surtax (which phases out the benefit of the graduated rates) and the rates in excess of 50 percent are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million.

In 2003, the estate and gift tax rates in excess of 49 percent are repealed.

In 2004, the estate and gift tax rates in excess of 48 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002.) In addition, in 2004, the family-owned business deduction is repealed.

In 2005, the estate and gift tax rates in excess of 47 percent are repealed.

In 2006, the estate and gift tax rates in excess of 46 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $2 million.

In 2007, the estate and gift tax rates in excess of 45 percent are repealed.

In 2009, the unified credit effective exemption amount is increased to $3.5 million.

The GST exemption remains at $1,060,000 adjusted for inflation until 2004 when it increases to $1,500,000 and thereafter it is the same as the estate tax exemption.

2. State Death Tax Credit. The Act makes significant changes in the state death tax credit. The credit remains the same through the end of 2001.

In 2002 the credit is 75% of the amount allowed by section 2011(b), in 2003 it is 50%, in 2004 it is 25%.

For decedent’s dying after December 31, 2004, the state death tax credit is repealed and replaced with a deduction equal to "the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent)."

What does the parenthetical mean? Does it apply to section 2044 property?

Most states with estate taxes equal to the amount of the state death tax credit will
need to amend their statutes if they want to continue to generate revenue because after 2004 there will be no such credit. If some states elect not to impose a new estate tax that will create a substantial benefit for those dying residents of such states.

Depending on the amount of any new state estate taxes decedent’s dying in 2005 and thereafter may be subject to a higher rate of tax than they would have been before reform. For instance, in 2005 the maximum estate tax rate is 47%. If a state imposed an estate tax with a top rate of 16% that would net to 8.48% after deducting it on the federal return. The total tax, therefore would be 55.48%.

There are certain limitations described by the Statement of Managers as follows:

Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

3. Expansion of section 6166. The number of partners and shareholders permitted for section 6166 property is increased from 15 to 45. An additional provision is added for certain lending and finance businesses. These provisions are effective for decedents dying after December 31, 2001.

4. Estate Tax Recapture from Cash Rents of section 2032A property. The Joint Committee Summary provides:

The conference agreement provides that, if on the date of enactment or at any time within one year after the date of enactment, a claim for refund or credit of any overpayment of tax resulting from the application of net cash lease provisions for spouses and lineal descendants (sec. 2032A(c)(7)(E)) is barred by operation of law or rule of law, then the refund or credit of such overpayment shall, nonetheless, be allowed if a claim therefore is filed before the date that is one year after the date of enactment. This provision is effective for refund claims filed prior to the date that is one year after the date of enactment.

5. Repeal of section 2057. Effective for decedents dying after December 31, 2003. The net effect of this repeal, and the increase in the exemption, is a slight benefit for owners of closely-held businesses.


2. **Continuation and Modification of the Gift Tax.** The gift tax continues with the top tax rate being the highest individual income tax rate (35%). The $1,000,000 lifetime exemption continues as does the $10,000 annual exclusion.

Except as Treasury may provide in regulations, a transfer in trust will be treated as a taxable gift under section 2503 unless the trust is treated as wholly owned by the donor or the donor’s spouse under subpart E of part I of subchapter J of chapter 1. That is, transfers to grantor trusts are not treated as taxable gifts. The purpose of this provision is presumably to ensure that a transfer is either taxed for income tax purposes or remains as a part of the income base of the donor. The provision is unclear in a number of respects. For instance, what are the consequences of transfers from the grantor trust? Will that be a gift? If so, then will use of assets by trust beneficiaries be deemed to be a gift, for instance?


4. **Changes in Basis.** The step-up in basis rules of section 1014 are repealed for decedents dying after December 31, 2009.

Assets acquired from a decedent will have as basis the lower of fair market value as of the date of death and the decedent’s adjusted basis, plus (1) up to $1,300,000 in the aggregate (limited by unused built-in losses and loss carryovers), and (2) up to $3,000,000 if acquired by a surviving spouse, of additional basis may be allocated to property owned by the decedent (but not in excess of the fair market value of the assets). These amounts will be adjusted for inflation after 2009. The specifics of the latter provision are as follows:

"(1) IN GENERAL. -- In the case of property to which this subsection applies and which is qualified spousal property, the basis of such property under subsection (a) (as increased under subsection (b)) shall be increased by its spousal property basis increase.

"(2) SPOUSAL PROPERTY BASIS INCREASE. -- For purposes of this subsection --

"(A) IN GENERAL. -- The spousal property basis increase for property referred to in paragraph (1) is the portion of the aggregate spousal property basis increase which is allocated to the property pursuant to this section.

"(B) AGGREGATE SPOUSAL PROPERTY BASIS INCREASE. -- In the case of any estate, the aggregate spousal property basis increase is $3,000,000.

"(3) QUALIFIED SPOUSAL PROPERTY. -- For purposes of this subsection, the term 'qualified spousal property' means --

"(A) outright transfer property, and

"(B) qualified terminable interest property.

"(4) OUTRIGHT TRANSFER PROPERTY. -- For purposes of this subsection --

"(A) IN GENERAL. -- The term 'outright transfer property' means any interest in property acquired from the decedent by the decedent’s surviving spouse.

"(B) EXCEPTION. -- Subparagraph (A) shall not apply where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail --

"(i)(I) if an interest in such property passes or has passed (for less than an adequate and full consideration in money
or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse), and

"(II) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse, or

"(ii) if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust. For purposes of this subparagraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

"(C) INTEREST OF SPOUSE CONDITIONAL ON SURVIVAL FOR LIMITED PERIOD. -- For purposes of this paragraph, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if--

"(i) such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event, and

"(ii) such termination or failure does not in fact occur.

"(5) QUALIFIED TERMINABLE INTEREST PROPERTY. For purposes of this subsection--

"(A) IN GENERAL. -- The term 'qualified terminable interest property' means property--

"(i) which passes from the decedent, and

"(ii) in which the surviving spouse has a qualifying income interest for life.

"(B) QUALIFYING INCOME INTEREST FOR LIFE. The surviving spouse has a qualifying income interest for life if--

"(i) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and

"(ii) no person has a power to appoint any part of the property to any person other than the surviving spouse. Clause (ii) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

"(C) PROPERTY INCLUDES INTEREST THEREIN. The term 'property' includes an interest in property.

"(D) SPECIFIC PORTION TREATED AS SEPARATE PROPERTY. -- A specific portion of property shall be treated as separate property. For purposes of the preceding sentence, the term 'specific portion' only includes a portion determined on a fractional or percentage basis.

There are various special rules. With respect to joint property, so long as only the decedent and the surviving spouse are joint tenants or tenants by the entirety the decedent will be treated as owning only 50% of the property but if otherwise then it is a consideration test. Community property is treated as being owned entirely by the decedent spouse.

A decedent is treated as owning the property in a revocable trust (as defined in section 645(b)(1)). A decedent is not treated as owning property by reason of a power of appointment; however, property transferred to a trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter,
amend, or terminate the trust. In addition, other property passing from a decedent by reason of death to the extent it passes without consideration may have additional basis allocated to it.

Property acquired by a decedent by gift or inter vivos transfer for less than full and adequate consideration within three years of death is not eligible for the allocation of additional basis. This limit does not apply to property acquired from a spouse unless the spouse acquired the property within three years by gift or inter vivos transfer for less than full consideration.

Section 691 property (income in respect of a decedent property) is not eligible for additional basis allocations.

Beneficiaries other than tax-exempt entities will not recognize gain upon receipt of property from an estate where the liabilities exceed basis (so-called negative basis property). Section 101 dealing with life insurance is unaffected.

Section 121 will be amended to allow an estate, a revocable trust, or heirs, to exclude gain on the sale of a principal residence to the same extent the decedent could have.

The Section allows a $250,000 exclusion ($500,000 for married taxpayers filing jointly) of gain on a principal residence used as such for two of the preceding five years.

Various rules dealing with foreign entities are included and the estate of a nonresident alien will be allowed a $60,000 aggregate basis increase.

5. Returns for Large Transfers. Instead of estate and gift tax returns there will be other returns required for transfers in excess of $1,300,000.

6. Distributions from Qualifying Domestic Trusts. Distributions from QDOTs will continue to be taxed as they are under current law through December 31, 2020. However, QDOTs will not be taxed at death in the estate of the surviving spouse after December 31, 2009.
ADDENDUM B

PLANNING IN VIEW OF H.R. 1836
Planning In View of H.R. 1836

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July 1, 2001

A. General Comments.

1. Repeal will not exist for only one year. Reasonable people refuse to believe that the tax act will be allowed to apply literally. It is simply unbelievable that the estate tax would disappear in 2010 only for the system we have today to reappear in 2011.

2. Thus, the law must be changed. How can it be changed? In at least three ways: (a) repeal can be made permanent, (b) the 2009 regime can be made permanent, or (c) an entirely new approach (e.g. a capital gains tax at death) can be imposed.

If the repeal is made permanent we can assume that many of the glitches, loopholes, and inconsistencies in the carry-over basis regime will be fixed between now and then. Thus we should consider what will happen with carry-over basis but we should not be too concerned with many of the specifics.

If the 2009 regime - - i.e., the current estate tax system with increases in the amount of the exemption - - is maintained we should expect certain glitches and loopholes to be fixed over time. An example might be the limiting of valuation discounts.

We cannot reasonably speculate on the effects of an entirely different system that might replace the estate tax.

3. What factors affect how the law is changed? One is the ongoing budget battle - - the tension between those who want to limit spending by depriving the federal government of revenue (because that is more politically palatable than actually opposing spending) and those who want to do things with the revenue (whether it be spend it, pay down debt with it, apply it to “fix” Medicare or Social Security, or whatever) will continue. Crucial is whether deficits or surpluses are projected; at the moment surpluses are projected because economic growth is projected to continue at, more or less, 3.1% annually adjusted for inflation, but if that drops to 2.7% the projections change to a substantial deficit.

A related factor includes control of Congress and the Presidency over the next decade. One way to look at this is that with a President who campaigned to eliminate the estate tax and a Congress that was largely in favor of doing so, all that could be accomplished was repeal for one year. On the other hand, another way to look at it is that a future Congress will be very reluctant to reimpose what has been described as repealed. Reinstatement of a tax, as a public relations matter,
is surely more difficult than raising rates (as with the income tax).

Some experts argue that by the latter part of the decade there will be other problems that will occupy Congress. For instance, ever increasing numbers of taxpayers will be subject to the AMT. Reforming that system will reduce tax revenues; if revenues need to be increased then the estate tax is a possible target.

Campaign finance reform is another factor. One driving force for repeal are taxpayers who have more than any reasonable exemption amount would protect but not enough that they can leave virtually any amount to descendants regardless of the amount of tax. Those taxpayers contribute heavily to political campaigns, directly and indirectly, and they want repeal. If their contributions are reduced somewhat then perhaps their influence will be as well.

A final factor is the predilections of the early and mid-generation baby boomers. On the one hand, in 10 years the earliest boomers will be ready to retire and will want, it is said, Social Security on a sound footing. The same is said to be true for those boomers who are a bit younger, being born through the early 1950s.

On the other hand, some of those boomers will be looking to an elderly surviving parent and the amount they receive by inheritance will depend directly on the operation of the estate tax. If Social Security and Medicare are “fixed,” whatever that may mean at that time, these boomers - affluent, well-educated, used to being listened to - can be expected to be a potent force in favor of permanent repeal.

4. In talking to clients, that repeal must be reinstated in order to be effective after 2010 has great psychological importance. Many of our wealthier clients will not want to rely on one or more future Congresses (and Presidents) reinstating repeal and will conclude that it is more prudent to assume that repeal will not be reinstated. This should open the door to continue most of the planning that has been available. Clients who are likely to fall within the increased exemptions may want to wait and see what happens in the next few years before going beyond basic marital deduction/exemption equivalent planning.

B. Use Exemption Now.

1. Make gifts to grantor trusts with broad standards and beneficiaries, including the grantor’s spouse. This preserves maximum flexibility whether the estate tax is repealed or not. Income and appreciation may be removed from the grantor’s estate. Further distributions may be made if income shifting becomes desirable. Grantor trust status enables the grantor to “switch” assets with the trust should estate tax repeal and carryover basis be implemented.

2. Use the most leveraged transaction with which the client is comfortable. There are not good policy arguments for maintaining discounts outside of operating businesses and it is always possible that Congress will act to eliminate them.
If a client wants to go slowly and create virtually no audit risk, give $675,000 away today, taking a high discount and fully disclosing that on the gift tax return. If the gift is adjusted nothing has been lost and if, more likely, there is no adjustment, in three years additional gifts may be made.

If the client is likely to die more than three years after a transaction, but before December 31, 2009, paying gift tax may continue to be a very good idea. Otherwise it would not be. Similarly, paying estate tax in the estate of the first spouse to die continues to be a good idea but only so long as the spouse is likely to die before repeal becomes effective.

3. For elderly clients, arrangements like partnerships that create the possibility of discounts have no downside in today's environment. The worst that happens is that they do not work and the client's estate pays the same estate tax that would have been paid ordinarily.

C. Review Your Formula Divisions Now.

1. Begin with the stereotype: husband has two children by his first marriage, remarries and has two children with his second wife. He has an estate of $6,000,000 let's suppose and second wife has $1,000,000. Husband is 55, his children by his first marriage are 31 and 29. Second wife is 45 and his children with her are 10 and 8.

Husband realized several years ago that he should give something to his older children at his death because his second wife is 10 years younger and is likely to survive him by close to 20 years. Husband decides to leave the maximum amount he can without creating estate tax to his older children -- $600,000 at the time. The division was written as a formula with no caps or minimums.

If husband dies today the older children will receive $675,000 rather than $600,000. If husband dies with the same formula in place the amount the older children will receive increases to $3,500,000. That is probably not what husband had in mind, but who is to say. Litigation may result.

2. Let's suppose now that we have husband and wife, each with $3,500,000, first marriage, and everyone gets along. Under a traditional formula, when the first spouse dies everything will be added to a trust for the benefit of spouse and descendants. What sort, if any, instructions should be given to the trustee about making distributions among the spouse and descendants? Is a boilerplate statement that spouse is the primary beneficiary but her taxable estate should be considered good enough?

Consider the effect if spouse survives past repeal. Spouse has no taxable estate. Does that mean that spouse should receive more from the trust, and what does “more” mean if the trust has standards like health, maintenance, and support?

3. More spouses may be tempted to elect to take against the Will, depending on
the terms of the credit shelter and marital disposition. This possibility may pose additional ethical issues when representing both husband and wife. In addition, more postnuptial agreements may be required.

D. **Review Your Estate Plans Generally.**

1. **Charitable Beneficiaries.** Where plans have charity in as a beneficiary either because of, or the amount is because of, the estate tax the plan needs to be revisited. That can work in favor of or against charitable bequests.

Suppose, for instance, elderly parent has no spouse and a $3,000,000 estate. Parent has decided that each of two children should receive $1,000,000; the estate tax would be a little over $1,000,000, and so there is nothing left over for charity, despite what parent would like to do. If parent lives until 2006 parent can leave $1,000,000 to each child without estate tax. What does that mean parent would like to do?

Suppose parent has looked at the assets of children and grandchildren and has decided that they have “enough” and that it is too expensive to give them more. With the change in the law, especially repeal of the estate and generation-skipping tax, that may change. What does parent want to do?

In general we know that parents want their children to get more than 50% (more or less) of their estates, otherwise they would not pay estate planners to plan. Does that mean that parents want their descendants to get 100% of their estates?

2. **Trust Provisions.** Trusts continue to be an excellent planning device. They may help avoid creditors, they may limit property subject to division in divorce, and they may enable income shifting as years pass. Trusts need to be drafted as flexibly as possible. The interests of the beneficiaries other than taxes need to be considered. The power of independent trustees to create new trusts and divide trusts should be given. Beneficiaries should be given broad special powers of appointment in most instances.

3. **Exit Strategies.** If you have GRATs, Sales to Grantor Trusts, QPRTs, and the like in existence that will continue after the repeal of the estate tax consider whether an exit strategy is desirable and, if so, what it might be. The gift tax persists after the estate tax is repealed other than for gifts to grantor trusts. There may be reasons to try and collapse transactions if repeal become imminent to ensure that grantors who are the most likely to die have sufficient property to which to allocate basis.

4. **Reverse Exit Strategies.** Discounts will not necessarily be a good thing after repeal in a carryover basis regime. Thus, ensuring that the decedent has control of entities will become important. How is that control to be obtained? Perhaps through gifts from the younger generations or purchases by the older generation. Ensuring that those transactions can occur easily becomes an important part of planning.
5. Life Insurance. Because of the special treatment of life insurance under section 101, appreciation inside a life insurance policy will receive, in effect, a basis step-up. Assuming the law does not change on this point, life insurance becomes a desirable asset to own. Insurance should be held in a trust to avoid estate tax should death occur prior to repeal.

6. Tax Increase for Smaller Estates. The beneficiaries of an estate of a single person worth $3,000,000 may actually be worse off after repeal than before. Before repeal, in 2009, the estate would pay no estate tax and the assets would pass to the beneficiaries with a full basis step-up. After repeal, in 2010, the estate would pay no estate tax but the basis step-up would be limited to the basis of the assets plus $1,300,000. Stated differently, if the decedent had an adjusted basis of less than $1,700,000 in the example the beneficiaries would be worse off. Clients and beneficiaries will need to be made aware of such oddities because they may affect a client’s decisions.

E. Choice of Jurisdiction.

1. Rule Against Perpetuities. States continue to repeal the rule against perpetuities. Those states will become increasingly desirable places to situate trusts if the generation-skipping tax is repealed.

2. State Income Taxes. State income taxes cannot be forgotten by planners. Existing trusts which are not grantor trusts with respect to any of the beneficiaries in many instances may be moved from state to state to avoid or minimize state income taxes.

3. State Inheritance or Estate Taxes. If some states impose an estate or inheritance tax after the state death tax credit is repealed other states that have no such taxes will become more desirable places in which to be domiciled at death. Florida, for instance, receives only about 2% of its revenues from its pick-up tax and may decide to forgo that revenue in favor of being a “tax-haven” for the elderly.

4. Other State Law Changes. Some states may pass statutes allowing for trusts to be modified to take into consideration changing tax laws.

F. Drafting To Direct Allocation of Basis.

In addition to the formula clause drafting issues that arise, the question of directing the personal representative how to allocate basis increases becomes important. Many estate plans contain provisions that allow a personal representative or trustee to ignore basis in allocating assets; generally that is because all assets, other than IRD, are assumed to have a stepped-up basis as of date of death. That will no longer be the case and such directions will probably be inappropriate.

How basis is to be allocated among beneficiaries is not obvious in many instances. For instance, suppose the family farm, with improvements, is passing to one beneficiary who is...
not going to sell it. Does that mean neither the farm nor the improvements should receive additional basis? What about depreciation? The same issue arises for many business interests.
PLANNING AND DRAFTING FOR FLEXIBILITY:

A Practical Checklist

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SECTION B
PLANNING AND DRAFTING FOR FLEXIBILITY:

A PRACTICAL CHECKLIST

by

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He has served as president of the Denver Estate Planning Council, president of the Centennial Estate Planning Council, president of the Denver Tax Association, program chairman of an annual meeting of the National Association of Estate Planning Councils, chairman of the Income Taxation of Trusts and Estates Committee of the Real Property, Probate and Trust Law Section of the American Bar Association, editor of the "Tax Tips" column for The Colorado Lawyer magazine, chairman of the Probate Rules and Forms Committee of the Colorado Bar Association, adjunct professor in the Graduate Tax Program of the University of Denver, and as a member of the Tax Section Council of the Colorado Bar Association.

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PLANNING AND DRAFTING FOR FLEXIBILITY

A Practical Checklist

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SECTION B
PLANNING AND DRAFTING
FOR FLEXIBILITY:
A PRACTICAL CHECKLIST

by
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I. Introduction

Nothing remains constant in this world, except, possibly, the terms of the irrevocable
documents written by lawyers for their clients. There are many areas where it is
impossible to predict future events which, if known in advance, would cause the client’s
estate planning documents to be drafted differently. Such areas include:

A. Changes in the tax or probate laws which will alter the desirability of the making
   of gifts in outright vs. trust form, or that will alter the desired details of trust
   arrangements.

B. Financial bad luck or imprudence, resulting in creditor problems or bankruptcy.

C. Bad marriages, resulting in overreaching spouses and/or divorce.

D. Beneficiaries who are more or less successful than anticipated, or who develop
   mental, physical, drug, alcohol, or other problems.

Only dispositions in trust offer the flexibility and protection necessary to subsequently
adapt gifts made under an irrevocable estate plan for changed circumstances.
II. Basic Planning and Drafting for Tax Flexibility

There is great skepticism concerning whether or not the new 2001 tax law will really phase in as scheduled. However, there are a number of tax-oriented planning and drafting techniques that make sense. Some are tried and true techniques that are often ignored.

A. Husband and wife can review the titling of their assets, and their beneficiary designations, to assure that the less wealthy spouse will have sufficient assets to fully utilize the changing exemption equivalent (if he or she dies first).

B. Husband and wife can utilize disclaimer trust arrangements, rather than a marital deduction formula clause, where it is possible that the increasing exemption equivalent will eliminate the need for a bypass trust.

C. Husband and wife can continue to each use a survivorship presumption (in the event of simultaneous death) that provides that the other was the survivor. In the event of simultaneous deaths, one estate will have 9 months to disclaim assets from the other. But this will allow the estates to be equalized (causing neither being in a higher estate tax bracket than is necessary).

D. Husband and wife can continue to utilize QTIP trusts, and to extend the due date for filing the estate tax return for 6 months, in order to preserve the right for 15 months to equalize the estates by filing a partial QTP election (causing neither to be in a higher estate tax bracket than is necessary).

E. Bypass trusts can be drafted to allow the surviving spouse, who may also be the trustee, to selectively release powers and benefits, either in a fiduciary or non-fiduciary capacity, in case the law changes.
F. In bypass trusts, consideration should be given to whether payment of income should be discretionary (to allow income tax planning flexibility), or whether the surviving spouse should be granted mandatory income payments and a Five-by-Five withdrawal right (to maximize the TPT credit in the event of limited survival by the surviving spouse).

G. Beneficiaries of trusts (such as surviving spouses benefitting from QTIP trusts) should be encouraged to make annual exclusion gifts to non-beneficiaries of such trusts - possibly by directing the distribution of additional principal to the trust beneficiary if such gifts are made.

H. Grant special powers of appointment to allow the rewriting of remainder interests where changes in the tax laws make it beneficial to do so.

I. Draft in contemplation of disclaimers (i.e., include well planned cascading default provisions).

J. Provide for a flexible “Crummey” clause by:

1. Causing indirect gifts, such as direct premium payments, to trigger the Crummey withdrawal right.

2. Payments in satisfaction of a Crummey withdrawal right to be made in kind.

3. The ability to exclude persons in the withdrawal class from having withdrawal rights in advance of future gifts.

4. Tiered withdrawal rights (i.e., the first $5000/year withdrawal by spouse, balance, if any, of withdrawal to be held equally by children, etc.) and
hanging powers to allow trust to be used in the future for larger than originally contemplated future gifting.

K. If drafting intentionally defective trusts, provide a means for the grantor to get out of grantor trust status if it later becomes too burdensome.

L. Consider gifts in trust, with flexible provisions, rather than outright gifts, to protect the assets from taxation at the beneficiary's death. A beneficiary can have many powers and rights without causing such beneficiary to own such trust for estate tax purposes, including:

1. The right to receive trust income.

2. The right to be trustee and make (i.e., self-determine) discretionary distributions for health, education, support, and maintenance.

3. The right to say where the trust goes (i.e., a special power of appointment).

4. The right to control trust investments.

5. The right to vote trust securities.

6. The right to hire and fire trustees.

7. A Five-by-Five withdrawal right (subject to estate taxation of any outstanding, unexercised power at death).

M. Consider allowing the attorneys in fact named in durable powers of attorney (and trustees of revocable trusts where the grantor old and/or sick) to make annual exclusion gifts.

1. Define "annual exclusion" generically, so that it won't be limited to $10,000 as future increases phase in.
2. It may be wise to require that similarly situated beneficiaries (i.e., children) or branches of the family (i.e., each child and his or her family) to be treated equally.

3. Limit what the power holder can give himself or herself, to avoid the argument that the power holder has a taxable power of appointment if he or she dies while the power of attorney is still outstanding.

N. Allow the trustee to grant to (and to take away from) a general power of attorney, so that basis step-up and generation-skipping tax consequences can be controlled.

O. Utilize statements of intent and savings clauses, so that technical drafting errors can be fixed through a valid construction or reformation of the document.

III. General Planning and Drafting Ideas

A. Allow attorneys in fact under financial and medical powers of attorney to name substitutes and successors.

B. If it is desired that children become fiduciaries when old enough, draft them into the documents now on a contingent basis.

C. When identifying family members, consideration should be given to future changed circumstances (divorces, births, adoptions by and away, children in gestation, etc.). For example, in an irrevocable life insurance trust, should “spouse” be: (1) the current spouse in all event (i.e., even if subsequently divorced), (2) whoever the spouse if at the insured’s date of death, or (3) the current spouse if still married to the insured at death, otherwise no spouse (i.e., children become the beneficiaries).
D. When making gifts of specifically-described assets, consider what is desired if such assets are sold, added to, or converted to different assets.

E. When making pecuniary gifts or mandating periodic fixed-dollar distributions from trusts, consider providing an inflation adjustment factor and/or interest on delayed payments.

F. In irrevocable life insurance trusts, allow distributions prior to the death of the insured.

G. Allow trustees to early terminate smaller trusts that no longer are feasible, or larger trusts that no longer fulfill their purpose.

H. Allow executors and trustees broad powers to distribute funds to guardians, custodians, etc., on behalf of an incapacitated beneficiary. Allow the trustee to distribute to other trusts for the beneficiary’s benefit. Also, allow trustees to distribute income “to or for the benefit of” the beneficiary, so that a beneficiary’s bills can be paid directly where the beneficiary has creditor problems.

I. Authorize unusual distributions, such as for legal expenses to enforce the support obligation a beneficiary’s natural parent, the burial of a beneficiary (even though they would otherwise no longer be a beneficiary), etc.

J. Allow alternative ways for beneficiaries to benefit from the trust, such as the making of loans, the use of trust property, investment by the trust in the beneficiary’s business, etc.

K. Provide that a specific state’s law is to govern the validity and construction of the will or trust, but that its administration will be governed by the law of situs.
L. Allow the trustee to change the situs of a trust.

M. Allow the trustee to be changed, including firing present trustees and overriding the appointment of successor trustees, by specific trustees and/or beneficiaries.

N. Provide for unitrust payments, rather than income payments, to be made to an intended “income beneficiary” to allow the trustee more flexibility to invest for total return.

O. Allow maximum flexibility by appointing trust protectors and granting third parties broad special powers of appointment, so that the trust’s terms can be rewritten in the future.

P. Grant carefully drafted special powers of appointment to the beneficiary.
   1. Should the power normally be limited to exercise in favor of the settlor’s descendants?
   2. Should the beneficiary’s surviving spouse also be an object of the power, perhaps limited to a % of the trust’s or to income only?
   3. What if all descendants have already died - should the objects of the power then be expanded?

Q. Consider jurisdiction shopping for a state with no rule against perpetuities, no state income taxes on trusts, and/or with stronger protection of trusts against creditors.
IV. The "Dead Hand" Approach to Estate Planning

A. Many clients desire to influence and control the behavior of their heirs long after the client's death. Such controls are valid as long as they don't violate public policy.

B. Rewarding Desired Behavior

1. Authorize (and possibly give bonus distributions) upon the beneficiary's achieving good grades, graduation from college or graduate school, getting married, having children, keeping a job, etc.

2. Provide some sort of matching distributions based on the beneficiary's earned income, and allow the trustee to supplement worthwhile but unremunerative work with added distributions.

3. Authorize and encourage distributions to allow the purchase of a home, starting a business, marriage, travel, or other desired activities.

C. Discouraging Undesired Behavior

1. Require the beneficiary to furnish reasonably required information to the trustee, and penalize the failure to do so.

2. Authorize or direct the trustee to require drug and alcohol testing, and to withhold all distributions to beneficiaries who fail such tests.

3. Generally allow the trustee to postpone the termination of a trust if the trustee believes that the settlor's purposes would not be fulfilled (i.e., the beneficiary has a problem, such as a pending divorce or bankruptcy,
involvement in a cult, a drug or alcohol problem, is terminally ill and an adverse tax result would occur, etc.).

V. Conclusion

It is impossible to foresee all of the changes that may take place prior to complete disposition being made under the estate planning documents that we draft. Accordingly, we must draft flexibility into our documents and provide for a thoughtful succession of fiduciaries.
ESTATE PLANNING IN VIEW OF H.R. 1836

A Panel Discussion

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SECTION C
PANEL DISCUSSION ISSUES:
ESTATE PLANNING IMPLICATIONS OF THE 2001 TAX ACT

The panel discussion will expand upon the earlier coverage of the estate planning provisions of the 2001 Tax Act in the sessions of Turney Berry and Ted Atlass. Discussion of planning ideas and implications arising from the new law will be covered, and, to the extent time allows, questions will be taken from the audience.

Discussion topics will include:

1. Do we believe that the new law will actually phase in as currently planned?

2. What do we tell the clients who call and ask if they need to review their estate plans?

3. What planning steps do we need to undertake, short-term and long-term?

4. When, and how, do we start drafting for possible estate tax repeal?

5. Will dynasty trusts still make sense after estate tax repeal?
6. How will spouses, and surviving spouses, be impacted?

7. How will charities be impacted?

8. How will states be impacted?

9. How will the life insurance industry be impacted?

10. How will trust departments be impacted?

11. How will accountants be impacted?

12. How will probate litigation be impacted?
13. How will appraisers be impacted?

14. What impact will the new law have on T&E practice, generally?

15. Concluding thoughts by panelists.
WHAT ESTATE PLANNERS NEED TO DO IN THE WAKE OF H.R. 1836: A DIGEST OF CURRENT IDEAS AND CONCERNS FLOATING AROUND THE INTERNET

By

James C. Worthington

Stites & Harbison, PLLC

I. Funding Formulas

A. Overfunding of the Credit Shelter Trust will be a particular concern where the marital share and non-marital share beneficiaries are not the same.

B. The formula should fund the marital share first, especially if it is to a marital fund because that indicates a client’s desire to place the surviving spouse’s assets in trust to the least extent possible. By drafting the formula this way, the Credit Shelter Trust will be completely unfunded if repeal takes place. For an example of a formula that accomplishes this, see Exhibit A to this Outline. Where the client is only using the Credit Shelter Trust to preserve the exemption, this should be a satisfactory result if repeal takes effect.

C. When the exemption equivalent is $2 million or $3.5 million, or where the beneficiaries of the marital and non-marital shares are different, some suggest placing a dollar limit on the amount going into the non-marital trust.

1. Has anybody seen proposed language?

2. If the limit is either a dollar amount or a percentage, it will be hard to accommodate some asset mixes, such as those with rapidly fluctuating values.

D. Review your existing GST Exempt Trusts

1. If a GST trust is to be funded by reference to the maximum available exemption, was it your client’s intent to fund the trust with:

   a $3.5 million?

   b 0?

2. For existing irrevocable trusts, stop funding them.

3. For existing revocable trusts, this could be a serious problem if the grantor or testator is no longer able to amend the document.

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1 The author thanks Lea Ann Breeden, a Brandeis School of Law student working in the firm’s Louisville office, for her research assistance in preparing this manuscript.
II. Provisions for Amendment by a Trust Protector or Otherwise

A. For an examples, see Exhibit B.

B. When drafting, one must be careful to avoid creating a general power of appointment.

C. When drafting, one must be careful to avoid making gifts incomplete.

D. Will banks and trust companies be willing to take on this responsibility?

E. Special Issues with QTIP Trusts:
   1. The power to terminate may create a terminable interest that results in the loss of the marital deduction.
   2. QTIP trusts should be drafted so that remainder interests are not contingent and are not spendthrift. Doing so may make it easier to terminate the trust by the agreement of parties or by court order.

III. Disclaimer Trusts

A. The advantage is flexibility. This may be especially important for couples with combined estates under $3 million. After 2004, when the exemption equivalent is $1.5 million, the use of Disclaimer Trusts will avoid very over-funded Credit Shelter Trusts for a group of clients who probably don’t want a surviving spouse to be a “trust fund kid”.

B. Many professionals criticize them for at least two reasons:
   1. The surviving spouse might not cooperate.
   2. The surviving spouse may not have even a special power to appoint because Code § 2518(c) requires that the disclaimed property “passes without any direction” by the person making the disclaimer.

C. If using this technique, you should probably draft a closing letter reminding the client that their estate plan will require professional advice during the estate administration, and that the surviving spouse is not required to cooperate and that failure to do so could have costly estate tax consequences for the surviving spouse.

D. Some practitioners have suggested the use of a partial QTIP election in the amount of the available exemption equivalent as an alternative to the Disclaimer Trust. That non-elected amount would fund a bypass-type trust. Advocates of this alternative note that it gives 15 months, rather than 9 months with a qualified disclaimer, to decide how to dispose of the estate.
IV. Gifts

A. We should advise our clients to continue making exemption gifts.

1. Clients with the available exemption equivalent can give up to $675,000.00 each this year. Plan on a busy last week of the year.

2. And don’t plan a New Years vacation: We will be making first of the year gifts to use the difference between that and next year’s $1 million exemption.

B. We should not advise our clients to make gifts that require the payment of gift tax in an era of estate tax reform and possible repeal.

C. We should continue to use techniques, such as Family LLCs, to leverage gifts. For example, a client who makes a gift of either $675,000 or $1 million of underlying assets, and claims a discount should not have to pay any tax even if the Service completely ignores the discount valuation.

V. Business Succession Planning: The de-unification of the estate and gift taxes may discourage lifetime business succession planning. However, by developing ways to split income and control, we should be able to accommodate clients’ needs within the framework of estate tax reform.

VI. Miscellaneous Ideas

A. Remind clients to begin keeping records with respect to capital gains.

B. Every Power of Attorney should include provisions for making gifts and making disclaimers. If not, you should have a reason you did not include those provisions.

C. We need to determine the extent of our duty to inform clients of the new law.

D. We should be prepared to talk with clients who want us to revise their Living Will Directives to avoid December 31, 2010 (“Y210”) problems.

E. Some of our clients’ Irrevocable Life Insurance Trusts may want to buy convertible term insurance to handle potential estate taxes for the next few years and possibly beyond.

F. A few prognosticating professionals predict that use of Dynasty Trusts, especially those established in states that have repealed the Rule Against Perpetuities (possibly Kentucky?) and that do not have a state income tax, will be more widespread if repeal happens.
VII. Synthesized Consensus

A. If our colleagues ask us whether we have updated our resume, we should let them know that we would be very busy even without an estate tax. The following techniques are not exclusively estate tax driven:

1. Charitable Remainder Trusts.
2. Family LLCs.

B. This new law will test our role as counselors and our ability to persuade our clients to continue thinking about and taking action to plan their estates despite a popular perception that they do not need to do that.

C. We should treat the new law as a reform, not a repeal.

D. In fact, if we sharpen our persuasive skills and convince our clients to act now rather than to procrastinate, we have an opportunity to be very busy in 2002.
EXHIBIT A

The Trustee shall first transfer to my spouse in fee simple, the MARITAL FUND share, consisting of trust assets selected by it and that have a value which when added to the value of all other interests in property passing to my spouse as a result of my death or otherwise in a manner qualified for the marital deduction under the provisions of the Internal Revenue Code in effect at the time of my death will equal the maximum marital deduction allowable to my estate under the provisions of the Internal Revenue Code, less the amount, if any, required to increase my taxable estate to the maximum amount as to which, considering the unified credit (the applicable exclusion amount) and the credit for state death taxes (provided use of this credit does not require an increase in the state death tax paid) but no other credit, there will be no federal estate tax payable by reason of my death. The Trustee shall satisfy this provision by transferring to the MARITAL FUND only cash or other assets that are capable of qualifying for the marital deduction. In satisfying this division, the Trustee shall value the assets allocated to the MARITAL FUND for the purpose of this Paragraph as of the date or dates of transfer to the MARITAL FUND. In no event shall the assets transferred to the MARITAL FUND be liable for the payment of inheritance, estate, or other similar death taxes of the United States of America, of any of its states or territories, or of any foreign country or territory, imposed against my estate or the recipients of my estate, whether passing by my Will or otherwise. The Trustee shall transfer the remaining trust assets to the FAMILY TRUST, to be held, administered and distributed as provided in the next Paragraph.
EXHIBIT B

Special Provisions for Trust Protector

The Grantors hereby designate ______________________ as the initial Trust Protector.

The Trust Protector shall have the power, by an instrument filed with the Trustee, to amend the dispositive or administrative provisions of this Trust (including the provisions relating to the Trustee); provided that only descendants of the Grantors shall benefit from any dispositive amendment and the Grantors shall not be given any right or power with respect to the Trust assets and, provided further, that all trusts shall terminate within the applicable rule against perpetuities as provided herein. The Trust Protector may use this power to address unforeseen changes in or application of federal and state tax laws and/or regulations. The Trust Protector may exercise this power from time to time, and may release this power in whole or in part. In the event that the initial Trust Protector is unwilling or unable to serve as a Trust Protector hereunder, a majority of the Beneficiaries of the Trust, with the guardian of a minor Beneficiary representing such Beneficiary’s interest, (in consultation with the initial Trust protector, if available) shall be authorized to appoint a successor Trust Protector, which shall be a corporate institution within the continental United States having trust assets under administration of at least $10,000,000 or an individual (other than either of the Grantors, any other person who has contributed property to the Trust, any descendant of the Grantors or any spouse of any descendant of the Grantors). The Trust Protector shall not at any time be liable for any action or default by it in connection with the administration of the Trust estate, unless caused by a willful commission by it or an act in breach of this Trust Agreement. The Trust protector shall be entitled to reimbursement for expenses and reasonable compensation for services actually rendered.
ASSET PROTECTION IN A DIVORCE CONTEXT

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This Article discusses a number of different mechanisms that may be utilized to protect assets from the claims of spouses in the event of death or divorce.

A. CREATING TRUSTS AND ESTATE PLANNING DEVICES THAT PROTECT FAMILY MEMBERS IN THE EVENT OF A DIVORCE

1. Trusts. The use of trusts to protect assets with respect to potential domestic disputes has been around for a long period of time. Typically, these trusts were used by senior generations passing property to younger generations either through an inter vivos or a testamentary trust. The typical situation involves property that is placed in trust to benefit a child and any lineal descendants. An additional technique involves the naming of siblings as trustees of reciprocal trusts for the children. In that situation, only the trustee may terminate the trust as desired instead of automatic termination at a particular age of a particular beneficiary. This technique will prevent the spouse of a beneficiary for whom a trust is named from attempting to claim an interest in a trust through transmutation. It also helps to ensure that the beneficial interest in the trust will retain its characterization as separate property.

The creation of a trust is fairly straightforward. A written document or agreement should set forth the obligations and responsibilities of the trustee and the rights retained by the grantor. Additionally, there must be a transfer of some value to the trustee contemporaneously with the execution of the agreement. Finally, there must be an intent by the grantor to create a trust arrangement. With respect to inter vivos trusts, there are two types that may be established. The first type is referred to as a living or revocable trust. The second type is an irrevocable trust.

(a) Revocable Trusts. In a revocable trust, the grantor typically reserves the right to amend or revoke the trust at any time during his life. This retained power may result in the assets in this trust being subject to the claims of the spouse as marital property. These trusts are recommended primarily in the context of funding with separate property prior to marriage. In that case, these trusts create a clear paper trail to help with the identification of the assets and the income and appreciation thereon as separate property. These trusts should not be relied upon to insulate assets acquired during the marriage.

1 The authors thank Jason C. Williams, a University of Kentucky College of Law student working in the firm’s Louisville office, for his research assistance in preparing this manuscript.
(b) **Irrevocable Trusts.** Funding an irrevocable trust with separate property prior to the marriage is the best use of a trust to protect assets. In that event, the grantor converts the separate property interests into a beneficial interest, if any, in the trusts. The vesting in an independent trustee of discretion to make distributions of income and principal from the trust will further reduce the likelihood of a spouse claiming an interest in the underlying property. It also will diminish further the value that may be placed on the beneficial interest in the trust. Many people, however, are reluctant to completely part with the control of an asset that is necessary in this context.

2. **Separate or Marital Property in a Divorce.** The statutes that govern divorce proceedings are found in Chapter 403 of the Kentucky Revised Statutes (KRS). The property of an estate can either be separate or marital, and the disposition of property is governed by KRS 403.190, a copy of which is included in the Appendix of this manuscript.

Property is presumed to be marital, unless shown to be separate property. KRS 403.190(3). Appreciation of non-marital property, however, may itself be marital property. *Brandenburg v. Brandenburg*, 617 S.W.2d 871 (Ky. Ct. App. 1981). In the case of *Glidewell v. Glidewell*, 859 S.W.2d 675 (Ky. Ct. App. 1993), the court found that non-vested retirement pension rights are part of the marital estate since the funds that contributed to the pension were funds that could have been spent by the family during the marriage. Division should wait, however, until the pension vests.

Using a similar analysis, the Court of Appeals found in *Moss v. Moss*, 639 S.W.2d 370 (Ky. Ct. App. 1982) that the husband's degree to practice pharmacy is marital property. The Court valued the right as the amount spent for direct support and school expenses during the period of education, plus reasonable interest and adjustments for inflation.

Despite the rule that a professional license is not marital property, the Court in *Owens v. Owens*, 672 S.W.2d 67 (Ky. Ct. App. 1984) determined that the value of the husband's law practice was "marital property" since the value of the practice, as it would be exchanged for a whole or partnership interest, would necessarily not include the transfer of the license.

Spendthrift trusts are generally created to allow the beneficiary to receive payments in the future, to guarantee that the beneficiary will not transfer those rights, and to guarantee that the payments will not be taken to pay the beneficiary's debts. One may not create a spendthrift trust for one's own benefit. KRS 381.180(7)(a). Kentucky Courts would not consider an irrevocable spendthrift trust as "property" of the marital estate. It might, however, be treated as a source of income that courts could consider in determining child support. The Kentucky statute providing for spendthrift clauses in trusts is KRS 381.180, a copy of which is included in the Appendix to this manuscript.
3. Income From Trusts Characterized as Property or Otherwise.

Pursuant to the alimony or maintenance statute, KRS 403.200, the court shall consider several factors in determining whether to award alimony. These factors include the “financial resources of the party” seeking support. KRS 403.200(2)(a). Thus, whether a trust is marital or non-marital property, its existence affects the married couple’s rights because trust income is a factor in settling both alimony, Ahrens v. Ahrens, 230 S.W.2d 73 (Ky. Ct. App. 1950), and child support. KRS 403.212(2)(b).

4. Discretionary and Non-discretionary Trusts and Their Impact in Divorce.

If the terms of the trust allow the trustee the power and duty to perform acts of management and require the trustee to exercise judgment, the trust is called a discretionary or active trust. Under a discretionary trust, the beneficiary has no control over the distribution of money.

If the terms of the trust only give the trustee the power to perform mechanical acts and the trustee is merely the recipient of property, it is a non-discretionary trust or passive trust. Under a non-discretionary trust, the beneficiary has control over the distribution of money.

The impact on whether the beneficiary has a “property” interest for divorce purposes depends upon the classification of the trust. If the beneficiary has no control over the trust proceeds, how and when the money is dispersed, there is no property right. The Family Court should not consider the trust as “property” and the proceeds should not be reachable by creditors.

If the beneficiary can control how and when the distribution of the trust is made, then the court could consider at least a portion of the trust as “property.”

B. SHEelterING ASSETS TO PROTECT AGAINST CLAIMS OF SPOUSES UPON DEATH OR DIVORCE

1. Identification of Claims.

The different claims that arise under state law for a spouse in the event of death or divorce are discussed below.

(a) Divorce.

(i) Alimony. KRS 403.200.

(ii) Property Settlement. In order to settle marital property rights, the property must first be classified as either marital or separate property pursuant to KRS 403.190.
(iii) **Child Support.** Child support obligations, although a consideration in a divorce that involves children, KRS 403.212, may not be resolved by the spouses prior to the marriage. Specifically, child support obligations may not be affected by a marital agreement. *Edwardson v. Edwardson*, 798 S.W.2d 941, 946 (Ky. 1990).

(b) **Death.**

(i) **Elective Share of Surviving Spouse.** KRS 392.020.

(ii) **Spousal Exemptions.** A surviving spouse may, upon application to the District court, withdraw up to $1,000.00 from the deceased spouse’s bank account. KRS 391.030(2). In addition, the first $7,500.00 of money or personal property is exempt from creditors’ claims in favor of a surviving spouse or children if there is no surviving spouse. KRS 391.030(1)(c).

(iii) **Dower / Curtesy.** KRS 392.020 governs this issue and states as follows:

After the death of the husband or wife intestate, the survivor shall have an estate in fee of one-half (1/2) of the surplus real estate of which the other spouse or anyone for the use of the other spouse, was seized of an estate in fee simple at the time of death, and shall have an estate for his or her life in one-third (1/3) of any real estate of which the other spouse or anyone for the use of the other spouse, was seized of an estate in fee simple during the coverture but not at the time of death, unless the survivor's right to such interest has been barred, forfeited or relinquished. The survivor shall also have an absolute estate in one-half (1/2) of the surplus personalty left by the decedent. Unless the context otherwise requires, any reference in the statutes of the state to “dower” or “curtesy” shall be deemed to refer to the surviving spouse's interest created by this section.

2. **Sheltering Assets.**

A variety of methods are available to shelter assets from the claims of a spouse. The preferred mechanism is a prenuptial agreement that satisfies the statutory requirements. In Kentucky, such agreements have been recognized for estate planning purposes since 1916. *Stratton v. Wilson*, 185 S.W. 522 (Ky. 1916). Our courts, however, have only recognized them in the divorce context since 1990. See *Gentry v. Gentry*, 798 S.W.2d 928 (Ky. 1990); *Edwardson v. Edwardson*, 798 S.W.2d 941 (Ky. 1990). If for whatever reason a prenuptial agreement is not utilized, there are several other vehicles that may prove to be effective to protect assets from a claim of a spouse.

(a) **Marital Agreements.**

The use of marital agreements by spouses takes on varying levels of importance depending upon the perspective of the parties involved. The following discussion of marital agreements should be construed according to two different perspectives. First, a
spouse entering into a marriage may insist upon a marital agreement to insulate his or her existing assets from the claims of the spouse (e.g., such a request for a marital agreement often occurs in second marriages). The second perspective is from that of the senior generation that has transferred substantial assets to a younger generation. Many times these assets are considered to be “family monies” that the younger generation should not expose to the claims of a spouse in the event of a divorce. In the latter situation, however, it is frequently difficult to convince younger generation members to even request a potential spouse to enter into marital agreements. However, partnerships and limited liability companies may be used by the older generation in such situations without the direct participation by the younger generation.

(i) Prenuptial Agreements. The preferred mechanism to shelter assets from the claims of a spouse is a prenuptial agreement.

Prior to 1990, a marital agreement made in contemplation of divorce was deemed to be void. Specifically, Kentucky courts determined that “the marital relation should not be disturbed or its happiness marred, but that it should be upheld and encouraged, and that the parties to it should not be led into the breaking of its vows by the allurements of any stipulations which they may enter into before marriage.” Stratton, 185 S.W. at 525.

In 1990 the Kentucky Supreme Court put an end to this policy by holding “that a husband and wife in Kentucky may define by agreement their rights in each other’s property, regardless of any rights which would otherwise have been excluded or conferred by KRS 403.190. Such agreements, provided they are otherwise valid contracts, are entitled to enforcement upon dissolution of the marriage.” Gentry, 798 S.W.2d at 934.

To be enforceable in Kentucky, a prenuptial agreement must be entered into fully and voluntarily, it must be conscionable with full disclosure of pertinent assets, it cannot lack mutuality, nor be procured by fraud or duress, and can only apply to disposition of property and maintenance.

In Edwardson, the court determined that “before parties should be bound by agreements which affect their substantial rights upon dissolution of marriage, it should appear that the agreement was free of any material omission or misrepresentation.” 798 S.W.2d at 945.

In Kentucky, to determine whether the “knowledge” element is satisfied, consultation with an attorney prior to the execution of the marital agreement is important; however, the consultation does not mean that the spouse necessarily entered into the agreement knowledgeably. Moreover, determining whether duress or undue influence occurred largely depends upon the specifics involved. The presentation of a prenuptial agreement to a spouse at the last minute prior to the wedding is likely to support a claim of duress.
To be enforceable, a marital agreement must have full and adequate disclosure.

At one extreme, parties would be required to make written disclosure of every asset together with appraised values. At the other extreme, a vague oral disclosure in which the parties provided one another with some general information would be sufficient....[A]s a practical matter, the more complete the disclosure which is required, the greater the likelihood that the agreement will ultimately be held invalid. A requirement of precise disclosure would therefore defeat what has been determined to be sound policy. On the other hand, if we uphold agreements on the basis of just 'any old disclosure,' then the disclosure requirement will have been essentially eliminated from the law....Such agreements should not be held invalid unless there appears to have been deception, fraud or material omission.

Lawson v. Loid, 896 S.W.2d 1, 2 (1995).

(ii) Postnuptial Agreements. More and more married couples are attempting to use postnuptial agreements to address marital rights prior to the actual commencement of divorce proceedings. These fall into two categories, Reconciliation Agreements and Postnuptial Contracts.

(1) Reconciliation Agreements. Reconciliation agreements allow a spouse who has grounds for a divorce to defer a pursuit of those rights in exchange for certain concessions with respect to interests in marital property. Kentucky courts seem deliberately silent on the enforceability of such agreements. One court determined that the reconciliation agreement between the parties was unenforceable but added that it did “not mean to intimate that all separation or property settlement or reconciliation agreements are unenforceable....” Clark v. Clark, 425 S.W.2d 745, 748 (1968).

Adding some clarity, our Court of Appeals observed that “KRS 403.180 neither addresses itself to nor affects or prohibits reconciliation agreements. It is axiomatic in this jurisdiction that the law favors any steps parties may take to settle litigation, especially those which have the effect of reuniting a family.” Whalen v. Whalen, 581 S.W.2d 578, 579 (Ky. Ct. App. 1979). When determining whether or not reconciliation agreements were against public policy, the court looked to a 1906 case: “It (the law) favors the reconciliation of husband and wife. A contract for the re-establishment of a ruined home is one which equity is swift to approve. Whether the contract in question is contrary to public policy is not to be determined from one clause of it but from the whole instrument. The contract as a whole does not tend to produce estrangement between husband and wife. The contract brought them together, and, taken as a whole, it is in aid of the
marital relation, and is therefore not opposed to public policy, but in accord with it.” Id. at 580.

It thus appears that a reconciliation agreement would be enforceable in Kentucky, subject to the usual concerns about fairness, disclosure, and the like.

(2) Postnuptial Contracts. The Court of Appeals has stated that two parties could enter into a valid postnuptial contract “if such an agreement was fair and equitable, and supported by an adequate consideration.” Campbell v. Campbell, 377 S.W.2d 93, 94 (Ky. Ct. App. 1964). The court went on to explain that “if the subject of a contract is lawful and the parties are sui juris, the right to bind themselves cannot be restricted because it is to the disadvantage of one of the parties making it.” Id. at 95.

The concern of adequate consideration was also explained by the Campbell Court’s statement that “mutual promises form a valuable consideration for an agreement where there is benefit to the promisor or detriment to the promisee.” Id. at 95.

(b) Corporations, Partnerships and Limited Liability Companies.

These entities also may be used by spouses to protect their respective assets. The transfer of assets to these types of entities does not necessarily result in the assets being determined to be separate property. Use of these entities does, however, enhance the ability to determine which assets are marital property and which assets retain separate property status. The advantages and disadvantages of each of these types of entities is discussed briefly below.

(i) Limited Liability Companies. In recent years, the most popular vehicle for sheltering assets, after the prenuptial agreement, has been the limited liability company. These are particularly attractive when a senior generation is attempting to impose upon the younger generation a mechanism to protect the “family monies.”

(1) Advantages of Limited Liability Companies.

a) Limited Liability. Unlike a partnership, limited liability companies offer limited liability to all members.

b) No Taxation. Limited liability companies may be taxed as partnerships for federal tax purposes. As such, there is no entity level tax.

c) Eliminate Control. Non-voting members have no voice in the management of the partnership. The voting members control the entity. A voting member may retain the discretion to control distributions of cash. In other words, although a member will receive his share of income from the business each year and then report the same for federal tax purposes, that member may not
necessarily receive distributions of cash. A spouse will not want to attempt to claim an interest in an asset on which he or she will be paying tax each year because he or she may not necessarily receive any distributions of cash to fund the obligation. In addition, it is easier in the LLC context to change the allocation of income and expenses on an annual basis than in a corporation.

d) **Diminish Value of Assets.** The transfer of assets to a LLC can result in a discounted valuation relative to that of the underlying assets. The typical discounts are related to a minority interest and lack of marketability. These discounts should not be affected by the recent legislation reforming the federal estate and gift tax system. It is for this reason again that LLC interests are not attractive for a spouse to attempt to claim in a divorce proceeding.

(2) **Disadvantages of Limited Liability Companies.** The primary disadvantages of a limited liability company is the annual filing fee of $15.00 in Kentucky, and the possibility of some increased accounting fees.

(ii) **Partnerships.** Partnerships are also useful for sheltering assets. In addition, partnerships offer protection just in case an event occurs that could result in liability. A general partnership should not be used; a limited partnership should be used to shelter assets. In Kentucky, a limited partnership requires at least two individuals: a general partner and a limited partner. A limited partner may also own a general partnership interest. But, any general partner will be personally liable for acts and errors of the entity.

(1) **Advantages of Limited Partnership.**

a) **Limited Liability.** The liability of a limited partner is limited to his investment in the entity. General partners are personally liable for the obligations of the entity.

b) **No taxation.** Partnerships are pass-through entities so there is no entity-level taxation, unlike a corporation.

c) **Control of Management.** Limited partners have no voice in the management of the partnership. General partners control the entity. A general partner may retain the discretion to control distributions of cash. In other words, although a partner will receive his share of income from the business each year and then report the same for federal tax purposes, that partner may not necessarily receive distributions of cash. A spouse will not want to attempt to claim an interest in an asset on which he or she will be paying tax each year because he or she may not necessarily receive any distributions of cash to fund the obligation. In addition, it is easier in a partnership context to change the allocation of income and expenses on an annual basis as compared to a corporation.
d) Diminish Assets for Valuation Purposes. The transfer of assets to a limited partnership can result in a discounted valuation relative to that of the underlying assets. The typical discounts are related to a minority interest and lack of marketability. These discounts should not be affected by the recent legislation reforming the federal estate and gift tax system. It is for this reason again that these types of interests are not attractive for a spouse to attempt to claim in a divorce proceeding.

(2) Disadvantage of Limited Partnership. The primary disadvantage of a limited partnership is that some person must act as the general partner and therefore be exposed to liability. This can be avoided through corporate general partners, but that does add some complexity to the structure.

(iii) Corporations. Corporations are rarely used as estate planning devices or as shelters for assets from the claims of spouses because of the growing popularity of limited liability companies. Nevertheless, they are discussed as follows:

(1) Advantages. Set forth below is a brief listing of the advantages of transferring assets to a corporation prior to marriage for purposes of sheltering the assets, and income and appreciation thereon, from the claims of a spouse.

a) Shareholder Agreements. Shareholder agreements may be executed by the stockholders of corporations. Although these agreements may address ownership issues in the event of a divorce, it is not recommended that a shareholder forfeit or agree to sell his interest in the company in the event of a divorce. However, the agreements may so limit the ability of a shareholder to control or be involved with a company that a spouse may not attempt to claim an interest in the asset.

b) Diminish Assets for Valuation Purposes. The value of an interest in a closely-held business is worth significantly less than the underlying assets themselves. It is for this reason that a transfer to a different entity would reduce the holdings of a spouse for purposes of calculating a spouse’s net work for property settlement. The implementation of discounts for minority interest and lack of marketability are not necessarily available when a spouse owns property outright. See Rev. Proc. 59-60 regarding the valuation of closely-held businesses.

c) Control over Governance. A spouse may transfer significant assets to a corporation yet still control management or governance of the entity. This control will also discourage a spouse from attempting to claim an interest in these types of property interests.
d) **Limited Liability.** A spouse will gain a level of protection with respect to the liability upon transferring assets to a corporation. This benefit is particularly significant when the spouse is not involved in the day-to-day operations of the property.

(2) **Disadvantages.**

a) **Federal and State Taxation.** A disadvantage to transferring assets to a corporation is that the corporation will be required to file federal and state tax returns and pay tax on the income therefrom. Federal taxation of corporations begins at 15% and rises to 35%. In Kentucky, each corporation is required to pay taxes ranging from 3% to 7.25% depending on the corporation’s taxable net income. Upon the dissolution of the corporation, it is responsible for payment of taxes assessed during the period of that taxable year in which the corporation had an income in the state. The use of an S corporation may not relieve Kentucky residents of the obligation to pay taxes. The relevant section of KRS 141.040 states:

Every S corporation shall pay the tax imposed under subsection (1) of this section whenever the net capital gain of such corporation exceeds twenty-five thousand dollars ($25,000), and exceeds fifty percent (50%) of its taxable income for the taxable year and its taxable income for such year exceeds twenty-five thousand dollars ($25,000).

b) **Costs of Administration.** The administration and management of a corporation can be costly, especially compared to the benefits. For example, stock certificates must be issued anytime there is a change of ownership.

(iv) **Funding.** When creating any of the entities referenced above, an important issue is whether the spouse has commingled any marital property with the separate property that is placed into the entity. If so, the use of marital property may effect a transmutation of the interest in the entity from separate to marital property.

(c) **Other Methods.** Another method used to shelter assets is an Acknowledgment, Waiver, and Release of rights in specific separate property. This form may be utilized when the spouse who anticipates receiving the separate property (e.g., typically the recipient of a gift from a senior generation) does not have sufficient consideration to enter into a postnuptial agreement. These types of forms would typically be between the senior generation and the spouse of the younger generation family member. It is prudent to recite that the younger generation family member is a third-party beneficiary of the agreement.

(d) **Fraudulent Conveyances.** With respect to the funding and transfers of assets to the entities referenced above, KRS 378.010 addresses fraudulent conveyances. Kentucky courts have held that a transfer of assets immediately prior to marriage may constitute fraud on the dower. *Mathias v. Martin*, 2000 Ky. App. LEXIS 113 (2000).
C. MARITAL AGREEMENTS.

1. Elements. Prenuptial agreements typically include a waiver of all state law rights of the respective spouses upon both death and divorce. The document should contain references to property rights that may be in dispute between the parties in the event of a death or divorce. Ownership is determined by the name or names in which the property interest is titled or registered, provided that all state law rights have been eliminated. This structure is an attempt to eliminate the notion of transmutation of assets from separate to martial property based upon a party’s purported contribution to the preservation and appreciation of the property interests. Set forth below is both a brief discussion of some of the dispositive provisions of the agreement and issues that should be considered during negotiation of a prenuptial agreement.

2. Death Provisions. The negotiations for prenuptial agreements frequently start with the notion that each party should retain the property brought into the marriage in the event of death or divorce. Although this position is reasonable with respect to divorce, it may not necessarily reflect the intent of the parties if the marriage is dissolved by death. Frequently, in those situations, the parties are in an amicable relationship. Also, upon separation by death there is an overall greater sense of fairness with respect to the division of property rights between the parties. Set forth below are some suggestions on how to negotiate a share of the predeceased spouse’s estate.

(a) Percentage of Estate. To determine the percentage of the estate to which a surviving spouse is entitled first requires the agreement of what constitutes the “estate.” Many times, the computation requires the determination of gross estate for federal tax purposes less certain deductions and expenses (i.e., funeral administration expenses, secured debts). In other cases, the percentage of the estate is determined with reference to the appreciation of the predeceased spouse’s estate from the date of the marriage to the date of death. In that event, there needs to be consensus on the valuation of the estate at the time of the marriage. Also, a similar valuation must be used for determining the date of death value. The values that are used for estate tax purposes should not be referenced because it is in the best interest of the estate beneficiaries that these values be as low as possible, and that conflicts with the surviving spouse’s goals.

(i) Outright Distribution. A spouse will frequently attempt to obtain an outright distribution from the estate of the predeceased spouse. In that event, the following issues must be determined: (1) when the outright distribution will be paid; (2) the form in which the outright distribution should be paid (e.g., whether the value may be paid in cash or in kind); and (3) when in-kind distributions are permitted (which may be required when an illiquid estate is involved), who selects the assets that may be used to satisfy this obligation.

(ii) In Trust. Often a spouse prefers to leave certain assets of the estate in trust for the surviving spouse with the knowledge that upon the death of the surviving spouse, those assets will be transferred to the beneficiaries designated by the first spouse. In that event, several issues need to be addressed. First, the trustee must be identified.
Also, since no federal taxes are due on certain qualifying property interests transferred to a surviving spouse, the trust provisions should comply with the marital deduction requirements under Internal Revenue Code Section 2056 to ensure this tax-advantaged treatment.

Another important issue is the term of the trust. To comply with Section 2056, this term will need to be for the life of the surviving spouse. What constitutes income and the amount of income distributed each year and whether the trustee has the ability to encroach upon the principal of the trust for the benefit of the surviving spouse must also be determined.

(iii) Vesting Schedules. The spouses may negotiate over a schedule of percentages to be used in the event the marriage is dissolved by death. A schedule of percentages that increases with the length of the marriage accommodates the changing circumstances of the couple’s life together. Although Kentucky does not have a statutory vesting schedule, we need only look one state to the south at the vesting schedule set forth at § 31-4-101 of the Tennessee Code Annotated. That statutory vesting schedule starts with 10% and increases to 40% after eight years of marriage. This concept has been utilized with lower percentages and longer vesting schedules (e.g., 4% per year for every year after the 3rd anniversary of the marriage, not to exceed 40%). It is always recommended, however, that a minimum and/or a maximum percentage be used.

(b) Sum Certain from Estate. In other situations, the parties may agree that regardless of the value of a predeceased spouse’s estate, the surviving spouse will get a stated amount. Frequently, this amount is obtained through an insurance policy. The prenuptial agreement should include a covenant to maintain the insurance policy. It also should provide that in the event the insurance proceeds are insufficient, the surviving spouse may claim an interest to the extent of the insufficiency against all assets included in the estate.

(c) Liability for Taxes. For federal estate tax purposes, it is important to ensure that property that passes to the surviving spouse qualifies for the marital deduction. The surviving spouse must obtain at least a qualifying income interest for life in the property, meaning that he or she must receive distributions of all income from the property at least once a year. In addition, no person other than the surviving spouse may control or direct the disposition of this property during the spouse’s lifetime. It is also recommended that a stipulation provide that the federal taxes will not be imposed upon property passing to the surviving spouse.

3. Divorce Provisions. The prenuptial agreement provides that both parties waive any rights to maintenance, alimony, or spousal support. As such, parties frequently engage in the negotiation of property rights in lieu of alimony. The primary distinction between alimony and property settlements is the taxation of the distributions. It is highly recommended that the payments upon divorce if any, be determined as property settlements or payments constituting alimony for federal income tax purposes. Payments
in lieu of alimony and property settlements may be tied to appreciation of net worth and/or an investment schedule that increases during the length of the marriage. In addition, how long the spouse will be required to pay the obligation should be addressed. Finally, whether any interest will accrue on the payments during such period of time should also be resolved.

4. Remaining Provisions. The remaining provisions of the form agreement address such issues as the obligation to waive rights in qualified retirement plans after the marriage as required by federal law, the resolution of debts incurred prior to the marriage in the separate names of the spouses, and responsibility for legal fees and disclosure requirements.

D. TOOLS AVAILABLE FOR ESTATE PLANNING IN A SEPARATION AGREEMENT

There are various methods whereby one or both of the parties in a divorce can benefit from appropriate structuring.


Under IRC § 1041, no gain or loss is recognized on a transfer of property between spouses, or former spouses, if incident to a divorce. Under this Internal Revenue Code section, the transferee's basis for determining gain or loss, is equal to the transferor's basis immediately before the transfer. This rule covers transfers at any time during the marriage whether or not the spouses are contemplating a divorce, and also covers transfers between former spouses if "incident to a divorce." A transfer between former spouses is treated as incident to divorce if it (1) occurs within one year after the date on which the marriage ceases; or (2) is related to the cessation of marriage. A transfer of properties is treated as related to the cessation of marriage if the transfer is pursuant to a divorce of separation agreement, and the transfer occurs not more than six years after the date on which the marriage ceases. IRC § 1041 also applies where the transfer of property to a third person on behalf of a spouse is either (1) required under the divorce or separation agreement; (2) pursuant to the request of the former spouse; or (3) the former spouse consented to or ratified the transfer to the third party.

The parties could use IRC § 1041 if the parties wish to fund a trust which would enable the "poorer" spouse to utilize his or her unified exemption equivalent (currently $675,000 but increasing to $3.5 Million over the next eight (8) years) when he or she dies. The trust would provide for mandatory income distributions with the principal remaining at the "spouse's" death to be held in trust and/or distributed to the children. This technique could save the family hundreds of thousands of dollars in estate taxes (assuming the "wealthier" spouse has assets exceeding $675,000 prior to the transfer).

This Internal Revenue Code Section could also be used to dispose of an interest in a closely held business. For example, one spouse could transfer stock in a closely held corporation to the other spouse, and after the divorce becomes final, the corporation
could redeem the stock of the spouse who no longer wishes to have an interest in the business. If structured properly, the redemption would qualify for favorable capital gain treatment and would not be treated as a dividend.

One must also meet the requirement of IRC § 2516 to avoid the imposition of gift tax on a transfer between spouses. Section 2516 of the Internal Revenue Code provides that where a husband and wife enter into a written agreement relative to the marital property rights and a divorce occurs either one year before or two years after the execution of the agreement, any transfer of property pursuant to the agreement to either spouse in settlement of his or her marital rights or to provide a reasonable allowance for support of the issue of the marriage during minority is deemed to be a transfer made for full and adequate consideration. Any transfers in excess of a reasonable allowance are treated as gifts.

2. Qualified Domestic Relations Order ("QDRO"). Under IRC § 414(p), a QDRO could be utilized to obtain the cash that is "trapped" in a spouse’s retirement plan. This Code Section has certain specific requirements that must be met, and if structured properly, the income tax consequence shifts form the Plan Participant to the transferee. If not structured correctly, the Plan Participant must report the income even though such Participant receives no money from the Plan. Moreover, if the ultimate recipient of the segregated funds is a person other than the former spouse, the recipient is deemed to be a person other than an alternate payee, as defined in IRC § 414(p), and the Plan Participant, not the recipient, is subject to tax upon the distribution.

If the transferee does not wish to pay income taxes on the distribution, he or she can rollover such distribution to an IRA and defer the payment of income tax until he or she receives payments form the IRA.

IRC § 408(d)(6) provides that the transfer of an IRA or any part thereof to a former spouse under a decree of divorce or a written instrument incident to divorce is a non-taxable transaction, and that the IRA will thereafter, be treated as the IRA of the transferee spouse. Although a QDRO is not necessary, however, the property settlement agreement or similar instrument must be drafted appropriately.

3. Deductible Alimony Payments. Depending on the parties' desires, payments between spouses incident to a divorce can be deductible by the payor and includible in income by the payee. IRC § 71 contains the various rules, and once again, certain specific requirements must be met. The most obvious requirement is a stipulation by the parties of the intent to treat the payments as deductible alimony to the payor and includible in taxable income to the recipient. Failure to meet these requirements could cause unintended income tax consequences to the parties.

4. Child Support Payments. Child support payments, which are specifically designated as child support (or if such a payment is reduced upon the happening of a contingency relating to a child's attaining a specific age, marrying, dying, leaving school, or otherwise) are not deductible.
5. **Taking Advantage of the Dependency Exemption.** In general, the custodial parent is entitled to the dependency exemption assuming that the parents together (or at least one of them) contribute one-half of the child’s actual support. The parties can agree to “allocate” the dependency exemption, but if the non-custodial parent is utilizing the dependency exemption, IRS Form 8332 must be attached to that parent’s income tax return for the year he or she claims the dependency exemption.

6. **Personal Residence Planning.** Under IRC § 121, an individual can exclude up to $250,000 of gain from the sale of a marital residence. In order to qualify for this exclusion, the taxpayer must have owned the residence for at least two of the five years immediately before the sale, the residence must be used by the taxpayer as a principal residence for periods totaling at least two of the five years immediately before the sale, and the taxpayer cannot use IRC § 121 more than once within a two-year period.

IRC § 121(d)(3) contains a special provision for divorce situations. Under this Code Section, if an individual has received the property transaction governed by IRC § 1041, the period such individual transferee owned such property is the period the transferor owned the property. In addition, for purposes of determining the use of the property, an individual is treated as using property as such individual’s principal residence during any period of ownership while such individual’s spouse or former spouse is granted use of the property under a divorce or separation instrument. Another alternative would be for the parties to sell the house while they are married, which would qualify for the $500,000 gain exclusion, and then transfer the sales proceeds or a portion thereof, from one spouse to the other spouse.
APPENDIX A

KRS 403.190. Disposition of property.

(1) In a proceeding for dissolution of the marriage or for legal separation, or in a proceeding for disposition of property following dissolution of the marriage by a court which lacked personal jurisdiction over the absent spouse or lacked jurisdiction to dispose of the property, the court shall assign each spouse's property to him. It also shall divide the marital property without regard to marital misconduct in just proportions considering all relevant factors including:
(a) Contribution of each spouse to acquisition of the marital property, including contribution of a spouse as homemaker;
(b) Value of the property set apart to each spouse;
(c) Duration of the marriage; and
(d) Economic circumstances of each spouse when the division of property is to become effective, including the desirability of awarding the family home or the right to live therein for reasonable periods to the spouse having custody of any children.
(2) For the purpose of this chapter, "marital property" means all property acquired by either spouse subsequent to the marriage except:
(a) Property acquired by gift, bequest, devise, or descent during the marriage and the income derived therefrom unless there are significant activities of either spouse which contributed to the increase in value of said property and the income earned therefrom;
(b) Property acquired in exchange for property acquired before the marriage or in exchange for property acquired by gift, bequest, devise, or descent;
(c) Property acquired by a spouse after a decree of legal separation;
(d) Property excluded by valid agreement of the parties; and
(e) The increase in value of property acquired before the marriage to the extent that such increase did not result from the efforts of the parties during marriage.
(3) All property acquired by either spouse after the marriage and before a decree of legal separation is presumed to be marital property, regardless of whether title is held individually or by the spouses in some form of co-ownership such as joint tenancy, tenancy in common, tenancy by the entirety, and community property. The presumption of marital property is overcome by a showing that the property was acquired by a method listed in subsection (2) of this section.
(4) If the retirement benefits of one spouse are excepted from classification as marital property, or not considered as an economic circumstance during the division of marital property, then the retirement benefits of the other spouse shall also be excepted, or not considered, as the case may be. However, the level of exception provided to the spouse with the greater retirement benefit shall not exceed the level of exception provided to the other spouse. Retirement benefits, for the purposes of this subsection shall include retirement or disability allowances, accumulated contributions, or any other benefit of a retirement system or plan regulated by the Employees Retirement Income Security Act of 1974, or of a public retirement system administered by an agency of a state or local government, including deferred compensation plans created pursuant to KRS 18A.230 to 18A.275 or defined
contribution or money purchase plans qualified under Section 401(a) of the Internal Revenue Code of 1954, as amended.

History
APPENDIX B

381.180. Estates in trust subject to debts of beneficiary - Spendthrift trusts excepted - Other exceptions.

(1) Estates of every kind held or possessed in trust shall be subject to the debts and charges of the beneficiaries thereof the same as if the beneficiaries also owned the similar legal interest in the property, unless the trust is a spendthrift trust.

(2) As used herein, unless the context otherwise requires, "spendthrift trust" means a trust in which by the terms of the instrument creating it a valid restraint on the voluntary and involuntary alienation of the interest of a beneficiary is imposed.

(3) Specific language shall not be necessary to create a spendthrift trust and it shall be sufficient if the instrument creating the trust manifests an intention to create a spendthrift trust.

(4) If an instrument creating a trust provides that a beneficiary is entitled to receive income of the trust and that his interest shall not be alienable by him and shall not be subject to alienation by operation of law or legal process, the restraint on the voluntary and involuntary alienation of his right to income due and to accrue shall be valid.

(5) If an instrument creating a trust provides that a beneficiary is entitled to receive principal of the trust at a future time and that his interest shall not be alienable by him and shall not be subject to alienation by operation of law or legal process, the restraint on the voluntary and involuntary alienation of his right to principal shall be valid.

(6) Although a trust is a spendthrift trust, the interest of the beneficiary shall be subject to the satisfaction of an enforceable claim against the beneficiary:

(a) By the spouse or child of the beneficiary for support, or by the spouse for maintenance;

(b) If the trust is not a trust described in subsection (7)(b) of this section by providers of necessary services rendered to the beneficiary or necessary supplies furnished to him; and

(c) By the United States or the Commonwealth of Kentucky for taxes due from him on account of his interest in the trust or the income therefrom.

(7) (a) If a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary alienation of his interest, his interest nevertheless shall be subject to alienation by operation of law or legal process.

(b) This subsection shall not be construed to subject to alienation any interest in an individual retirement account or annuity, tax sheltered annuity, simplified employee pension, pension, profit-sharing, stock bonus, or other retirement plan described in the Internal Revenue Code of 1986, as amended, which qualifies for the deferral of current income tax until the date benefits are distributed.

History
(2355: amend. Acts 1966, ch. 61, § 1; 1974, ch. 386, § 69; 1990, ch. 220, § 1, effective July 13, 1990.)
DEALING WITH LIFE INSURANCE IN
THE ESTATE PLANNING PROCESS

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DEALING WITH LIFE INSURANCE IN THE
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SECTION E
Dealing with Life Insurance in the Estate Planning Process

I. Basic Uses of life insurance

A. To create a larger estate thereby assuring adequate funds for survivors.

B. Liquidity to pay taxes and expenses, -- avoidance of a forced sale of valuable non liquid assets

C. Life insurance may constitute a source of funds for the surviving family members during interim period of estate administration.

D. In business context, life insurance proceeds may be used to fund obligations under agreements w/ surviving owners and/or business entity to purchase the deceased owner’s business interest.

II. Overview of federal taxation of life insurance

A. Estate Tax Consequences

The proceeds of a life insurance policy under the terms of which the decedent is the insured are included in the gross estate of the decedent/insured if the proceeds are either

1. Payable to the executor, IRC §2042(1), or

2. Payable to designated beneficiaries if the decedent had any incidents of ownership in the policy. IRC §2042(2)

   a. Incidents of ownership include the right of the insured or her estate to the economic benefits of the insurance, including the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy. Treas. Reg. §20.2042-1(c)(2).

   b. Incidents of ownership may include powers over the choice of settlement option, and the retention of a possible reversionary interest by the insured. Treas. Reg. §20.2042-1(c)(3) & (4).

(1) A reversionary interest is an incident of
ownership only if the value of the reversionary interest exceeded 5 percent of the value of the policy immediately before the decedent's death. IRC §2042(2).

(2) It is immaterial whether the reversionary interest arose by express provision in the insurance policy or any instrument of transfer or by operation of law.

c. A decedent does not possess incidents of ownership over an insurance policy on her life where the decedent's powers devolved to her as a fiduciary and were not exercisable for her personal benefit, provided that the decedent did not transfer the policy to the trust and did not furnish consideration for maintaining the policy. Rev. Rul. 84-179, 1984-2 C.B. 195.

d. Where the insured is a sole or controlling shareholder of a corporation, incidents of ownership possessed by the corporation may be attributed to that shareholder with respect to proceeds payable to a beneficiary other than the corporation. Treas. Reg. §20.2042-1(c)(6), Skifter Est. v. Comr. 468 F.2d 699 (2d Cir., 1972).

e. A life insurance policy owned by a partnership, with the proceeds payable other than to, or for the benefit of the partnership, may be includible in the deceased insured partner's gross estate. See Rev. Rul. 83-147, 1983-2 C.B. 158.

3. Transfer of life insurance policy within three years of death

a. Transfer of the policy within three years of death of the transferor-insured results in the full amount of proceeds payable by reason of death being included in the gross estate. IRC §2035(a)(2).

b. Where the policy is transferred more than three years prior to insured's death, the proceeds should not be included in the insured's gross estate even if the decedent continues to pay the premiums.

c. Note that in accidental death policies or
similar situations [i.e., certain term policies] each premium payment may be deemed to create a new policy. See Bel v. U.S., 452 F.2d 683 (5th Cir. 1971), cert. denied, 406 U.S. 919 (1972) where each payment of the annual premium after the creation of the policy was considered a purchase of a new policy.

B. Income Tax Treatment

1. Income earned by the investment of policy assets is not taxed to the insured even though it inures to the benefit of the insured either by increasing the cash surrender value or by being available to pay insurance proceeds.

2. Generally the interest paid on loans incurred to purchase and/or maintain life insurance policies is not deductible. IRC §264(a).

3. Policy-loan interest is generally subject to the general rules which preclude a deduction for consumer interest expense per IRC §163(h)(1).

4. Life insurance proceeds payable by reason of death of the insured are not gross income to the payee. I.R.C. §101

5. Any amounts received under a life insurance contract on the life of one who is terminally ill or chronically ill are excluded from gross income as amounts paid by reason of the death of the insured. IRC §101(g)(1).

6. If any portion of the death benefit under a life insurance contract on the life of a terminally ill or chronically ill insured is sold or assigned to a viatical settlement provider, the amount paid for the sale or assignment shall be treated as an amount paid under the life insurance contract by reason of the death of the insured. IRC 101(g)(2)(A)

7. If a life insurance policy is transferred to another for valuable consideration, the amount excluded from gross income shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. IRC §101(a)(2).
a. Two exceptions:

(1) gifts or other transfers where the basis of the transferee is determined in whole or in part from the basis of the transferor.

(2) transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

b. Example: Insured sells the life insurance policy on Insured's life to Purchaser for the full fair market value. At the death of Insured, Purchaser has gross income to the extent that the proceeds payable at death exceed the amount paid (including any subsequent payment of premiums)

8. Post-death interest on insurance proceeds is included in the gross income of the recipient. IRC §101(d)

C. Gift Tax Consequences


2. This may be a present interest and may therefore qualify for the annual exclusion.

III. Insurance Trusts

A. Estate Planning advantages

1. Proceeds can be paid to beneficiary at time of insured's death so that trustee may immediately invest the cash proceeds received from the insurer.

2. Trust can coordinate collection, investment and disposition of proceeds of several policies.

3. Trust can be used for purposes similar to those of any other trust, [e.g., sprinkling income and corpus, generation-skipping, marital deduction provisions, and avoidance of intricate local law problems, such as paying proceeds to minors and dealing w/ policy ownership when the beneficiary
predeceased the insured.

4. Avoid probate

5. May avoid possible exposure to beneficiary’s creditors if trust was irrevocable prior to insured’s death.

B. Revocable Insurance trusts

1. May be funded or unfunded

2. Trustee may own the policy during insured’s life

3. Insured may own policy and designate trust as beneficiary

4. Funded insurance trust
   a. Grantor transfers property to the trust and income from trust corpus is used to pay premiums on policies.
   b. Insurance policies are often transferred to the trust

5. Taxation of revocable insurance trust
   a. No gift on transfer of policy and/or other property to the trust as there has been no surrender of dominion and control. Treas. Reg. §25.2511-2(b).
   b. No estate tax advantage.
      (1) Full value of trust, including the life insurance proceeds, is included in the gross estate of decedent per IRC §2038.
      (2) Note that the insured is considered to have an "incident of ownership" in life insurance policy held in trust, if under the terms of the policy the insured has the power (as trustee or otherwise) to change beneficial ownership in the policy or its proceeds. Treas. Reg. §20.2042-1(c)(4)
      (3) Insurance proceeds may qualify for the estate tax marital deduction if the trust qualified under IRC §2056(b)(5) or (7).
c. The trust income remains taxable to the grantor of the trust. IRC §676(a).

C. Irrevocable Inter Vivos Trust

1. Life insurance policy is transferred to the trust which may be otherwise funded or unfunded.
   a. If unfunded, the life insurance premiums must be paid by someone other than the trust, presumably the insured or a beneficiary of the trust.
   b. If funded, the grantor will transfer sufficient property to pay the premiums or the income from the trust property will be used to pay the premiums.

2. Tax consequences
   a. Gift tax
      (1) Transfer of property, including life insurance policies, to trust is a gift for federal tax purposes.
      (2) If trust is unfunded, payment of premiums on life insurance owned by the trust constitutes an additional gift.
      (3) But payment of premiums by trust using trust income or property is not an additional gift.
      (4) If annual exclusion is desired, trust should have a demand (Crummey) power.
   b. Estate tax
      (1) Assuming that the grantor has retained no incidents of ownership in the insurance policies and retained no beneficial interest in the trust itself, and the irrevocable transfer was completed during life, the death of the grantor/insured should result in the imposition of no estate tax.
      (2) However, if the trust directs the trustee to pay debts and taxes of the estate of the decedent from policy proceeds, funds required for such purposes are includible

(3) If decedent purchased an insurance policy as collateral security for a loan or other accommodation, its proceeds are considered receivable for the benefit of the estate. Id.

(4) If the trust instrument authorizes the trustee to make loans to the executor to pay estate debts and taxes, or authorizes the trustee to purchase assets from the estate, such loans and/or purchases do not trigger the estate tax.

(5) If, the policy is transferred to the trust within three years of death, the proceeds will be included in the insured’s gross estate. IRC §2035(a)(2).

(6) But if the policy is acquired directly by the trust from the insurance company within 3 years of the death of the insured, §2035 should not apply. See Headrick Est. v. Comr., 93 T.C. 171 (1989) aff’d, 918 F.2d 1263 (6th Cir. 1990).

c. Income Tax

The grantor of a funded insurance trust will be taxed on that portion of the trust income that is or may be applied to the payment of premiums on policies insuring the life of the grantor or the spouse of the grantor. IRC §677(a)(3).

D. Testamentary trusts

1. Established for nontax reasons.

2. Since there is no transfer during life, no gift tax will apply.

3. Full value of insurance proceeds will be subject to the estate tax.

4. No income tax planning needed as proceeds will not be paid to the trust until after death of insured.

5. Estate planner should determine under local law
a. Whether policy proceeds can be paid directly to the testamentary trustee. If not, proceeds could be paid to the estate for distribution to the testamentary trustee

b. Whether, if desired, the insurance policy proceeds will be safeguarded from the claims of creditors

c. Whether the proceeds will be included in the probate estate, and thereby subject to the probate costs.

d. Whether beneficiary designations and similar insurance documents must be completed with testamentary formalities and

e. Whether periodic probate accountings will be required for the testamentary trust even though specifically waived in the trust instrument.

E. Preparation of the Insurance Trust Agreement

1. Whether the trust is to be funded or unfunded

2. If unfunded, who has the responsibility for paying periodic insurance premiums

3. If funded, who has responsibility for paying periodic insurance premiums, particularly if the income generated from other trust assets is insufficient for this purpose

4. If trust investment income is in excess of premium requirements, whether that income is to be accumulated or distributed to trust beneficiaries

5. Whether the trust is to be revocable or irrevocable

6. Whether policy proceeds should be used to alleviate liquidity problems in the grantor's estate, either by a loan, a contribution to the estate, or a purchase of assets from the estate

7. Whether the trustee can use insurance policy settlement options to defer receipt of the proceeds; and

8. Administrative powers of the trustee (including powers to use any corpus to pay insurance premiums
and to purchase new policies on the life of the
trust grantor or the trust grantor's spouse)

IV. Insurance Planning and the Marital Deduction

A. Insurance trust can be structured so that it is not
subject to tax in the estate of either spouse

B. Insurance proceeds which are taxed in the estate of the
insured may qualify for the estate tax marital deduction where

1. The surviving spouse is the beneficiary

2. The insurance trust assets are includible in the
insured's gross estate and the trust qualifies
either under IRC § 2056(b)(5) (life estate with
general power of appointment or §2056(b)(7)
(qualified terminable interest property).

C. Cross-ownership of policies (each spouse purchases the
policy insuring the life of the other spouse)

1. Since there is no transfer by the insured, §2035
does not apply in the event of the death of the
insured within three years.

2. If the insured spouse dies first, the proceeds are
potentially subject to the estate tax in the estate
of the surviving spouse.

3. If the owner spouse predeceases, the value of the
life insurance policy is included in the gross
estate under IRC §2033. However the amount
includible is the replacement value of the policy
rather than proceeds.

4. The owner spouse may dispose of the policy by will,
designating someone other than the insured as the
owner of the policy.

Note: if the insured spouse is the executor
of the owner's estate, the insured could be
deemed to have incidents of ownership in
his/her capacity as executor.

5. Disadvantage of cross-ownership of policies

a. If owner-spouse becomes incompetent his/her
attorney in fact or guardian has control of
the policy
b. In the event of separation or divorce the ownership of insurance policies may become an issue.

c. Where the insurance policy is owned by the spouse and the beneficiary is someone other than the spouse, at the death of the insured spouse the owner-spouse is considered to make a gift of the entire policy death proceeds to the beneficiary. Goodman, 156 F.2d 218, (2d Cir. 1946).

D. Joint and survivor life insurance policies

1. Proceeds are payable on the death of the surviving spouse and will be available to meet the liquidity needs of that estate.

2. Premiums may be structured to be payable only until the first insured dies.

3. Disadvantages
   a. Proceeds not available to family on the death of the first spouse to die, although borrowing against the cash value of the policy may be possible.
   b. Disposition in event of divorce may be unclear

V. Employment related life insurance

A. Group Term life insurance

1. Employee may exclude from income the cost of non-discriminatory group term life insurance provided by the employer up to the cost of $50,000 of such insurance. IRC §79(a).

2. Employer may deduct the full cost of such insurance as an ordinary and necessary business expense under IRC §162(a)(1).

3. The assignment of an interest in a group term policy is subject to the gift tax.
   a. The value of the gift will be small because term policy has no cash or loan value.
   b. Each payment of premiums to continue coverage
constitutes an indirect gift to the assignee and outright assignments of the policy to an individual should qualify for the annual donee gift tax exclusion to the employee/donor.

c. The transfer of a group term policy to a trust and subsequent payments of premiums may be future interest not qualifying for the annual exclusion, depending on the terms of the trust.

4. As the employee has incidents of ownership in such policy, such policy will be includible in the employee's gross estate unless assigned to another.

5. Employee can assign all incidents of ownership in the policy to another person or to a trust assuming permitted to so do under state law and the terms of the master policy.

a. Many policies contain a conversion privilege permitting the employee to convert to individual insurance upon termination of employment. Retention of such conversion privilege is not considered an incident of ownership for purposes of Section 2042. Rev. Rul. 84-130, 1984-2 C.B. 194, acquiescing in Smead Est. v. Comr., 78 T.C. 43 (1982).

b. Where employee has assigned all incidents of ownership in the policy to another, the employee must continue to include in gross income the cost of the policy in excess of $50,000.

6. Transfer of group term policy and section 2035(a).

a. Issue is whether the group-term insurance policy is treated as a one-year contract which the employer purchases and the employee transfers each year, or whether the coverage is of a continuing nature, automatically renewable each year, so that a new transfer (for §2035 purposes) does not occur each year.

b. Where the group-term policy is renewable automatically upon the payment of the premium without further evidence of insurability, the rights and obligations of the parties continue from the policy's inception. The renewal does not create new rights or constitute a new
purchase of insurance and therefore payment of the renewal premium is not a "transfer" for purposes of IRC §2035. Rev. Rul. 82-13, 1982-2 C.B. 132.

c. A change in the employer’s master insurance plan carrier where the new policy is "identical in all relevant respects" to the previous arrangement, should not trigger the application of §2035. See Rev. Rul. 80-289, 1980-2 C.B. 270; PLR 9436036.

d. Does an increase in the amount of face value coverage under the same policy within three years of death constitute a transfer for purposes of §2035?

7. The estate planner should

a. Be sure that both statutory and policy procedures are followed in order to assure the effective transfer of all policy rights.

b. Insured must make an absolute and irrevocable assignment of all rights under the policy, including incidents of ownership enumerated in the policy and any "non-policy" incidents.

c. The assignment of incidents of ownership should include an anticipatory assignment of all replacement coverage and any increases in coverage under the same or a different master policy.

d. Ensure that the policy does not return to the insured by the terms of the will of the donee or by intestate succession, or in a capacity as executor of the estate of the donee or as trustee of a trust created by a donee;

e. Consider how the policy proceeds can continue to be made available to meet the liquidity needs of the insured’s estate without having those proceeds included in the gross estate.

B. Split-dollar Insurance

1. Split-dollar life insurance is an arrangement between two parties (usually an employer and employee) to share the cost of life insurance premiums and to divide the proceeds between the employer and the employee’s beneficiary.
2. Employer pays that part of the annual premium cost equal to the current year’s increase in cash surrender value of the policy, while the employee pays the balance of that premium cost.

a. Since the cash surrender value increases slowly during the early years of a policy, the employee bears a substantial portion of the premium cost during those years. After the first year, the employee’s share of the premium decreases and, in some situations, that share becomes zero after the policy has been in force for several years.


a. Table 2001 is substituted for P.S. 58

(1) much lower values, based on the more-recent mortality experience reflected in the tables under Section 79(c), relating to the valuation of group-term life insurance coverage.

(2) applies regardless of the date on which the split-dollar arrangement was implemented.

(3) Taxpayers may use either Table 2001 or P.S. 58 rates for taxable years ending on or before 12/31/01.

(4) Taxpayers must use Table 2001 for taxable years ending after 12/31/01 and until issuance of permanent guidelines

b. Taxpayers may continue to determine the value of current life insurance protection by using the insurer’s lower published premium rates that are available to all standard risks for initial issue one-year term insurance, subject to several restrictions:

(1) Three requirements must be met in order to use insurer’s published premium rates rather than Table 2001:

(a) The insurer generally makes those rates known to persons who apply to the insurer for term insurance coverage
(b) The insurer regularly sells term insurance at such rates through its normal distribution channels and

(c) Insurer does not more commonly sell term insurance at higher premium rates to standard risk individuals (using the definition of "standard risk" most commonly used by the insurer for the issuance of term insurance).

(2) There is no assurance that the insurer’s published premium can be used to value the term coverage after 12/31/03 with respect to a life insurance contract (or individual certificate) issued after 3/1/01.

c. Equity split-dollar arrangements is defined by Notice 2001-10 as "an arrangement under which the employer’s interest in the policy’s cash surrender value is generally limited to the aggregate amount of the employer’s premium payments". The employee receives the benefit of any growth in the cash surrender value above the amount of premiums paid by the employer, or the employee derives the economic benefit of any positive return on the employer’s investment in the policy.

(1) policy cash values accruing to the employee will be taxable as either compensation income under §83 or as a loan under §7872.

(2) characterization will depend on the substance of the transaction, including the contractual positions and actions of the parties.

(3) for example, an equity split-dollar arrangement would be treated as a loan if there were a reasonable and bona fide expectation that the employer would receive repayment of its share of the premiums at a fixed or determinable future date, and if the cash surrender value of the contract did not, by its terms, represent property transferred to the employee for purposes of Section 83.
d. Notice 2001-10 establishes 6 specific rules for determining whether an equity split-dollar plan should be taxed as a loan or as current compensation income.

(1) The IRS will accept the parties' characterization of the employer's payments under a split-dollar arrangement, if

(a) that characterization is not clearly inconsistent with the substance of the arrangement,

(b) that characterization has been consistently followed by the parties from the inception of the arrangement, and

(c) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.

(2) An equity split-dollar arrangement that is characterized as a loan will be taxed under §7872, the employee will have no additional compensation income for the value of the insurance protection provided under the life insurance contract, and the cash surrender value of the contract will not be taxed as property transferred to the employee under Section 83.

(a) The employee would have additional gross income if the employer's premium payments were not repaid in accordance with the terms of the agreement, and to the extent that Section 72 applies to distributions actually received by the employee under the insurance contract.

(3) Parties to an equity split-dollar arrangement will be treated as having adopted non-loan treatment if the employer's payments are not consistently treated as loans. The parties, in such case, must fully account for all the economic benefits that the employee derives from the arrangement.
means that:

(a) the employer will be treated as having acquired beneficial ownership of the life insurance contract through its share of the premium payments,

(b) the employee will have compensation income under Section 61 equal to the value of the life insurance protection provided to the employee each year, reduced by any payments made by the employee for such protection,

(c) the employee will have compensation income under Section 61 equal to any dividends or similar distributions made to the employee under the life insurance contract and

(d) the employee will have compensation income under Section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life insurance contract, reduced under Section 83(a)(2) by any consideration paid by the employee for such interest in the cash surrender value.

(4) The IRS will not treat an employer as having transferred part of the cash surrender value to an employee under Section 83, merely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer on termination of the split-dollar arrangement.

(5) If compensation treatment is selected by the parties, the employee has currently reportable income under Section 61 for the term insurance coverage (technically the amount at risk), reduced by premiums the employee has made or reduced by any taxable income the employee was required to report because of dividends received.
or credited as well as any income reportable under section 83.

IRS will accept any reasonable method for determining the allocation, including a pro-rata allocation.

(6) Employer's premium or other payment for the benefit of an employee under a split-dollar arrangement will be treated as compensation income to the employee under Section 61, if the employer neither acquires a beneficial ownership interest in the life insurance contract through such payment nor has a reasonable expectation of receiving repayment of that amount through the policy proceeds or otherwise.

e. Planning under 2001-10

(1) All existing plans must be immediately reviewed and parties must determine how to report the economic benefits from such arrangements in the future, whether to terminate and how to terminate.

(2) Future equity split dollar arrangement will have to be drafted to fit clearly within either the loan or compensation definitions.

(3) Notice 2001-10 applies to existing split-dollar arrangements as well as those created after issuance of the Notice.

(4) May have serious problems because plans may have been drafted without care to distinguish between loan and compensation characterization, or plans were drafted as one but administered as the other.

f. Conventional split-dollar insurance should become more popular because Table 2001 reduces the amount of taxable income imputed to the insured. [It also increases the amount the employer must contribute]

g. Equity split-dollar insurance is more complex under Notice 2001-10.

(1) Parties must treat every payment made by
an employer as:

(a) Below-market loan

(b) Employer investment in the contract that will be returned to the employer at some future date (the extent to which the employee has no current or future taxable income; or

(c) Compensation income, taxable currently to the insured employee under Section 61 or Section 83.

(2) If treated as below-market loan,

(a) Section 7872 causes current income taxation on the imputed interest, but avoids additional taxation when the employee receives the balance of the policy equity at the termination of the policy.

(b) Should be able to treat the employer’s portion of the premium as a loan if payable at some fixed and determinable date.

(3) If structured as compensation under section 83,

(a) Employee is not required to recognize income if the increase in the employee’s interest in the cash surrender value of the policy is subject to substantial risk of forfeiture.

(b) But if the employee’s entire interest in the policy is currently transferable, it is not subject to a substantial risk of forfeiture.

(c) IRS has stated in 2001-10 that employee can avoid current income taxation on the equity built up in the policy and not returnable to the employer until the agreement is terminated "pending the publication of further guidance".

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Conclusion: Life insurance will continue to be an important part of estate planning even if estate tax is repealed for more than one year.

REFERENCES

This outline is taken from the following sources:

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William P. Streng, 800 T. M., Estate Planning


Grassi "Key Issues to Consider When Drafting Life Insurance Trusts" 28 Estate Planning 217 (May 2001)


THE USE OF TECHNOLOGY IN AN ESTATE PLANNING PRACTICE

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SECTION F
THE USE OF TECHNOLOGY IN AN ESTATE PLANNING PRACTICE

PART ONE: TRUSTS AND ESTATES LAW PRACTICE SOFTWARE

Compiled And Updated By Jefferey M. Yussman

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Compiled And Updated By Theodore B. Atlass

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SECTION F
Like many areas of the law - and indeed the world - the advancements in, and proliferation of, estate planning and administration software can feel mind-boggling, and often is. When we last presented this session in 1998, the computer and internet were still relative novelties, and there were relatively few software systems (not to mention good systems) available for the estate planner to review, evaluate, and use. Now there is so much material and so many good systems from which to choose, that it's even more mind-boggling to think about evaluating all of the available systems to determine which are best for your office. We will attempt in this session to give you a "heads-up" on software and systems which are available for your use - after you do your own due diligence, of course.

Attached to this introduction is a listing of most of the major products which are presently available on the market for assisting the estate planner in the following areas:

I. Estate Planning
   A. General Calculations and Illustrations
   B. Charitable Giving
   C. Retirement Planning
   D. Tax Utilities (factors, rates, other calculations)

II. Document Drafting

III. Probate Administration Forms

IV. Fiduciary Accounting

V. Asset Valuation

VI. Tax Returns
   A. Tax Forms on CD ROMs
   B. Form 706 Death Tax Preparation
   C. Form 709 Gift Tax Preparation
   D. Form 1041 Fiduciary Income Tax Preparation

VII. Research (on-line and CD-ROM)
    (Also see Ted Atlass' Comprehensive Outline)

I have also attached computer generated copies of the following articles which I believe you will find of Interest:
I. If There’s a Will, There’s a Way on the Web, Robert J. Bmbrogi, American Lawyer Media (law.com), December 21, 2000.


While the programs and choices of software can seem overwhelming, they are also (generally speaking) much more sophisticated and user-friendly than just 3 years ago. However, there is no substitute to investigating each and every system you intend to consider using - particularly with regard to compatibility with your current system. You should also focus on what you intend to accomplish with each system you purchase and whether it may be integrated with other systems you are using or considering using. In this respect, using systems of the same publisher can often (although not necessarily always) prove helpful and productive. Whatever choices you make, relax, have fun (expect some not-so-fun days), and (Document ultimately) increase your productivity!
## I. Estate Planning

### A. General Calculations and Illustrations

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<th>Programs</th>
<th>Web Site URL</th>
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<th>Telephone #</th>
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<tr>
<td>BNA Estate Tax Planner</td>
<td><a href="http://www.bnasoftware.com">www.bnasoftware.com</a></td>
<td>BNA Software</td>
<td>(800) 372-1033</td>
</tr>
<tr>
<td>EPLAN</td>
<td><a href="http://www.ustrust.com">www.ustrust.com</a></td>
<td>U.S. Trust Company of New York</td>
<td>(212) 852-1000</td>
</tr>
<tr>
<td>Estate Forecaster</td>
<td><a href="http://www.estateforecaster.com">www.estateforecaster.com</a></td>
<td>RIA Group</td>
<td>(800) 958-1216</td>
</tr>
<tr>
<td>Estate Planning Concepts and Explorer</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 890-5558</td>
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<tr>
<td>Estate Planning Tools</td>
<td><a href="http://www.brentmark.com">www.brentmark.com</a></td>
<td>Brentmark Software</td>
<td>(800) 879-6665</td>
</tr>
<tr>
<td>Estate Quick-Plan; Estate Cost Estimator</td>
<td><a href="http://www.kettley.com">www.kettley.com</a></td>
<td>Kettley Publishing</td>
<td>(800) 777.3162</td>
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<tr>
<td>Factors</td>
<td><a href="http://www.impact-tech.com">www.impact-tech.com</a></td>
<td>Impact Technologies Group, Inc.</td>
<td>(800) 438-6017</td>
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<tr>
<td>Intuitive Estate Planner</td>
<td><a href="http://www.ustrust.com">www.ustrust.com</a></td>
<td>US Trust Company of New York</td>
<td>(212) 852-3564</td>
</tr>
<tr>
<td>Leimberg's Estate Planning QuickView; Number Crucher</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 890-5558</td>
</tr>
<tr>
<td>Tiger Tables</td>
<td><a href="http://www.leimberg.com">www.leimberg.com</a></td>
<td>Leimberg &amp; LeClair, Inc.</td>
<td>(610) 527-5216</td>
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<tr>
<td>TrustWise 3.0 and ILITs</td>
<td><a href="http://www.tigertables.com">www.tigertables.com</a></td>
<td>Lawrence P. Katzenstein Esq.</td>
<td>(314) 367-4193</td>
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<td>Tvalue Tax Calculations</td>
<td><a href="http://www.osisoft.com">www.osisoft.com</a></td>
<td>OSI Software</td>
<td>(800) 432-6947</td>
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<tr>
<td>Vista; Progeny</td>
<td><a href="http://www.timevalue.com">www.timevalue.com</a></td>
<td>TimeValue Software</td>
<td>(800) 426-4741</td>
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<tr>
<td>Zcalc Excel Spreadsheet Addin</td>
<td><a href="http://www.tax.cch.com">www.tax.cch.com</a></td>
<td>ViewPlan Division of CCH Inc.</td>
<td>(800) 344-3734</td>
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<td></td>
<td><a href="http://www.zcalc.com">www.zcalc.com</a></td>
<td>Lexite Development</td>
<td>(847) 255-9807</td>
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### B. Charitable Giving

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<td>BeneQuick; BeneView</td>
<td><a href="http://www.tax.cch.com">www.tax.cch.com</a></td>
<td>ViewPlan Division of CCH Inc.</td>
<td>(800) 344-3734</td>
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<tr>
<td>Charity</td>
<td><a href="http://www.osisoft.com">www.osisoft.com</a></td>
<td>OSI Software</td>
<td>(800) 432-6947</td>
</tr>
<tr>
<td>Charitable Financial Planner</td>
<td><a href="http://www.brentmark.com">www.brentmark.com</a></td>
<td>Brentmark Software</td>
<td>(800) 879-6665</td>
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<tr>
<td>Charitable Scenario</td>
<td><a href="http://www.ptec.com">www.ptec.com</a></td>
<td>Philanthro Tec</td>
<td>(704) 845-5527</td>
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<tr>
<td>Charitable Quick-Plan</td>
<td><a href="http://www.kettley.com">www.kettley.com</a></td>
<td>Kettley Publishing</td>
<td>(800) 777-3162</td>
</tr>
<tr>
<td>Crescendo Pro, Lite, Estate, Plus and Presents</td>
<td><a href="http://www.crescendosoft.com">www.crescendosoft.com</a></td>
<td>Crescendo Software (Comdel, Inc.)</td>
<td>(800) 858-9154</td>
</tr>
<tr>
<td>EPLAN</td>
<td><a href="http://www.ustrust.com">www.ustrust.com</a></td>
<td>U.S Trust Company of New York</td>
<td>(212) 852-3564</td>
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<tr>
<td>NumberCruncher; Charitable GPR Plus</td>
<td><a href="http://www.leimberg.com">www.leimberg.com</a></td>
<td>Leimberg &amp; LeClair, Inc.</td>
<td>(610) 527-5216</td>
</tr>
<tr>
<td>PGCALc Planned Giving Manager &amp; Mini Manager; GiftCalcs</td>
<td><a href="http://www.pgcalc.com">www.pgcalc.com</a></td>
<td>PG Calc Inc.</td>
<td>(617) 497-4970</td>
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### C. Retirement Planning
### Programs

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<tr>
<td>NumberCruncher; Pension &amp; Roth IRA Analyzer</td>
<td><a href="http://www.leimberg.com">www.leimberg.com</a></td>
<td>Leimberg &amp; LeClair, Inc.</td>
<td>(610) 527-5216</td>
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<tr>
<td>PenD'Calc</td>
<td><a href="http://www.pendcalc.com">www.pendcalc.com</a></td>
<td>PenD'Calc Corporation</td>
<td>(800) 766-7327</td>
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<tr>
<td>Pension &amp; Roth IRA Analyzer; Estate Planning Tools; Retirement Quick-Plan</td>
<td><a href="http://www.brentmark.com">www.brentmark.com</a></td>
<td>Brentmark Software</td>
<td>(800) 879-6665</td>
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<td></td>
<td><a href="http://www.kettley.com">www.kettley.com</a></td>
<td>Kettley Publishing</td>
<td>(800) 777-3162</td>
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#### D. Tax Utilities (factors, rates, other calcs)

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<td>Estate Planning Tools; IRS Factors; IRS Interest &amp; Penalties</td>
<td><a href="http://www.brentmark.com">www.brentmark.com</a></td>
<td>Brentmark Software</td>
<td>(800) 879-6665</td>
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<tr>
<td>Estate Practice Assistant</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 890-5558</td>
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<td>Factuary</td>
<td><a href="http://www.tax.cch.com">www.tax.cch.com</a></td>
<td>ViewPlan Division of CCH Inc.</td>
<td>(800) 344-3734</td>
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<td>Inter-Est</td>
<td><a href="http://www.inter-est.com">www.inter-est.com</a></td>
<td>Cammack Computations Co.</td>
<td>(800) 594-5826</td>
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<tr>
<td>NumberCruncher; IRS Factors; Charitable GPR Plus</td>
<td><a href="http://www.leimberg.com">www.leimberg.com</a></td>
<td>Leimberg &amp; LeClair, Inc.</td>
<td>(610) 527-5216</td>
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<tr>
<td>Tiger Tables</td>
<td><a href="http://www.tigertables.com">www.tigertables.com</a></td>
<td>Tiger Tables Software</td>
<td>(314) 231-2800</td>
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<td>ZCalc</td>
<td><a href="http://www.zcalc.com">www.zcalc.com</a></td>
<td>Lexite Development</td>
<td>(847) 255-9807</td>
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#### II. Document Drafting

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<td>Bank One - One Source for Wills &amp; Trusts; California &amp; Florida Wills &amp; Trust</td>
<td><a href="http://www.fastdraft.com">www.fastdraft.com</a></td>
<td>InterActive Professional Software</td>
<td>(414) 765-2689</td>
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<tr>
<td>Capsoft and HotDocs Template Products (various states)</td>
<td><a href="http://www.lawgic.com">www.lawgic.com</a></td>
<td>Lawgic Publishing</td>
<td>(415) 898-8855</td>
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<tr>
<td>DL: Drafting Libraries</td>
<td><a href="http://www.capsoft.com">www.capsoft.com</a></td>
<td>Capsoft Corporation (Matthew Bender)</td>
<td>(801) 354-8000</td>
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<td>Drafting Libraries</td>
<td><a href="http://www.draftinglib.com">www.draftinglib.com</a></td>
<td>Attorney's Computer Network, Inc.</td>
<td>(610) 347-1500</td>
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<tr>
<td>Document Production System (all 50 states)</td>
<td><a href="mailto:sales@dpsbyals.com">sales@dpsbyals.com</a></td>
<td>Advanced Logic Systems</td>
<td>(800) 454-7703</td>
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<tr>
<td>Documents On Disk</td>
<td><a href="http://www.insmark.com">www.insmark.com</a></td>
<td>InsMark Inc.</td>
<td>(925) 543-0500</td>
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<td>Drafting Wills and Trust Agreements (Wilkins)</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 890-5558</td>
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<tr>
<td>FastDraft</td>
<td><a href="http://www.fastdraft.com">www.fastdraft.com</a></td>
<td>InterActive Professional Software</td>
<td>(888) 554-2542</td>
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<tr>
<td>Lawyer's TrustMaker; Lawyer's WillWriter</td>
<td>none</td>
<td>Legisoft, Inc.</td>
<td>(800) 676-0479</td>
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<tr>
<td>ProDoc Will Forms</td>
<td><a href="http://www.prodcom.com">www.prodcom.com</a></td>
<td>Automated Legal Systems, Inc.</td>
<td>(800) 759-5418</td>
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<tr>
<td>Trust Plus; Will-Do-It; Trust Plus Irrevocable</td>
<td><a href="http://www.cowleslegal.com">www.cowleslegal.com</a></td>
<td>Cowles Legal Systems</td>
<td>(800) 366-1730</td>
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<td>Wealth Transfer Planning (Blattmachr)</td>
<td><a href="http://www.LawOnTheWeb.com">www.LawOnTheWeb.com</a></td>
<td>The Technology Group, Inc.</td>
<td>(410) 576-2040</td>
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<td>WinDraft</td>
<td><a href="http://www.lawtech.com">www.lawtech.com</a></td>
<td>Eidelman Associates</td>
<td>(313) 769-1500</td>
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<td>WillDraft</td>
<td><a href="http://www.expertext.com">www.expertext.com</a></td>
<td>ExperText Systems Ltd.</td>
<td>(416) 971-8454</td>
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<tr>
<td>WillMaker</td>
<td><a href="http://www.nolo.com">www.nolo.com</a></td>
<td>Nolo Self Help Law Center</td>
<td>(510) 549-1976</td>
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<tr>
<td>WILLPower</td>
<td><a href="http://www.kiplinger.com/software">www.kiplinger.com/software</a></td>
<td>Block Financial Corp./Kiplinger</td>
<td>(800) 457-9526</td>
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#### III. Probate Administration Forms
**Programs**

- Capsoft's HotDocs Forms (CA, CO, MD, NJ, NY, PA, TX)
- Document Production System (all 50 states)
- Henson's Transfers
- InTrust - RLT Creation and Funding
- Legal Ease Auto Systems - Probate
- Lexis Practice Area Forms
- Probate System by ProDoc (CO, FL, TX)
- Trust Terminator
- West's Desktop Practice Systems

**Web Site URL**

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<tr>
<th>Publisher</th>
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<tr>
<td>Capsoft Corp. (Matthew Bender/Lexis)</td>
<td>(510) 446-7316</td>
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<tr>
<td>Advanced Logic Systems</td>
<td>(800) 454-7703</td>
</tr>
<tr>
<td>Jane Schuck &amp; Associates</td>
<td>(800) 694-7624</td>
</tr>
<tr>
<td>AtLaw Software</td>
<td>(800) 828-5154</td>
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<tr>
<td>Microcomputer Concepts, Inc.</td>
<td>(813) 381-4010</td>
</tr>
<tr>
<td>LEXIS-NEXIS Group</td>
<td>(800) 356-6548</td>
</tr>
<tr>
<td>Automated Legal Systems, Inc.</td>
<td>(800) 759-5418</td>
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<tr>
<td>Cowles Legal Systems</td>
<td>(800) 366-1730</td>
</tr>
<tr>
<td>West Group</td>
<td>(800) 890-5558</td>
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**Programs**

- 6-in-1 Estate Administration System
- ACTEC Quicken Templates
- FASTER
- Fiduciary Accounting for Trusts and Estates (FATE)
- ProBATE Plus
- ProEstate
- TEdec Fiduciary Accounting System
- Zane/Fiduciary Accounting System

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<tr>
<td>Evaluation Services Inc.</td>
<td>(201) 784-8500</td>
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<td>Essential Software</td>
<td>(414) 797-5500</td>
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<tr>
<td>Kettley Publishing</td>
<td>(800) 777-3162</td>
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<tr>
<td>Innovative Professional Software, Inc.</td>
<td>(800) 284-6105</td>
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<tr>
<td>West Group</td>
<td>(800) 323-1336</td>
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<tr>
<td>Brentmark Software</td>
<td>(800) 879-6665</td>
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<tr>
<td>Estate Valuations &amp; Pricing Systems, Inc</td>
<td>(818) 313-6300</td>
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<tr>
<td>MMR Software</td>
<td>(503) 686-9470</td>
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<tr>
<td>Leimberg &amp; LeClair, Inc.</td>
<td>(610) 527-5216</td>
</tr>
<tr>
<td>Financial Data Service, Inc.</td>
<td>(714) 891-9243</td>
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**V. Asset Valuation**

**Programs**

- Appraise
- Advanced Business Valuation
- Business Quick-Plan
- Value Expert
- EPScom
- Estate Planning Tools
- EstateVal (EVP) + CostBasis
- EE Bond, StampPro, CoinPro, BaseballPro
- NumberCruncher, Business Quick-Plan
- Wallace Historical Securities Pricing

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### B. Form 706 Death Tax Preparation

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<td>706 Plus</td>
<td><a href="http://www.probate-software.com">www.probate-software.com</a></td>
<td>ProBATE Software Publishing Co.</td>
<td>(800) 288-9169</td>
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<td>BNA 706 Preparer</td>
<td><a href="http://www.bnasoftware.com">www.bnasoftware.com</a></td>
<td>BNA Software</td>
<td>(800) 372-1033</td>
</tr>
<tr>
<td>Federal Estate Tax Returns (FET)</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 323-1336</td>
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<tr>
<td>Quik 706</td>
<td><a href="http://www.lacknergroup.com">www.lacknergroup.com</a></td>
<td>Lackner Computer Group, Inc.</td>
<td>(412) 279-2121</td>
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<tr>
<td>Lacerte Form 706</td>
<td><a href="http://www.lscsoft.com">www.lscsoft.com</a></td>
<td>Lacerte Software Corp.</td>
<td>(800) 765-4065</td>
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<tr>
<td>Tedec Fiduciary Accounting System</td>
<td><a href="http://www.tedec.com">www.tedec.com</a></td>
<td>Tedec Systems, Inc.</td>
<td>(800) 345-2154</td>
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<tr>
<td>UST 706/709</td>
<td><a href="http://www.ustrust.com">www.ustrust.com</a></td>
<td>US Trust Company of New York</td>
<td>(212) 852-1000</td>
</tr>
<tr>
<td>Zane/706</td>
<td><a href="http://www.zanenet.com">www.zanenet.com</a></td>
<td>Zane &amp; Associates, Inc.</td>
<td>(800) 331-2533</td>
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### C. Form 709 Gift Tax Preparation

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<td>709 Plus</td>
<td><a href="http://www.probate-software.com">www.probate-software.com</a></td>
<td>ProBATE Software Publishing Co.</td>
<td>(800) 288-9169</td>
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<td>BNA 709 Preparer</td>
<td><a href="http://www.bnasoftware.com">www.bnasoftware.com</a></td>
<td>BNA Software</td>
<td>(800) 372-1033</td>
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<tr>
<td>Federal Gift Tax Returns (FGT)</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
<td>(800) 323-1336</td>
</tr>
<tr>
<td>Lacerte Form 709</td>
<td><a href="http://www.lscsoft.com">www.lscsoft.com</a></td>
<td>Lacerte Software Corp.</td>
<td>(800) 765-4065</td>
</tr>
<tr>
<td>Quik 709</td>
<td><a href="http://www.lacknergroup.com">www.lacknergroup.com</a></td>
<td>Lackner Computer Group, Inc.</td>
<td>(412) 279-2121</td>
</tr>
<tr>
<td>Zane/709</td>
<td><a href="http://www.zanenet.com">www.zanenet.com</a></td>
<td>Zane &amp; Associates, Inc.</td>
<td>(800) 331-2533</td>
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### D. Form 1041 Fiduciary Income Tax Preparation

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<td>(800) 288-9169</td>
</tr>
<tr>
<td>FASTER</td>
<td><a href="http://www.ttsoa.com">www.ttsoa.com</a></td>
<td>Trust Tax Services of America,</td>
<td>(508) 753-9311</td>
</tr>
<tr>
<td>Fiduciary Income Tax Returns (FIT)</td>
<td><a href="http://www.westgroup.com">www.westgroup.com</a></td>
<td>West Group</td>
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VII. Research (on-line and CD-ROM)

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Kleinrock's Tax Library
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Note: Much of the preceding data was obtained, with permission, from a list compiled by Daniel B. Evans for a seminar, which he and Joe Hodges presented, at the ABA TechShow in 2000.
If the only certainties in life are death and taxes, then it is easy to understand the value of an estate-planning lawyer whose job it is to apply the laws governing both. For the lawyers who toil in this field, the Internet offers a way to research tax and probate laws, keep current with new developments, and even obtain sample estate plans.

While the Web is home to a surprisingly large number of estate-planning sites, the bulk of them are aimed at consumers and offer little of use to professionals. For this reason, a good place to start is the Estate Planning Links Web Site, http://www.estateplanninglinks.com/. Created and maintained by lawyers, it may well be the most extensive collection of estate-planning links, with pointers to sites for estate and gift taxes, elder law, probate and trusts, charitable planning and philanthropy, and estate planning software. Originally compiled in 1995 by Dennis Kennedy, then a trusts and estates lawyer in St. Louis, it is now maintained by Dennis Toman, partner with Booth Harrington Johns & Toman, in Greensboro, N.C.

Another comprehensive, well-organized, and up-to-date collection of links to estate-planning resources on the Web is Legal Research for Estate Planners, http://www.geocities.com/jasonhavens/LREP.html. Created by Jason Havens, an estate-planning lawyer in Fort Myers, Fla., this annotated guide covers both national and state-specific sites and also indexes sites by topic and type of resource.

Always a good place to start for research into any legal topic is Cornell University's Legal Information Institute (LII), and such is the case with its library of Estate Planning Law Materials, http://www.law.cornell.edu/topics/estate_planning.html. Here you will find hypertext versions of 26 U.S.C. Subtitle B, covering federal estate and gift taxes, as well as the related provisions of the Code of Federal Regulations.

Also available are recent U.S. Supreme Court cases related to estate and gift taxes and the texts of the Uniform Probate Code, the Uniform Principal and Income Act, the Uniform Trusts Act, and the Uniform Fiduciaries Act. The LII also includes links to the Internal Revenue Service and related state probate, property, and tax statutes.

What was once one of the better estate-planning destinations -- California Estate Planning, Probate, and Trust Law, at http://www.ca-probate.com/ -- has
grown somewhat out of date, with a few too many stale articles and expired links, but remains a useful starting point nonetheless. Although oriented to California consumers, the site also offers much for lawyers in any state.

Among the features are an analysis of estate and gift tax aspects of the 1997 Budget Act, a collection of legal articles, a forms library, and links to other sites. Probably the most popular feature is the site's collection of wills on the Web -- one that includes the wills of such celebrities as Princess Diana, Jacqueline Kennedy Onassis, Elvis Presley, and Marilyn Monroe, as well as those of ordinary people, in some cases dating to the 15th and 16th centuries.

Two other sites with a state focus but broader appeal are the Pennsylvania Estate and Trust Cybrary, http://evans-legal.com/dan, and the Texas Probate Web Site, http://www.texasprobate.com/. Philadelphia lawyer Daniel Evans, an active member of and frequent author for the American Bar Association's Real Property, Probate, and Trust Law and Small Firm Management sections, maintains the former. It contains a number of useful articles on estate planning, practice management and legal technology.

The Texas site, published by Austin lawyer Glenn M. Karisch, grew out of his efforts to track and report on probate legislation in the state, and the legislation section remains a primary feature, with up-to-date information on bills affecting estate planning, probate law and trust law. A collection of links, prepared by Karisch for a presentation at the 1999 annual meeting of the American College of Trust and Estate Counsel, includes his annotations, with the best earning his "four chili pepper" rating.

THE NATIONAL OVERVIEW

For keeping current with the law on a national basis, a good bet is RIA, http://www.riahome.com/, the publisher of tax research products and software. Much of its sizable catalog of estate-planning products is available for delivery via the Web, including the monthly newsletter, Estate Planner's Alert; the more analytical Estate Planning Journal; the book, "Estate Planning Law & Taxation"; and several others. Of course, although they can be found on the Web, they're not free. An annual subscription to Estate Planner's Alert, for example, costs $165. But RIA offers free trials of some of its Web-based products and free demos of others.

Another tax and business-law publisher with a catalog of Web-based estate-planning products is CCH Federal and State Tax, http://tax.cch.com/. Follow the link "Financial and Estate Planning" to find online offerings such as CCH Solutions for Financial Planning, a Web-based library written by financial planning experts that includes analysis, advice, an online discussion forum, sample forms and documents, checklists, and more. Also featured is the Financial and Estate Planning Library, a comprehensive, online library that combines electronic versions of several CCH publications to provide daily news, in-depth analysis, expert commentary, full-text laws, financial calculators, interactive tax forms, and other practical features.

The site offers no pricing information, but provides phone numbers and e-mail addresses for those wanting to learn more.

While RIA and CCH require a paid subscription, a free site with a broad range of tax-analysis articles, including many on estate planning, is that of San Francisco lawyer and columnist Robert Sommers, aka The Tax Prophet, http://www.taxprophet.com/. Sommers has written prolifically for the former San
Francisco Examiner and elsewhere, and he publishes his many columns and scholarly articles on his Web site, richly illustrated with wizards and crystal balls. For a shortcut to his estate-planning articles, follow the "Tax Class" link to a page where he has indexed his articles by subject matter and level of sophistication.

SUBSTANCE WITHOUT SLICKNESS

In contrast to Sommers' professionally designed site, there is something decidedly homespun about Trusts and Estates.net, http://www.trustsandandestates.net/, from Fort Worth, Texas, estate-planning lawyer Noel Ice. Take, for example, Ice's front-page photo, with its label, "Not my best picture." But beneath the amateurish facade, there is real substance.

Ice has written a virtual treatise on estate planning for distributions from qualified plans and IRAs, which is available here in toto. He also offers a series of "nutshell" guides to estate planning topics, written for legal consumers. A variety of other articles, some written specifically for lawyers, fill out the site.

Bar association sites focusing on estate planning vary in substance and depth. Some provide only general membership information, while others strive to provide deeper levels of practical resources. One of the best comes from the National Academy of Elder Law Attorneys, http://www.naela.com/, an organization of lawyers who concentrate in legal issues affecting the elderly and disabled, including estate planning. NAELA restricts part of its site to members, but the public area has several useful features. For those seeking a lawyer, NAELA provides a directory of its members, which can be searched by lawyer name, firm name, location, or area of proficiency. NAELA's collection of links is particularly well done, with each link annotated with a brief description.

Less robust is the site of the American Bar Association Section on Real Property, Probate, and Trust Law, http://www.abanet.org/ rppt/home.html, with general information about section activities, membership and publications. It has the full text of Probate & Property, its bimonthly magazine, although access to many articles is restricted to section members, while only selected articles are available to non-members. It also has the tables of contents of Real Property, Probate, and Trust Journal, with selected issues available in full text, although, again, only to section members. Visitors can browse a catalog of estate-planning books and media published by the ABA and make purchases online.

The American College of Trust and Estate Counsel, http://www.actec.org/, also limits much of its Web site to its members. The public area provides little of substance. It includes a haphazard collection of links to estate-planning and other Internet resources. It also has the tables of contents from its newsletter, but no ability to retrieve the full text of any article. The membership section allows anyone to search for ACTEC fellows by state.

If your practice skills are a bit rusty, you may want to end your tour of estate-planning sites with the Crash Course in Wills and Trusts, http://www.mtpalermo.com/. What started as an outline by Kentucky lawyer Michael Palermo for an adult education class at a local community college evolved into this fairly detailed, hypertext manuscript covering the basics of estate planning. Browse the table of contents for specific chapters or flip page by page through the entire work. This award-winning site has been online several years, but Palermo keeps it current with updates reflecting developments in the law.
Inherit the Windfall

Flush with parents' money, baby boomers keep wealth management lawyers rolling in the dough.

Sharon Harvey Rosenberg Miami Daily Business Review June 26, 2001

After a stint as a special adviser to the U.S. Mission in Bosnia, Michael Kavoukjian, a trust and estate attorney, transferred from the New York office of White & Case to the law firm's Miami office in 1998. His work in war-torn Bosnia, he says, made his new assignment look easy by comparison. "Once you've negotiated with Serbs and Muslims, helping to resolve squabbles within a Miami family is a piece of cake," says Kavoukjian, who notes that relatives battling over inheritances are somewhat less likely to shoot you. Kavoukjian became the first full-time trust and estate specialist in the Miami office of White & Case. Since then, the department has grown rapidly. It now has 16 lawyers. As head of the wealth management practice in Miami, which it calls its private clients group, Kavoukjian is recruiting more attorneys. White & Case is not alone. Throughout Florida, law firms like Akerman Senterfitt, Greenberg Traurig, Shutts & Bowen and Gunster Yoakley are beefing up their wealth management and trust and estate planning departments. That's largely because of the trillions of dollars baby boomers are in the process of inheriting from their savings-oriented parents. "We are in the midst of the greatest intergenerational transfer of wealth," says Kavoukjian, the former co-chair of the American Bar Association's committee on estate planning and drafting. "The sums are staggering even with the current decline in the stock market."

OVERLAPPING WITH BANKERS

Law firms' so-called private client services groups bear a striking resemblance to private banking and trust management departments in the financial services world. Both focus on preserving the wealth of affluent individuals and families, which are typically those with at least $5 million to $10 million in investible assets. In that niche, lawyers and bankers often collaborate and refer business leads to each other. "We tend to look at it as a partnership," says Richard Ditizio, managing director of the Palm Beach, Fla., office of Citigroup Private Bank. While there is some overlap between banking and legal teams in the wealth management business, bankers, unlike lawyers, are able to sell a wide range of financial products such as mutual funds, investment services and insurance. In a few years, however, some lawyers predict that they, too, will be able to peddle financial products. That would be a new source of fees. But some ethics mavens fear that it could compromise the objectivity of advice offered to clients.

RULES FROM THE GRAVE

Some trusts drawn up by legal specialists in the trust and estate planning field enable wealthy individuals to continue exercising control over their assets even after death. These instruments accomplish this by establishing controls and stipulations with which heirs must comply to receive inherited funds. "It's making sure the money works for [the heirs] and not against them," says Nick Rubino of Rubino & Associates, a three-lawyer firm in Altamonte Springs, Fla. For example, fears of funding a do-nothing lifestyle can prompt a wealthy individual to link annual trust payments to an heir's gainful employment. Other trust stipulations limit amounts that can be spent on weddings, homes or new business ventures. One middle-aged South Florida man discovered after his parents' death that his sizable inheritance was tied to getting a college degree, according to trust professionals who handled the estate. He had resisted his parents' demand that he do so for decades. Only after he went to college and earned his degree did he inherit the money. In-law trusts and what Rubino calls "bimbo trusts" are other vehicles used to shield family assets from an offspring's spouse, or from a second or third wife. An in-law trust, for example, enables a married daughter or son to tap a family trust, but prohibits the child's spouses from getting direct access to the account. Like private bankers, estate planning attorneys often become intimately involved in family politics, real estate...
transactions and other financial maneuvers. For instance, Greenberg Traurig attorneys have helped clients buy vacation homes and lease private planes, says Daniel Mielnicki, national coordinator of Greenberg's wealth preservation group. Attorneys also get heavily involved in family businesses. At the 150-lawyer Gunster Yoakley, a West Palm Beach-based firm with 24 attorneys on its private wealth services team, James Davis recently crafted a benefits plan, employment contracts, a shareholders plan, a family trust and corporate succession plans for a large, family-run business involving parents and their adult children. "We're so close, we even e-mail jokes back and forth," Davis says. FROM BANKER TO LAWYER The movement of lawyers between wealth management law practice and private banking is brisk. Mielnicki, who works in Greenberg's Boca Raton, Fla., office, spent 20 years at a major New York firm before he moved to Florida in 1990 and joined Citigroup's Private Bank unit, where he was a tax planning specialist. He returned to law firm work five years ago. "It was a very enlightening period," Mielnicki says of his stint at Citibank. He says he got experience in cash flow, investment management and the risk-tolerance characteristics of the wealthy. Rubino says his background as a banker helps him understand the day-to-day administration of trust funds and investments. Rubino previously worked as an estate planning attorney for the Internal Revenue Service, then served as a trust officer for banks in Pennsylvania and Florida. "I've been doing the same thing, just from different sides of the table," Rubino says. The number of attorneys seeking trust and estate planning board certification has exploded in the last few years, says John Tan, a Bar certification specialist in Tallahassee, Fla. The increase has been driven by younger attorneys seeking to make themselves more marketable. In the past two years, more than 50 lawyers have applied for the annual trust and estate certification exam. In contrast, from 1988 through 1992, the average was only 15. From 1997 through 1999, the average was 31. There now are 319 board-certified specialists in Florida, compared with 278 five years ago. CONDITIONS RIPE With the current intergenerational wealth hand-off, the population demographics have never been better for lawyers. And as their own mortality looms, boomers are thinking ahead to their own legacies. A recent best-selling book about wealth in the United States, "The Millionaire Next Door," by Thomas J. Stanley and William D. Danko, identifies estate planning law as the top career choice for the next few years. The generation born before World War II is concerned about passing on wealth to grandchildren, while paying as little as possible in estate taxes, says Linda Suzanne Griffin, a Clearwater, Fla., trust and estate planning attorney. During the last 10 years, her practice volume has tripled. Griffin, a sole practitioner with two employees, has had to refer excess work to other lawyers. Ironically, the recent repeal of the federal estate tax laws may offer a boost to the field. While total repeal of the estate tax may or may not occur ultimately, new complications could send many Americans rushing to find a trust and estate planning lawyer. Some attorneys joke that proposed changes should be dubbed the Estate Planning Lawyers Full-Employment Act. "It's going to be a boon to this area of law practice," says Jerry Wolf, a shareholder in the Boca Raton and Fort Lauderdale, Fla., offices of Akerman Senterfitt, which employs 25 lawyers in its private client services unit. He's already noticed a growth in recruitment ads seeking estate and trust lawyers. Other firms see an increase in family disputes over large inheritances and are targeting the field of probate and estate planning litigation. They anticipate that the stock market decline will spark more lawsuits. Faced with diminished inheritances, family members are more likely to sue each other to get a larger slice of a smaller pie, says Miami lawyer William Palmer, who recently moved from Adorno & Zeder to Shutts & Bowen. Or else, he says, they'll sue account trustees and investment managers on the grounds that they've mishandled funds. "It just goes on forever," Palmer says.
Coping With a Tax That Has Nine Lives

By DAVID CAY JOHNSTON

PRESIDENT BUSH'S idea was simple enough: First thing we do, let's kill all the death taxes. . . .

The execution, alas, was not so simple.

His new tax law, which reduces estate taxes in stages starting next year, repeals them for the year 2010 and then resurrects them in 2011, is laced with many subtle provisions. And they can cause the uninformed to pay taxes unnecessarily, leave a spouse and heirs much more -- or much less -- than was intended and, perhaps, prompt litigation among family members.

But there are easy new ways for most people, especially those with more than $1 million and less than about $5 million of wealth, to avoid these problems. Anyone who has a will should review it with a lawyer, even though few wills may need to be rewritten; everyone without a will should get one. And particularly affluent people who have established trusts for their heirs should make sure that those trusts will still achieve what they were intended to do.

For residents of many higher-tax states, including New York, New Jersey and Connecticut, it may come as a surprise that total estate taxes will actually rise over the next few years.

That is because the law that will slowly, and temporarily, eliminate the federal estate tax also will reduce the credit allowed for state-level estate taxes. That potentially costly detail received little attention as politicians trumpeted the tax cut.

The law also poses difficult new questions about when to buy, keep or drop life insurance in a future that may, or may not, include an estate tax.

And what about making gifts to heirs over the coming years, especially gifts that would themselves be liable to tax? What about gifts to charities?

Congress and Mr. Bush have assured Americans of one thing: the coming decade will be rife with uncertainty about estate taxes. Experts on all sides of the debate agree that the new tax law will have to be modified, and some contend that it is so unworkable that it might have to be undone. Whether repeal is real remains an open question.

Most Americans die without a will, and the biggest mistake that even moderately wealthy people can make is to think that, now especially, they do not need to plan for the organization and disposition of their assets. That could be a very
costly mistake, especially when a family-owned business is involved, according to business-valuation experts, financial planners and estate-tax lawyers.

In another of its many counterintuitive effects, the repeal of the estate tax is likely to benefit some charities but cost others dearly, often in ways that are difficult to anticipate. And that, in turn, may create new tensions in wealthy families, tensions that will require more planning.

To gauge the complexities of the tax changes and what they may mean to your life, consider this situation: Suppose your parents are among the very rich, with at least $10 million. Under current law, estate taxes would take more than half of that amount if the second of them died this year.

Reasonably, you may be anticipating that, if your parents live until the tax is repealed in 2010, your inheritance will more than double, since all the money that would have gone to taxes can flow to you.

But odds are against such a windfall coming your way, said Douglas K. Freeman of Freeman, Freeman & Smiley, a large tax-law firm with offices throughout California. Just because there is less for the government does not mean there will be more for you. Many rich parents, after all, pick specific sums of money they want to leave to each child, Mr. Freeman and others said. Such decisions, these experts say, have less to do with taxes than with the parents' attitudes about money and the quality of their relationships with their children.

These experts said many wealthy people agreed with the philosophy of the billionaire investor Warren E. Buffett who has said that he will leave his children enough money to do anything, but not so much that they can do nothing. Mr. Freeman said clients had already begun contacting him to "ask what changes they need to make in their wills so that their children do not get more money."

So if heirs will not get the money that would have gone to estate taxes, who will?

"Charities will be major beneficiaries of repealing the estate tax," said Paul G. Schervish, a professor of sociology at Boston College who has spent years interviewing the rich about their behavior. Indeed, Mr. Freeman and a few other estate-tax lawyers say they have received calls from clients who want to make sure that money that does not go to estate taxes is donated to charity.

Veteran fund-raisers, however, say they expect the law to change the way people donate to charity, a shift that may benefit some charities while hurting others.

"Museums are going to lose out, because art they had expected in a bequest is going to stay in the family if the estate tax is repealed," said Robert F. Sharpe, a fund-raising consultant in Memphis.

Consider what happens if you have a $100 million estate -- $55 million in investments and $45 million worth of art -- and you want to limit your children's inheritance to $25 million.

Under current law, if you leave it all to your children, they would have to turn over the entire $55 million to pay the estate taxes, leaving them with only the art, which they could enjoy or sell, pocketing $45 million tax-free. Alternatively, you could donate the art to a museum or other charity, reducing the estate tax to a bit more than $30 million and leaving almost $25 million for your children.
Without the estate tax, however, there is no financial incentive to leave art to charities. The children could keep both the art and the entire $55 million portfolio -- unwelcome news for art museums that count on death bequests to enlarge their collections.

Charities will benefit from the law only if rich parents want to limit the amounts inherited by their children or other relatives. For example, if the parent with the $100 million estate wanted her children to receive only $25 million, she could still donate the art to a museum and give to charity the $30.25 million that would have gone to estate taxes. That would leave the children with the same $24.75 million they would have received before the federal estate tax was repealed.

Accountants and lawyers say a smarter tax strategy, if estate taxes are repealed, would be for the rich parent to give the art to charity during her lifetime and take the income-tax deduction herself, then put the $30 million gift to charity into a donor-advised fund at a community foundation with the children as the advisers. The fund would both teach the children about how to give and provide them with a source for charitable gifts that would not require them to dig into their own pockets.

Here is a guide for the wealthy, heirs and charities to changes in the estate-tax law -- and issues to discuss with family members and professional advisers.

Wills and Estate Plans

People with estate plans or wills should ask a lawyer to review them to make sure they take best advantage of the new law. Most plans and wills do not need revisions, but wills that use a formula to divide assets among a surviving spouse and children may find that the changes in estate-tax exemptions and the repeal for the year 2010 will result in too much or too little going to the spouse.

People with children from previous marriages need to be especially careful in this area, estate-tax lawyers say, to prevent litigation within the family.

Of course, even people who do not have enough assets to be liable for estate taxes should have a will, experts say, so that their property is disposed of as they intend.

The Moderately Wealthy

Next year, people can leave as much as $1 million without incurring estate taxes, up from $675,000 this year. That change alone will reduce the number of estates subject to estate taxes by about 40 percent. With a little bit of planning -- starting by making sure that at least $1 million in assets is in the name of each spouse -- a married couple can pass along $2 million tax-free.

The threshold rises to $1.5 million ($3 million for couples who plan) in 2004, $2 million ($4 million) in 2006 and $3.5 ($7 million) million in 2009. At that point, even considering growing wealth, fewer than 10,000 estates are likely to be subject to estate taxes. In 2011, when the estate tax is scheduled to resume, the threshold will fall back to $1 million a person ($2 million for couples who plan).
Tax-Free Gains

In 2010, the year of the repeal, people can pass along as much as $3 million of investment gains to a spouse and up to $1.3 million to other heirs without having to pay capital gains tax. For the maximum tax break, people should make sure that their wills give spouses the top priority in receiving property that has grown significantly in value, lawyers and other tax advisers say.

In other words, specifically bequeath to your spouse that Exxon Mobil stock that you bought at a split-adjusted $1 a share and now fetches nearly $90, or that Monet you picked up for a song decades ago that is now worth millions, so that you get the maximum benefit.

Wills should also guide executors on how to distribute property to take full advantage of the law. That means considering holdings like retirement accounts that pass outside the will and are not under an executor's control. In giving guidance on dividing tax-free and taxable property among heirs, you should also pay attention to whether an asset is likely to be sold by the recipient or, in the case of a family home on the lake, is likely to stay in the family for generations, said Sanford J. Schlesinger of Kaye, Scholer, Fierman, Hays & Handler, a law firm based in Manhattan.

But people who have some warning of their deaths, usually because of terminal illness, can easily circumvent the limitations on tax-free gifts, said Jonathan G. Blattmachr, who represents hundreds of the richest families in the United States for Milbank, Tweed, Hadley & McCloy, a law firm based in Manhattan. They can borrow against their assets and give cash or new securities bought with the borrowed money to heirs.

Consider someone with a $100 million estate, all of which is appreciated property. By borrowing $90 million and then giving away the borrowed money at death, the heirs would owe no taxes. The original property could then be given to a charity, which would sell the bequest to pay off the $90 million loan and keep the $10 million balance.

Retirement Accounts

The tax-law changes, combined with new I.R.S. rules, create opportunities to avoid or defer taxes on money inherited from retirement accounts. These accounts are not governed by wills, so their transfer must be coordinated with a will to achieve maximum tax savings.

Ed Slott, an accountant in Rockville Centre, N.Y., who publishes Ed Slott's IRA Advisor newsletter, recommends dividing retirement savings into several Individual Retirement Accounts and designating a different heir for each. Under the new I.R.S. rules, money can be moved back and forth among these accounts, without incurring taxes, so that each heir receives exactly the amount exempted from estate taxes. These allocations should change annually as the exempt amount rises to $3.5 million in 2009 from $1 million next year.

Even after you die, your children and grandchildren can split an inherited I.R.A. themselves. If it is a conventional I.R.A., each heir would pay taxes on the money only as they withdraw it. With a Roth IRA, withdrawals are tax-free. Heirs, however, must divide the money into separate accounts before the end of
the year after you die. If they miss that deadline, the deferral will be limited to the life span of the oldest heir.

The best new device, Mr. Slott said, is a rule allowing a spouse to reject his or her share of the retirement account within nine months after being widowed. If that is done, those who were named as contingent beneficiaries get the account instead and can make withdrawals over their lifetimes.

Remember, beneficiaries of these retirement plans are not determined by a will, but by the documents governing each account. This means that the will must be coordinated with the retirement accounts to get the maximum tax savings.

If you want to ensure that your grandchild, upon reaching adulthood, does not cash in his inherited account and spend it all on a sports car, you can create a trust for each beneficiary that governs withdrawals, said Seymour Goldberg, an accountant in Garden City, N.Y.

Family Gifts

Congress lets individuals make gifts of up to $10,000 a year to as many different people as they want. Couples may give twice as much. Larger gifts are subject to gift taxes, but those levies are not due until the donor has used up his lifetime exclusion. Next year, this limit will rise to $1 million, from $675,000, and stay there even during repeal of the estate tax and after it is resurrected.

Individuals who can afford it, and who want to, should make additional gifts up to the $1 million limit, said Sherman F. Levey, the senior estate partner at Boylan, Brown, Code, Vigdor & Wilson, a law firm in Rochester. Gifts above the tax-free limit are generally unwise, he said, because of the uncertainly about estate-tax repeal.

Charitable Gifts

Until the estate tax is fully repealed in 2010, people should rely on their conventional Individual Retirement Accounts as their first source for charitable giving, because the balance is subject to the estate tax and withdrawals are taxed as income, said Alan Halperin, an estate tax specialist at Stroock & Stroock & Lavan, a law firm in Manhattan. Donating these assets to charity "avoids both income and estate taxes," he said.

Roth IRA's are not attractive for charitable giving, he added, because withdrawals from those accounts are free of income tax.

If the estate tax is repealed as planned, accountants and lawyers say they will advise clients to donate money while they are still alive, and thus able to deduct their gifts from their income taxes.

Repeal of the estate tax would also make charitable remainder trusts more attractive for the charitably inclined, Mr. Halperin said. These trusts allow the donor to take an immediate income-tax deduction, avoid capital gains taxes on highly appreciated assets, receive a stream of income for life and then leave a charitable bequest.

Medical Care
As cold as it may sound, some people who expect inheritances have already asked tax lawyers about the cost -- and the legality -- of keeping a rich relative who has been declared brain dead on life support until the estate-tax repeal takes effect in 2010. Others have asked about terminating life support for a wealthy relative as that year draws to a close.

Mr. Blattmachr said wealthy individuals should carefully review the documents they have signed governing health care and life support in case they become incapacitated. The goal is to ensure that their wishes, not those of greedy relatives, prevail.

Insurance

Many people buy life insurance and put it into a trust so that their children can receive the proceeds tax-free as a replacement for money paid in estate taxes. Small businesses also use insurance to pay estate taxes and buy out the heirs of partners who die. Second-to-die life insurance, which pays off when the surviving spouse dies, is inexpensive and yet exceptionally profitable for insurers.

Estate-tax lawyers disagree about whether to buy such policies, continue existing ones or let them drop. The most cautious advice is to keep existing policies, because Congress may change its mind about repealing the estate tax, and future illness may make it impossible or prohibitively expensive to buy the same insurance later.

People who have sophisticated strategies in place to pass along wealth before the scheduled repeal, such as Grantor Retained Annuity Trusts and Qualified Personal Residence Trusts, may want to keep their insurance until these transfers are completed.

That way, if the benefactor dies before the gifts are disbursed, a process that could take 20 years, the insurance payout can still help the heirs pay whatever estate taxes are still due.

Falling (and Rising) Taxes

The highest federal estate-tax rate, paid on estates of more than $3 million, falls next year to 50 percent from 55 percent. The rate then falls by one percentage point annually until it reaches 45 percent in 2007.

But in 2004, a special exemption for family-owned businesses will cease to exist. That will mean higher estate taxes through 2009 for some wealthy Americans. (Special exemptions for working farms will continue.)

Further complicating the issue, Congress decided to undo the careful coordination of federal and state estate taxes, by limiting the credit for state-level taxes.

New Yorkers, for example, can apply only part of their state-level estate taxes to offset the federal levy. In the most extreme example, in 2004, on estates valued at more than $10.1 million, New Yorkers will pay 48 percent to the federal government and an additional 12 percent to the state, for a total of 60
percent, instead of the 55 percent total had the law not changed. Similar tax increases will affect those who die in most other states.

Organizations mentioned in this article:

Related Terms:

You may print this article now, or save it on your computer for future reference. Instructions for saving this article on your computer are also available.

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For many years the major tax publishers (i.e., BNA, CCH and RIA) had a near-monopoly on the materials that tax professionals use for basic tax reference and research purposes. Admittedly, that is still true as to the detailed narrative test provided in the major tax services and the older case law. But current materials (cases, rulings, forms, and publications) are readily available for little or no cost over the internet, and a number of sources now provide historical materials (cases, rulings, etc.) at a fraction of what has been charged for such information in the past. Let us explore what low-cost and no-cost alternatives now exist utilizing the internet.

I. Applicable Federal Rates

A. Brentmark
   http://www.brentmark.com/AFRs.htm

B. Crescendo
   http://WWW.Crescendosoft.Com/rateold.asp

C. IRS

D. PG Calc
   http://www.pgcalc.com/drate/

E. Philanthrotech
   http://www.ptec.comlhtml/body_afr.html

F. Pillsbury, Madison & Sutro
   http://www.pmstax.com/afr/

G. Time Value Software
   http://www.timevalue.com/afrindex.htm

II. Federal Courts — Case Law Links

A. Counsel Quest
   http://www.CounselQuest.com/courts.htm
B. Courts.Net
   http://www.courts.net/fed/index.html

C. Cornell Law School
   http://www.law.cornell.edu/opinions.html

D. Emory Law School
   http://www.law.emory.edu/LAW/refdesk/country/us/fedlaw.html

E. Brooklyn Law School
   http://brkl.brooklaw.edu/screens/fedcts.html

F. ILRG
   http://www.ilrg.com/caselaw/

G. LJX
   http://www.ljextra.com/cgi-bin/cir

H. Washburn Law School
   http://lawlib.wuacc.edu/washlaw/searchlaw.html

III. Federal Legislative and Regulatory Materials

A. Office of Law Revision Counsel (OLRC)
   http://uscode.house.gov/

B. ORLC — U.S. Code Search
   http://uscode.house.gov/usc.htm

C. ORLC — U.S. Code Download
   http://uscode.house.gov/download.htm

D. ORLC — U.S. Code Classification Tables

E. ORLC — Codification Legislation

F. CapWeb -- The Internet Guide to the U.S. Congress
   http://www.capweb.net/classic/index.morph
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 http://www.access.gpo.gov/congress/cong009.html |
| **H.** | Congressional Directory (GPO)  
 http://www.access.gpo.gov/congress/cong016.html |
| **I.** | Congressional Hearings (GPO)  
 http://www.access.gpo.gov/congress/cong017.html |
| **J.** | Congressional Quarterly  
| **K.** | Congressional Record (GPO)  
 http://www.access.gpo.gov/su_docs/aces/aces150.html |
| **L.** | Congressional Record Index (GPO)  
 http://www.access.gpo.gov/su_docs/aces/aces190.html |
| **M.** | NARA — Code of Federal Regulations  
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| **N.** | NARA — Federal Register (1995 - date)  
 http://www.access.gpo.gov/su_docs/aces/aces140.html |
| **O.** | NARA — Public Laws  
 http://www.access.gpo.gov/nara/nara005.html |
| **P.** | Federal Register (via GPO Gate)  
 http://www.gpo.ucop.edu/ |
| **Q.** | GPO Access on the Web (via Purdue)  
 http://thorplus.lib.purdue.edu/gpo/ |
| **R.** | History of Bills (GPO)  
 http://www.access.gpo.gov/su_docs/aces/aaces200.html |
| **S.** | Line Item Veto Notices (GPO)  
 http://www.access.gpo.gov/nara/nara004.html |
| **T.** | Senate, House & Executive Reports  
 http://www.access.gpo.gov/congress/cong005.html |
U. Senate & House Treaty Documents  
http://www.access.gpo.gov/congress/cong006.html

V. State.Net  
http://www.statenet.com/about

W. Thomas — Legislative Information on the Internet (LOC)  
http://thomas.loc.gov/

X. Today in Congress (Washington Post)  
http://www.washingtonpost.com/wp-srv/national/daily/cong2day.htm

Y. U.S. Code (Cornell) — Can be Updated  
http://www4.law.cornell.edu/uscode/index.html

Z. U.S. Code Classification Tables (U.S. House of Reps.)  
http://law.house.gov/usct.htm

AA. U.S. House of Representative — Misc. Pubs. And Committees  
http://www.access.gpo.gov/congress/house/index.html

BB. U.S. Senate — Misc. Pubs. And Committees  
http://www.access.gpo.gov/congress/senate/index.html

IV. Gateway Sites --- Federal Tax Forms & Publications

A. AICPA — Federal Tax Forms & Publications  
http://www.aicpa.org/irs/index.htm

B. FedWorld — Directory of all Files in IRS-UTL Library  
ftp://ftp.fedworld.gov/pub/irs-utl/00-index.txt

C. FedWorld — All Files in IRS-UTL Library  

D. IRS Forms and Publications  

V. Gateway Sites — General Tax

A. ABA LawLink  
http://www.abanet.org/lawlink/home.html
B. ABA — RPPTL Section Links
http://www.abanet.org/rppt/sites.html

C. ABA — Tax Section Links
http://www.abanet.org/tax/sites.html

D. Accounting Net
http://www.accountingnet.com/index.asp

E. AICPA — Links
http://www.aicpa.org/

F. Chicago Kent Links
http://www.kentlaw.edu/clc/lrs/lawlinks/taxes.shtml

G. Cyber CPA Links
http://www.cyber-cpa.com/research.html

H. Emory — Tax Links
http://www.law.emory.edu/FOCAL/tax.html

I. Emory — T&E Links
http://www.law.emory.edu/FOCAL/trusts.html

J. Guidestar — Charity Info
http://www.guidestar.org/index.html

K. Time Value Software — Links
http://www.timevalue.com/links.htm

L. Johnson’s Tax Page
http://www.unf.edu/students/jmayer/tax.html

M. ONU — Links
http://www.law.onu.edu/faculty/haight/tax_sites.html

N. PPC Tax — Links
http://www.ppcinfo.com/links.htm

O. Rutgers — Links
http://www.rutgers.edu/Accounting/raw/internet/tax.htm
P. Schmidt — Links
http://www.taxsites.com/

Q. Teahan — Links
http://www1.mhv.net/~teahan/weblaw.htm

R. Tax Law Sites
http://members.tripod.com/inetgroup/tax/

S. Tax Sites — Emory
http://www.law.emory.edu/LAW/refdesk/subject/tax.html

T. TaxMaster — Links
http://vls.law.vill.edu/prof/maule/taxmaster/taxhome.htm

U. TaxResources — Links
http://WWW.TaxResources.Com/

V. Kent Info — Links
http://www.kentis.com/siteseeker/taxlink.html

W. Essential Links — Taxes
http://www.el.com/elinks/taxes/

X. TaxWeb — Links
http://www.taxweb.com/

Y. TaxWorld — Links
http://www.taxworld.org/

Z. Will Yancey — Links
http://www.willyancey.com/

VI. Gateway Sites — International Tax Links

A. Canadian Legal Resources
http://www.mbnet.mb.ca/~psim/can_law.html

B. Canadian Tax Links

C. International Tax Links
http://www.taxsites.com/international.html
VII. Gateway Sites — State Tax Forms & Links

A. AICPA State Information
   http://www.aicpa.org/states/info/index.htm

B. Colorado Tax Forms
   http://www.state.co.us/gov_dir/revenue_dir/forms_download.html

C. Cyber CPA — State Tax Forms
   http://www.cyber-cpa.com/statetax.html

D. Federation of Tax Administrators — State Tax Forms

E. Schmidt — State & Local Taxes
   http://www.taxesites.com/state.html

F. Sales/Use Tax Registration Forms — Multi State Tax Commission
   http://www.mtc.gov/txpyrsvs/actualpage.htm

VIII. Internal Revenue Code

A. Internal Revenue Code (via Cornell) - 1/26/98 - Can be Updated
   http://www.law.cornell.edu/uscode/26/

B. Internal Revenue Code (via Walker) - 1/24/94 - Not Updated
   http://www.fourmilab.ch/ustax/ustax.html

C. Internal Revenue Code (via MIT) - 10/21/93 - Not Updated
   http://www.tns.lcs.mit.edu:80/uscode/

IX. Internal Revenue Service

A. IRS Gateway

B. Plain Language Regulations

C. Exempt Organization Search
D. Forms and Publications

E. Summary of 1997 Tax Law

F. Internal Revenue Bulletins

G. Join the Digital Dispatch Mailing List

H. Latest AFR Rate

I. Comment on Proposed Regulation

J. Tax Professional's Corner

K. Code and Subject IRS Telephone Directory
http://www.timevalue.com/irsindex.htm

X. Internet - Intro to Legal Research

A. Guide to Legal Research (ALI-ABA)
http://www.ali-aba.org/aliaba/intro.htm

B. Compleat Internet Researcher

C. Government INFOMINE Search Screen
http://infomine.ucr.edu/search/govpubsearch.phtml

D. How to Use the Internet for Legal Research

E. Law-on-the-Internet Booklist
http://www.abanet.org/lpmJmagazine/booklist.html

F. Internet for the Trusts and Estates Lawyer
http://members.iex.net/~jghodges/t&etxt13.htm
G. Robot-Driven Search Engine Evaluation Overview

H. Virtual Chase - Internet Research

XI. Legal Search Engines

A. All Law - Internet Gateway
   http://www.alllaw.com/

B. FindLaw - Internet Resources
   http://www.findlaw.com/

C. FindLaw - Law Crawler
   http://www.lawcrawler.com

D. Lawguru.com - Legal Research
   http://www.lawguru.com/search/lawsearch.html

E. Law Runner - Legal Research
   http://www.lawrunner.com/

XII. Tax Associations and Organizations

A. American Institute of CPAs
   http://www.aicpa.org/

B. American Bar Association - Tax Section
   http://www.abanet.org/tax/home.html

C. Tax Associations - Schmidt
   http://www.taxsites.com/associations.html#tax

XIII. Tax News and Current Developments

A. AICPA - News Flash

B. Deloitte Touche - Tax News and Views
   http://www.dtonline.com/tnv/tnv.htm
C. Ernst & Young - TaxCast
http://www.taxcast.com/ft-taxonews.htm

D. IRS - New Stand

E. PPC - Five Minute Update
http://www.ppcinfo.com/taxprod/5-min.htm

F. PriceWaterhouseCoopers - Tax News Update
http://www.taxnews.com/tnn_public/

G. Tax Analysts -
http://www.taxbase.org/

H. Tax Analysts -
http://www.tax.org/TaxWire/taxwire.htm

XIV. Tax Publishers --- Print and Electronic

A. ABA Publishing
http://www.abanet.org/abapubs/home.html

B. AICPA Catalog
http://www.aicpa.org/store/index.htm

C. ALI-ABA Publications
http://www.ali-aba.org/aliaba/catpage.htm

D. Bureau of National Affairs
http://www.bna.com/

E. Commerce Clearing House
http://www.cch.com/

F. Lexis
http://www.michie.com/

G. Lexis.com
http://web.lexis.com/xchange/

H. Loislaw
http://www.pita.com/
I. Matthew Bender & Co.
http://www.bender.com/

J. Practising Law Institute
http://www.pli.edu/

K. Practitioners; Publishing Company
http://www.ppcinfo.com/

L. Research Institute of America
http://www.riatax.com/

M. Shepard's/McGraw Hill
http://www.shepards.com/

N. Tax Analysts
http://www.tax.org/default.htm

O. Versus Law
http://www.versuslaw.com/

P. Warren, Gorham & Lamont
http://www.wgl.com/

Q. WestDoc
http://westdoc.com/welcome/default.wl?rs=WDOC1.3&vr=1.0

R. West Group On-Line Store
http://store.westgroup.com/

S. WestLaw
http://www.westlaw.com/
RECENT DEVELOPMENTS IN PLANNING FOR DISTRIBUTION OF RETIREMENT BENEFITS BEFORE AND AFTER DEATH

Edward A. Rothschild
Rothschild, Aberson & Miller
Louisville, Kentucky

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SECTION G
IMPORTANT NOTICE

This seminar outline and the seminar presentation is intended to provide the participants with guidance in estate planning and administration. The materials and the comments of the speaker do not constitute, and should not be treated as, legal advice regarding the use of any particular estate planning technique or the tax consequences associated with any such technique. Although every effort has been made to assure the accuracy of this material and comments, the speaker does not assume responsibility for any individual’s reliance on the written or oral information disseminated. You should independently verify all statements made in this outline and at the 28th Annual Estate Planning Institute held on July 13, 2001 before applying them to a particular fact situation, and you need to independently determine both the tax and non tax consequences of using any particular estate planning technique before recommending that technique to a client or implementing it on a client’s or your own behalf.
# Recent Developments in Planning for Distributions of Retirement Benefits Before and After Death

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**Section G**
I. GENERAL COMMENTS

We are finding quiet frequently that the largest single asset in our clients' estates are the total of their qualified plan and IRA accounts. These assets have very unique tax implications and are extremely hard to deal with in adopting practical estate planning for our clients. However, on January 17, 2001, the IRS' New Proposed Regulations on minimum required distributions (hereinafter referred to as 'MRD") were published in the Federal Register. These proposed regulations replace the proposed regulations originally issued on July 17, 1987 relative to the required minimum distribution rules. IRA owners and participants in qualified plan (hereinafter referred to as “Participant”) may elect to rely on these proposed regulations for distribution made in the 2001 calendar year and this regulations is mandatory for the calendar year 2002 and thereafter. We will address these changes including updating Roth IRA’s, in this Lecture. The interplay of the various income, excise and transfer taxes creates an array of opportunities, some of which will be simpler beginning in calendar year 2001. However, when dealing with qualified plans and IRA distributions careful planning is still imperative to save your clients sizable tax dollars.

II. REQUIRED BEGINNING DATE FOR QUALIFIED PLANS AND TRADITIONAL IRA’S

A. The required beginning date is the date on which periodic payments have to be paid to the qualified plan or IRA participant. The required beginning date (RBD) is normally April 1 immediately following the year in which the participant or IRA owner reaches age 70 ½.

B. The exception is if the participant of a qualified plan is still employed at age 70 ½ and owns less than a 5% equity interest in the employer, then he or she can postpone the mandatory pay out period until April 1 immediately following the date of retirement. (Small Business Protection Act of 1996).

1. One problem with the new definition of RBD under the 1996 Act is the uncertainty of the term “Retires”.

a) Must the participant work full-time or will merely be working on a part-time basis to qualify to defer the commencement of required distributions until sometime after the participant reaches 70 ½.

b) A non-binding discussion of “retiree” by IRS representatives have stated that 5% owner and retirement status are
determined separately for each qualified plan in which the individual participates. If so it appears that:

(i) A participant will be required to take distributions from plans in which he or she participated that are sponsored by employers for whom the participant no longer works, even though the participant continues to work for another employer after reaching age 70 ½.

(ii) A participant in a plan sponsored by an employer with respect to which the participant was a more than five-percent owner will be able to roll his or her accrued benefit into the plan of a new employer with respect to which the participant is not a more than five-percent owner and thereby defer the payment of the accrued benefit until he or she retires from the new employer.

C. If a participant dies before reaching his or her RBD and he or she has a designated beneficiary as of December 31 of the calendar year following the calendar year of his or her death, the minimum distribution rules require that the deceased participant’s plan benefits and IRAs be distributed over the designated beneficiary’s life expectancy, beginning no later than the end of the calendar year after the participant dies. Prop. Treas. Reg. §§ 1.401(a)(9)-3,A-3(a) and 1.401(a)(9)-5,A-5(b).

1. If the participant’s sole designated beneficiary is his or her surviving spouse and the spouse does not rollover the benefits, the distribution must commence by the end of the calendar year in which the participant would have reached age 70 ½. Prop. Treas. Reg. § 1.401(a)(9)-3, A-3(b). However, if the spouse rolls over the benefits, the spouse can wait until he or she is 70 ½ before reaching his or her RBD.

2. If the surviving spouse is the participant’s sole designated beneficiary, while a spouse is alive the applicable distribution period is the spouse’s life expectancy determined each year.

a) Once the spouse dies, the remaining applicable distribution period is the spouse’s life expectancy in the calendar year of his or her death, reduced by one for each calendar year that has elapsed since the year immediately following the calendar year of the spouse’s death. Prop. Tres. Reg. § 1.401(a)(9)-5,A-5(c)(2)

3. Unless the surviving spouse is the participant’s sole designated beneficiary, the life expectancy of the designated beneficiary is determined in the calendar year following the calendar year of the participant’s death, and is reduced by one year for each year thereafter. Prop. Treas. Reg. § 1.401(a)(9)-5,A-5(c)(1).

4. If the participant does not have a designated beneficiary by December 31 of the calendar year following the calendar year of his or her death, (the Estate as an example) the participant’s plan benefits or IRAs must be distributed by the end of the fifth calendar year following the calendar year of the participant’s death. Prop. Treas. Reg. § 1.401(a)(9)-5, A-5(c)(3).
D. If a participant dies after his or her RBD, the remaining plan benefits or IRAs must be paid to the participant’s designated beneficiary over the designated beneficiary’s life expectancy, determined in the year following the calendar year of the participant’s death, reduced by one year for each year thereafter, commencing by the end of the calendar year following the participant’s death. Prop. Treas. Reg. § 1.401(a)(9)-5, A-5(a)(1).

1. However, if the participant’s sole designated beneficiary is the participant’s spouse, the applicable distribution period is the spouse’s life expectancy determined each year until his or her death, when it then becomes the life expectancy of the spouse determined in the calendar year of the surviving spouse’s death, reduced by one for each calendar year that has elapsed since the calendar year immediately following the calendar year of the spouse’s death. Prop. Treas. Reg. § 1.401(a)(9)-5, A-5(c)(2).

2. If there is no designated beneficiary by December 31 of the calendar year following the calendar year of the participant’s death, the applicable distribution period is the life expectancy of the participant determined in the year of his or her death, reduced by one year for each year thereafter, Rather than all the benefits having to be paid out by the end of the calendar year immediately following the participant’s death as under the prior temporary regulation. Prop. Treas. Reg § 1.401(a)(9)-5,A-5(a)(2).

E. Regardless of whether the participant dies before or after his or her RBD, if the spouse is the beneficiary of all or part of the participant’s benefit or IRA, he or she may roll the benefit (or the part of which he or she is beneficiary) into his or her own IRA, or, in the case of an IRA, treat the decedent’s IRA as his or her own IRA. I.R.C. § 402©(9) and Prop. Treas. Reg. § 1.401(a)-8, A-5(a).

1. If the participant dies after his or her RBD, and the required minimum distribution has not been distributed to him or her before his or her death, the required annual minimum distribution for that year would have to be paid to the surviving spouse before the end of the year. Prop. Treas. Reg. § 1.408-8, A-5(a).

2. If the surviving spouse has already reached his or her RBD, he or she must begin receiving required minimum distributions in the year following the year of the participant’s death.

3. Apparently, the election to treat the decedent’s IRA as the spouse’s IRA may be made at any time after the participant’s death. Prop. Treas. Reg. § 1.408-8, A-5(a).


1. An individual beneficiary of a trust may be treated as a designated beneficiary if the trust meets certain requirements. Prop. Treas. Reg. § 1.401(a)(9)-4,A5

2. If there are two or more beneficiaries, only the oldest beneficiary will be treated as a designated beneficiary unless each beneficiary is entitled to a separate share of account. Prop. Treas. Reg. § 1.401(a)(9)-5,A-7(a)(1).

3. If there are two or more beneficiaries and one of the beneficiaries is not an individual, the participant will be treated as not having any designated beneficiary
unless the non-individual beneficiary is entitled to a separate share or a separate account. Prop. Treas. Reg. § 1.401(a)(9)-5,A-7(a)(1).

a) A separate account of a participant’s benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits. Further, the amounts of each such portion of the benefit will be separately determined for purposes of determining the amount of the required minimum distribution. Prop. Treas. Reg. § 1.401(a)(9)-8,A-3(a).

b) A benefit in a defined benefit plan is separated into segregated shares if it consists of separate identifiable components that may be separately distributed. Prop. Treas. Reg. § 1.401(a)(9)-8, A-3(b).

4. An individual, to be treated as a designated beneficiary, must be designated under the terms of the plan, including an affirmative election by the participant pursuant to the terms of the plan. Prop. Treas. Reg. § 1.401(a)(9)-4,A-1.

a) An individual who becomes entitled to the benefit under applicable state law is not a designated beneficiary. Prop. Treas. Reg. § 1.401(a)(9)-4, A-1.

b) Although not free from doubt, the participant will not have a designated beneficiary if his or her estate is the named beneficiary, even though an individual becomes entitled to receive the benefit by December 31 of the year following the year of the participant’s death. Prop. Treas. Reg. § 1.401(a)(9)-4,A-3(a).

III. METHOD OF CALCULATING DISTRIBUTIONS

A. Required Minimum Distribution

The new proposed regulations simplify the minimum required distribution rules by providing a simple uniform distribution table (See Exhibit A) that all participants can use to determine the minimum distribution required during their lifetimes with the exception of a spouse who is more than 10 years younger than the participant where a different table may be used.

B. This table known as the Minimum Distribution Incidental Benefit (hereinafter referred to as a (“UDT”)), eliminates the following prior requirements:

1. The need to determine a beneficiary by the required beginning date.
2. The need to decide whether or not to recalculate life expectancy each year in determining required minimum distributions, and
3. The need to satisfy a separate minimum incidental death benefit rule.

C. The new proposed regulations permit the required minimum distribution during the participants lifetime to be calculated without regard to the beneficiary’s age (except when required
distributions can be reduced by taking into account the age of a beneficiary who is a spouse more than 10 years younger than the participant) and permit the beneficiary to be determined as late as the end of the year following the year of the participant death.

1. When a designated beneficiary is the individual’s spouse and is more than 10 years younger than the participant, the participant and spouse’s actual joint life expectancy can be used to figure MRD’s. (See Table VI (Reg. 1.72-9 IRS Publication 590 Individual Retirement Arrangements and IRS Publication 939.

2. The new proposed regulations allow the participant to change designated beneficiaries after the required beginning date without increasing the required minimum distribution and allows the beneficiary to be changed after the participant’s death, such as by one or more beneficiaries disclaiming or being cashed out.

3. The new proposed regulations permit the calculation of post-death minimum distributions to take into account the participant’s remaining life expectancy at the time of death, thus allowing distributions in all cases to be spread over a number of years after death.

4. There can be a major problem if the beneficiary of the Plan dies before December 31 of the year following the date of the participant’s death.

D. The Uniform Distribution Period:

1. The required minimum distribution is determined by dividing the account balance as of December 31st of each year by the distribution period. For lifetime required minimum distributions, the new proposed regulations provide a uniform distribution period for all participants of the same age.

2. The UDT table is based on the joint life expectancies of the participant and an imaginary survivor 10 years younger at each age beginning at age 70.

3. For years after the year of the participant’s death, the distribution period is generally the remaining life expectancy of the designated beneficiary. The beneficiary’s remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the participant’s death, reduced by one for each subsequent year.

4. If the participant’s spouse is the participant’s sole beneficiary at the end of the year following the year of death, the distribution period during the spouse’s life is the spouse’s single life expectancy. For years after the year of the spouse’s death, the distribution period is the spouse’s life expectancy calculated in the year of death, reduced by one for each subsequent year.

5. If there is no designated beneficiary as of the end of the year after the participant’s death, the distribution period is the participant’s life expectancy calculated in the year of death, reduced by one for each subsequent year.

E. Determination of Designated Beneficiary:

1. These proposed regulations provide that, generally, the designated beneficiary is determined as of the end of the year following the year of the participant’s death rather than as of the participant’s required beginning date or date of participants death as under the 1987 proposed regulations. If participant dies prior to his MRD then decisions on post death distributions must be made no later than December 31, of the year following the
participants' death. If a beneficiary fails to take the first post death MRD based on his single life expectancy by that date then the entire account must be distributed no later than the last day of the fifth year after the year of participants’ death.

The new rules enable those who have already been taking MRD to effectively correct past mistakes which might have included not naming beneficiaries or of selecting a distribution method they later regretted. Since beneficiary designation (other than a much younger spouse) doesn’t effect the MRD and since there’s no longer any choice of distribution methods other than in the spouses exception, past decisions or lack there of are completely wiped out.

2. Thus, any beneficiary eliminated by distribution of the benefit or through disclaimer (or otherwise) during the period between the participant’s death and the end of the year following the year of death is disregarded in determining the participant’s designated beneficiary for purposes of calculating the required minimum distributions.

3. If, as of the end of the year following the year of the participant’s death, the participant has more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary, consistent with the approach in the 1987 proposed regulations.

F. Default Rule for Post-Death Distributions

1. The new proposed regulations change the default rule in the case of death before the participant’s required beginning date for a non-spouse designated beneficiary from the 5-year rule in Code Section 401(a)(9)(B)(ii) to the life expectancy rule in Code Section 401(a)(9)(B)(iii). Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule would apply in all cases in which the participant has a designated beneficiary.

2. As in the case of death on or after the participant’s required beginning date, the designated beneficiary whose life expectancy is used to determine the distribution period would be determined as of the end of the year following the year of the participant’s death rather than as of the participant’s date of death (as would have been required under the 1987 proposed regulations).

3. The 5-year rule would apply automatically only if the participant did not have a designated beneficiary as of the end of the year following the year of the participant’s death.

G. The MDR rules only dictate the minimum amounts that must be taken from qualified plans and IRAs. As under the prior proposed regulations. Participants and beneficiaries thereafter can always take larger distributions if desired.

H. The Economic Growth and Relief Act of 2001 (hereinafter referred to as “2001 Act”, states IRS must review the life expectancy tables used for calculating distributions under the required minimum distribution rules in order to reflect current life expectancies.

1. The preamble of the proposed regulations indicate that the IRS is aware of suggestions that the Section 72 Life Expectancy Tables used to calculate MRD should be revised to reflect increases in longevity because life expectancy has increased
increased since the 72 tables were issued in 1986. Therefore, future tables may be more beneficial to participants, spouses, and beneficiaries who wish to only receive the MRD each year.

2. The 2001 Act does not provide a date by which the IRS must revisit the Life Expectancy Tables

IV. FUNDING A TRUST WITH QUALIFIED RETIREMENT PLAN AND IRA DEATH BENEFITS AS A BENEFICIARY

A. In order for an individual who is the beneficiary of a trust to be treated as the participant’s designated beneficiary, the trust must satisfy four requirements during any period during which required minimum distributions are being determined by taking into account the designated beneficiary’s life expectancy.

1. The trust must be a valid trust or would be a valid trust under state law if it had a corpus.
2. The beneficiaries of the trust entitled to the plan benefits or IRA must be identifiable.
3. The trust must be either irrevocable or, by its terms, will become irrevocable at the participant’s death.
4. Certain documentation requirements must be satisfied.

B. Unless the participant’s designated beneficiary is his or her spouse and the spouse is more than ten years younger than the participant, these requirements (including the documentation requirements) must be satisfied by December 31 of the calendar year following the calendar year in which the participant dies.

1. If the spouse is the designated beneficiary and is more than ten years younger than the participant, these requirements must be satisfied at the RBD.

C. The requirement that the beneficiaries entitled to the plan benefits or IRAs be identifiable is necessary because the age of the oldest beneficiary is required to calculate the minimum distribution.

1. If there are any beneficiaries entitled to the plan benefits or IRAs which do not qualify as designated beneficiaries for purposes of calculating minimum distributions, such as charities or creditors (e.g., funeral expenses, etc.), the participant may be treated as not having a designated beneficiary. PLR 9820021.

D. Under the documentation requirements, the participant or trustee must furnish to the plan administrator by the participant’s RBD or December 31 of the calendar year following the calendar year in which the participant died either the trust instrument or a list of beneficiaries, including contingent and remainder beneficiaries, and the conditions on their entitlement.

1. In addition, the participant or trustee would have to certify that the list is complete and agree to furnish a copy of the trust instrument if requested.
2. If the spouse is the designated beneficiary and is more than ten years younger than the participant, and the trust agreement is amended, a copy of the amendment or corrected certification, if the amendment changes the information certified, must be furnished to the plan administrator within a reasonable time.

3. The documentation requirements are over-broad, since in many cases there will be numerous contingent and remainder beneficiaries that will have to be listed, as well as a description of how they will become entitled to receive a benefit.
   a.) Only the name and age of the oldest beneficiary of each separate share of the trust that is a beneficiary of the trust with respect to the plan benefit is needed by the plan administrator to determine the required minimum distribution.
   b.) A plan administrator will not usually be qualified to interpret the terms of a trust agreement.
   c.) No documentation should be required to be provided to the financial institution sponsoring an IRA, since IRA sponsors are not responsible for determining required minimum distributions and the account holder may take the total of the required minimum distributions calculated separately for each of his or her IRAs from any one or more of his or her IRA. Prop. Treas. Reg. § 1.408-8,A-9.

E. If a trust is the beneficiary of a qualified plan benefit or IRA, the question arises as to which beneficiaries of the trust must be considered in determining who is the oldest beneficiary and whether any beneficiary is not an individual.

1. If at least one beneficiary of the trust that must be considered for this purpose is not an individual, such as a charitable organization, then the participant will be treated as not having a designated beneficiary.

2. Apparently, any potential beneficiary of the trust including a non-individual beneficiary or a beneficiary who is older than the apparent designated beneficiary, must be taken into account in determining whether there is a “designated beneficiary” under the minimum distribution rules, unless such beneficiary would only become entitled to receive distributions from the plan or IRA if a prior individual beneficiary or beneficiaries have died prematurely.
   a.) The IRS has apparently taken the position that the only beneficiaries of the trust who can be disregarded are those who will only become entitled to receive a plan benefit or IRA distribution if he, she or it survives another beneficiary, and that beneficiary would either receive the balance of the plan benefit or IRA if he or she were alive at the relevant event (such as the death of the individual who was the original designated beneficiary), or all required minimum distributions made to the trust must be redistributed to the individual beneficiaries while they are alive.
      i. Example: If a participant names a trust as his or her beneficiary, and under the terms of the trust the oldest beneficiary is the participant’s spouse, then following the spouse’s death the assets of the trust, including the right to receive the remaining plan benefits are payable outright in equal shares to the participant’s three children who survive the spouse, further, if there are no children then living, to a charitable organization, the charitable organization would not be considered in determining
whether the participant had a designated beneficiary, because its entitlement to receive some of the plan benefit or IRA depends on none of the participant's children surviving the spouse. On the other hand, if the trust provided that the trust continues in existence after the spouse's death, and at the death of the last child to die the assets were payable to the charitable organization, the charitable organization would be considered in determining whether the participant had a designated beneficiary unless all required minimum distributions were required to be distributed to individual beneficiaries of the trust when received by the trust.

ii. In addition, at least the terms of the trust must not direct the use of any plan benefit or IRA distributions of the trust being used to pay debts or expenses of the participant's estate, including federal and state estate or inheritance taxes; otherwise the participant may not be treated as having a designated beneficiary because the participant's estate will be treated as a beneficiary of part of the plan benefit or IRA.

3. Some of the above problems can be eliminated after the participant's death by cashing out certain beneficiaries, such as the charity referred to in the example above, or, by having certain beneficiaries disclaim their interests, and by segregating plan benefits or account balances into separate accounts before December 31 of the year following the year of the participant's death. Prop. Treas. Reg. §§ 1.401(a)(9)-4, A-4(a) and 1.401(a)(9)-4,A-7(a).

V. PREMATURE DISTRIBUTIONS

A. A ten percent additional penalty tax is imposed on withdrawals from an IRA or from a qualified retirement plan before the participant attains the age of 59 1/2.

1. The most noted exception to this penalty tax are distributions to a beneficiary prior to age 59 1/2 made because of the death or disability of the participant

2. There are a number of other popular exceptions to the imposition of this penalty tax including the following:

   a. One of those exceptions relates to distributions of substantially equal periodic payments over the life expectancy of the participant or over the joint life expectancies of the participant and his or her beneficiary. For this exception to apply to distributions from a qualified retirement plan, the plan participant must have terminated employment. This termination of employment requirement, however, does not apply to distribution from an IRA § 72(T).

   b. A distribution rolled over to an IRA or another qualified retirement plan.

   c. A distribution to an alternate payee (spouse) pursuant to a QDRO

3. If the payment method changes before the later of five years after payments commence or attainment of age 59 1/2, there is a ten percent recapture tax penalty. The ten percent premature penalty tax is applied retroactively to payments that were previously exempt. An individual who has multiple IRAs can use the equal payment exception for one IRA without having to take distributions from any other IRA. § 72(t)(4); PLRs 9243054, 9050030 and 8946045.
4. Under the 2001 Act, qualified plans must provide that distributions of non-forfeitable accrued benefit of less than 5000 but more than 1000 is made from a qualified plan to an IRA if the participant does not elect to roll the funds into another qualified plan or IRA and does not elect to receive the distribution directly. The Plan Administrator is required not only to make the transfer to an IRA but also must notify the participant in writing that the distribution may be transferred without loss or penalty to another IRA. (see 401(a)(31)(B) and Sec: 402 (F)(1)(A) both as amended by the 2001 Act § 657 (a) (1) and 657 (b))

VI. ROLLOVERS

A. A participant in a qualified retirement plan may avoid current taxation on a distribution by rolling the distribution over into another qualified retirement plan or into an individual retirement plan.

B. There are five types of rollovers:
   1. Amounts may be transferred from one IRA to another.
   2. Amounts may be transferred from a qualified retirement plan to an IRA.
   3. A rollover from one qualified retirement plan to another.
   4. A rollover to a qualified retirement plan from an IRA if all amounts in the IRA are attributable to an earlier rollover contribution from a qualified retirement plan.
   5. A Roth IRA can only be rolled over to another Roth IRA.

C. An eligible rollover distribution is subject to automatic 20% withholding unless the distribution is transferred by a direct rollover to an eligible retirement plan that permits the acceptance of rollover distributions. A direct rollover is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee (i.e., the distribution is made in the form of a direct trustee-to-trustee transfer from a qualified retirement plan to the eligible retirement plan). Y 401(a)(31); Reg. Y 1.401(a)(31)-1.

D. With regard to a rollover from a qualified retirement plan to an IRA, the payout must be transferred into one or more IRAs within 60 days after receipt. It is not necessary, however, to transfer the entire amount into the IRA; but the portion not rolled over is taxed as ordinary income in the year received. However, unless the distribution is transferred by a direct rollover to the IRA, the distribution is subject to automatic 20 percent withholding. Reg. § 1.402(c)-2. In addition, don’t buy stock or other property with any cash distribution without first putting the cash back into the rollover IRA. Reinvesting cash distributions from a qualified plan or Keogh account into other property before depositing the property into a rollover IRA, even within the 60 day rollover period, does not qualify as a rollover contribution and instead, subjects the taxpayer to tax on the entire amount of distribution. Lemishow v. Commr 110 Tex IN011 (1998).

1. The spouse of an participant who receives an eligible rollover distribution from a qualified retirement plan or is the beneficiary of an IRA at the death of the participant, is permitted to roll over all or part of the distribution to an IRA or his or her own. The IRS has also ruled that, if the deceased spouse’s qualified retirement plan benefits are paid to a trust and the trust distributes the benefits to the surviving spouse, the surviving spouse may roll over the distribution. PLRs 9633-43,9633042,9533042, 9509028 and 9234032.
2. If the deceased spouse’s qualified retirement plan benefits are paid to the decedent’s estate and the surviving spouse is the sole beneficiary of the decedent’s residuary estate, IRS has ruled that the surviving spouse may roll over the distribution to an IRA. PLRs 9402023, 9351041, 9229022 and 9138067.

3. The surviving spouse was permitted to roll over the benefit to an IRA when the deceased spouse named a trust as the beneficiary of the death benefit payable from a qualified retirement plan, the trust beneficiaries disclaimed the benefit, and, as a result of the disclaimer, the benefit was paid to the surviving spouse. PLRs 9450041 and 9247026.

4. The surviving spouse may establish an IRA rollover account even if the spouse would not be eligible to establish a regular IRA. However, the surviving spouse may not roll over the distribution to another qualified retirement plan or from the rollover IRA to another qualified retirement plan in which the spouse is a participant. Y 402(c)(9).

5. Generally, a rollover by the surviving spouse is permitted where there is no discretion on the part of someone other than the surviving spouse. PLRs 9721028, 9710034, 9703036, 9626049, 9623064, 9623056 and 9620038.

F. An IRA acquired by a beneficiary upon the death of a non-spouse is an inherited IRA and does not qualify for rollover treatment. To the beneficiary’s own IRA.

G. The following distributions are not eligible as rollovers to an IRA: (Reg. 1.402(c)-2 [Q 7 A 4]

1. ESOP Dividends. Deductible dividends paid to participants by an ESOP. Therefore, a rollover of appreciated employer securities does not defer tax on net unrealized appreciation.

2. Life insurance policies.

3. A participant’s loan that is treated as a distribution is therefore not eligible for rollover. (Reg. 1.402(c)-2 [Q & A 4(d)].)

VII. LUMP SUM DISTRIBUTIONS FROM RETIREMENT PLANS

A. A lump-sum distribution is a distribution from a qualified retirement plan made within one taxable year to the recipient, represents the balance to the credit of the participant and meets the following requirements:

1. Only applicable to individuals born prior to January 1, 1936.

2. On account of separation from service in the case of an employee participant; or

3. On account of the participant’s death or,

4. On account of disability in the case of a self-employed individual. Disability for this purpose means unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration. Y 72 (m) (7).

B. “One taxable year” will usually be the calendar year.

C. To satisfy the requirement that the distribution be the “balance to the credit” of the participant, all pension plans are aggregated and all profit sharing plans are aggregated. A participant may receive a lump-sum distribution from a pension plan in one year and a lump-sum distribution from a profit sharing plan in a later year. However, special income averaging can only
be elected one time. A money purchase pension plan is aggregated with a defined benefit pension plan. Do not take out both profit sharing and pension plan benefits entirely in the same year. Lump sum treatment is not automatic, it has to be elected by filing Form 4972.

D. The taxable amount of a lump-sum distribution is the total distribution reduced by the participant’s basis, unrealized appreciation on employer securities (unless an election is made to include such unrealized appreciation) and accumulated deductible participant contributions plus income attributable to such contributions.

E. Lump sum averaging now only available to a participant born prior to 1936 (currently over 65 years of age). The recipient may elect ten-year averaging only. The calculation is computed as follows:
1. In calculating the ten-year averaging tax on a lump-sum distribution, based on the 1986 single, individual Federal income tax rates.
2. If the participant was age 50 on January 1, 1986, and commenced participation in the plan prior to 1974, then a portion of the distribution may be taxed as long-term capital gain at the 20 percent capital gain rate that was in existence in 1986. TRA’86, Act Y 1122(h) (3).
3. A lump sum distribution is excluded from the recipient’s adjusted gross income (AGI) Y 402(d) (3); Y 62(a)(8).
4. Only individual estates and trusts can elect to lump sum average. Partnerships or corporations will not qualify. Y 402(d) (4) (B).
5. The special tax treatment of a lump-sum distribution is not available to IRA’s, SEP-IRA’s or 403(b) Plans or if any part of the distribution is rolled over either to another qualified retirement plan or an individual retirement plan.

VIII. ROTH IRA

A. For taxable years beginning after 1997, TRA’97 created a new nondeductible IRA called the Roth IRA. The income and appreciation inside the Roth IRA is not taxable upon a qualified distribution, if made after five years of Roth IRA participation. However, a Roth IRA, like all other IRA’s is taxable for Federal estate tax purposes.

B. Qualified distributions from a Roth IRA are not included in the taxpayer’s gross income and are not subject to the additional 10% early withdrawal tax. To be a qualified distribution, the distribution must satisfy the five-year holding period and must meet one of four requirements, which are:
1. Individual attains age 59 ½; or
2. made to a beneficiary (or the individual’s estate) on or after the individual’s death; or
3. attributable to the individual being disabled; or
4. A distribution to pay for “qualified first-time home buyer expenses”.

C. Qualification to participate in a Roth IRA is subject to the following adjusted gross income (AGI) limitations: The maximum yearly contribution that can be made to an IRA is phased out for single taxpayers with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000. (Code Section 408A(6)(3). In addition, you are not allowed to rollover a regular IRA into a Roth IRA if a single taxpayer or a joint filer has an AGI in excess of $100,000.

D. Taxpayer and his or her spouse may contribute a maximum of $2,000 each per year to all IRA’s (deductible, and non-deductible Roth IRA’s). The $2,000 annual limit does not include rollover
contributions. Excess contributions to a Roth IRA are subject to a 6% excise tax under Code Sec 4973 (F). Roth IRA contributions are not deductible for Federal income tax purposes.

E. Distribution from one Roth IRA may only be rolled over tax-free to another Roth IRA.

F. There is no rule requiring any distribution to a Roth IRA participant before his or her death. However, unlike the original participant the person who inherits a Roth IRA is required to take distributions. Since the minimum distribution rules apply to all IRA’s including Roth IRA’s after the participants death. Therefore, the same rules apply as to Roth IRA’s based on the participant’s death either before or after the Participant of Roth IRA reaches age 70 ½.

G. Conversions from traditional IRA:
   1. A traditional IRA can be converted or rolled into a Roth IRA as long as the taxpayer is either a single filer or a married person filing jointly whose MAGI does not exceed $100,000. I.R.C. §§ 408A(c)(3)(B) and (d)(3).
   2. The regulations call such a rollover a “conversion”. Treas. Reg. Y 1.408A-8(b)(2).
   3. The $100,000 MAGI limit for traditional IRA to Roth IRA rollovers is determined in the year that the amount is distributed from the traditional IRA.
   4. Effective in 2005, required minimum distributions under I.R.C. Y 401(a)(9) from traditional IRAs and qualified retirement plans are excluded for purposes of the $100,000 MAGI limitation for conversions.

H. You can contribute to a Roth IRA even if you are over 70 ½ years old. However, contributions can only be made if the taxpayer has employment income and his or her adjusted gross income is below the limits discussed above.

I. The deadline for a contribution to a Roth IRA (like a deductible IRA) is the due date for filing the individual’s tax return for the year (without regard to extensions). Code Sec 408A(c) (7). Further, the 5-year holding period begins to run with the tax year to which the contribution relates, not the year in which the contribution is actually made.

J. A Roth IRA must be clearly designated as such in the IRA document Treas. Reg. 1.408A-2

K. A Simplified Participant Pension (SEP) or a Simple Retirement Account may be converted to a Roth IRA.

L. Traditional IRA to Roth IRA conversions are not allowed for married persons filing separate returns IRC 408A(c) (3) (B) (iii)

M. Under the 2001 Act, the maximum annual contribution that can be made to a Roth IRA each year under Code Section 219 (b) (1) (A) as amended by the 2001 Act will be as follows:

<table>
<thead>
<tr>
<th>For taxable years beginning in:</th>
<th>The deductible amount is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005 through 2007</td>
<td>$4,000</td>
</tr>
<tr>
<td>2008 and thereafter</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

N. For individuals 50 or older the increased maximum annual contribution that can be made to a Roth IRA each year will be as follows:

<table>
<thead>
<tr>
<th>For Year:</th>
<th>The deductible amount is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002 through 2004</td>
<td>$3,500</td>
</tr>
<tr>
<td>2005</td>
<td>$4,500</td>
</tr>
<tr>
<td>2006 and 2007</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
2008 and thereafter | $6,000

O. In certain Employee Plans, the employee may elect to make qualified Roth contributions.

IX. CONCLUSION

Important binding decisions to be made by the participant prior to his or her required beginning date to take certain mandatory distributions have been eliminated in the new proposed regulations. There is a single uniform distribution table that fits all except a spouse who is more than ten years younger than the participant, which will result in a smaller minimum annual distribution amount than under the uniform distribution table. It no longer makes any difference what age the beneficiary is or even if there is a beneficiary at or after RBD in determining the minimum required distribution to be paid to the participant. The fact that the designated beneficiary does not have to be determined until the end of the year following the death of the participant, potential post mortem tax planning particularly if the Federal Estate Tax is eliminated or greatly reduced, will still require important post death planning for beneficiaries of qualified plans and IRA's.

The use of trusts as a beneficiary of qualified plan and IRA benefits can increase the pay out period of benefits under the new proposed regulations and result in the long run in paying out more total benefits by increasing the life of the invested qualified plan or IRA funds. However, to accomplish this benefit, careful drafting of both the trust and beneficiary designation is required.

Although leaving the plan or IRA benefits to the participant’s estate is not as harsh as under the prior temporary regulations, still in almost all cases, the estate of the participant should not be named the beneficiary by the participant.

All qualified plan and IRA assets are included in the decedent’s estate, for Federal Estate Tax purposes and in some states for State Inheritance Tax purposes as well. In addition, the following penalty taxes may also be applicable: A 10% penalty for taking out the benefits when the Participant is too young; a 50% penalty if the minimum annual distribution is not distributed when the Participant reaches his or her required beginning date. In addition, a Generation Skipping Penalty tax of 55% can also be assessed if too much of the Participant’s total assets, which includes all qualified plan and IRA benefits, skip a generation which is usually grandchildren, but not always.

The Roth IRA has some sizable benefits over the years but is not available to many of our clients because of the adjusted gross income limitations. Very careful overall tax planning needs to be considered prior to transferring a taxable IRA into a Roth IRA.

Therefore even now after the proposed regulations the total value of the participant’s qualified plan and/or IRA benefits can still be reduced by up to 80% in taxes through the combination of income taxes, death taxes, and generation skipping taxes.

The new proposed regulations do not reduce the careful estate planning needs during the lifetime of the participant and following the participants death.
NOTE: The distribution period is based on the joint and last survivor expectancy of an individual with an age in the first column and a beneficiary 10 years younger than the participant redetermined each year. The applicable percentage, is rounded to four decimal places, determined by dividing the distribution period into 100. However, if the participant's designated beneficiary is a spouse who is more than ten years younger than the participant, the applicable distribution period is their joint and last survivor expectancy as redetermined each year under Table VI under the new proposed regulations.
FAMILY LIMITED PARTNERSHIPS AND
THE U.S. TAX COURT

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SECTION H
FAMILY LIMITED PARTNERSHIPS AND THE U.S. TAX COURT

What Should Be Learned From The Jones, Knight, Shepherd and Strangi Cases?

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SECTION H
Family Limited Partnerships and the U.S. Tax Court (What should be learned from the Jones, Knight, Shephard and Strangi Cases?)

The purpose of this presentation is to consider four cases decided within the past year that relate to the valuation of partnership entities established for estate planning purposes. I was consulted as an expert and had post-trial discussions in two of the cases and have familiarity with the parties in the other two cases tried. In addition, I plan to discuss some other cases that settled before trial, the valuation and litigation strategies of the parties, and the range of outcomes I am seeing as an expert in these cases. Time permitting, I may further outline some of my own preferences for estate planning and the ranges of discounts and approaches I tend to apply as a function of the types of assets and interests being evaluated.

The lessons from these cases and experiences are as follows:

1. The Tax Court appears to be disinclined to disallow the form of the entity from which gifts are being made or interests held in the estate are valued; thus, the variety of recent arguments advanced by the IRS as to why family limited partnerships should be deemed legally invalid for gift and estate tax purposes.

2. The Tax Court will strictly and liberally apply the willing seller concept to reduce the applicable discounts and restrictions, consider control aspects of all of the interests contained in a single gift or estate, and apply other aspects of
the transfers to invalidate or reduce the discounts applied to the underlying property transferred to a partnership.

3. The Tax Court will tend to choose discounts for lack of control and lack of marketability that are: (i) based on appropriate market data; (ii) carefully explained in the context of the market data considered; and (iii) moderate in amount. The court is likely to find disfavor with experts that appear to be stretching to excessive discounts, including double discounting or assuming the worst restrictions to be applicable, or that look at the issue from the "willing buyer" perspective and ignore the "willing seller" perspective.

4. Absent the legal issues, there is a fairly tight range of minority interest discounts applied by most experts in these cases. Experts tend to use closed-end fund discounts to determine discounts for lack of control. Experts will tend to differ more on discounts for lack of marketability. These differences are based on their interpretation and application of the restricted stock studies and observed secondary market discounts for limited partnerships. I often find these minority and lack of marketability discount issues resolved or settled at trial.

Estate of Albert Strangi, Deceased, Rosalie Gulig, Independent Executrix, Petitioner, v. Commissioner of Internal Revenue, Respondent

This case was tried in September 1999 and decided by Judge Cohen. The decision was filed on November 30, 2000, at 115 T.C. No. 35.
The issues for decision were: (1) whether the Strangi Family Limited Partnership (SFLP) should be disregarded for federal tax purposes because it lacks business purpose and economic substance; (2) whether SFLP is a restriction on sale or use of property that should be disregarded pursuant to section 2703(a); (3) whether the transfer of assets to SFLP was a taxable gift; and (4) the fair market value of decedent’s interest in SFLP at the date of death.

Note: Our firm had discussions with counsel for both the respondent and petitioner but was disqualified from appearing at trial due to a conflict.

SFLP was formed on August 12, 1994, as a limited partnership in Texas with a 1% corporate general partner, Stranco. A total of $9,876,929 was contributed to the partnership upon formation. Approximately 75% of that amount was composed of cash equivalents and marketable securities. The remaining 25% included real estate and other income rights.

The decedent owned 47% of Stranco and Ms. Gulig purchased 53% of Stranco on behalf of herself and the three children of decedent. Thus, the general partner was owned 47% by decedant and 13.25% each by four individuals. [This was extremely helpful in obtaining discounts. The lack of a controlling shareholder of Stranco and the purchase of shares in Stranco by the decedent’s heirs allowed for the minority status of decedent’s interests to be sustained and full discounts on valuation to be realized.] Mr. Gulig, spouse of Ms. Gulig, was employed to manage the daily affairs of SFLP and
Stranco on behalf of the partners. [This was also a very helpful fact. It meant that a separate individual with the capacity to perform management services was responsible to the partnership and Stranco.]

From September 1993 until his death on October 14, 1994, the decedent was ill (died of cancer) and had 24-hour home healthcare. [The fact of the illness, lack of capacity, and potential risk of death led respondent to argue that the SFLP was set up solely as a device for reducing estate taxes.] A person providing services to decedent hurt her back and her medical surgery was paid for by the partnership. [Not a good fact for the estate. Potentially establishes a failure to operate SFLP independent of donor.]

In 1995, SFLP made distributions to the estate of $3,187,800 in order to allow the estate to pay inheritance taxes. Also, distributions to the heirs were made in 1995 and 1996. The partnership extended lines of credit to the individuals partners in 1996 and established divided accounts for the four heirs. In 1997, SFLP advanced funds to the estate to post bonds in connection with the review of the estate tax issue. [These facts were used by the respondent as evidence of a lack of substance and of the lack of a legitimate business purpose for the SFLP.]

Discussion of the Legal Findings

I was surprised by the court’s findings on pages 13 and 14 of the opinion. I felt that there were legitimate business and estate preservation motives that the court appeared to dismiss in its opinion. This appeared to reflect to court’s lack of appreciation of the risks that can arise once a decedent is no longer available and the risks in this
instance. In my own experience, [see my Thursday presentation] the risks of suits and litigation involving the estate are real and more common than the court realizes.

That being said, my concerns were over the following issues: (1) a failure of the decedent to make timely gifts or to sell or convey a larger percentage of SFLP during his lifetime; (2) the short amount of time between the date of formation of SFLP and the date of death; and (3) the use of funds from SFLP to serve the interests of the estate both before and after the date of death. Thus, reading the opinion of the court up to page 15 would lead to the conclusion that the court would disallow the discounts associated with interests in SFLP and sustain the legal position of the respondent. Indeed, Judge Parr, in a dissent [pages 29-31] reaches the conclusion that no valuation discounts should be allowed for this reason. Nevertheless, on page 16, the court finds that SFLP was validly formed and, despite the “subjective intentions” [in other words, tax motives], the form of the partnership should be respected.

The court also rejects that respondent’s argument that the effect of placing assets in a partnership creates a restriction on the transfer or sale that should be disregarded under section 2703(a).

The court further rejected the gift on formation argument raised by the petitioner on pages 19 to 21 of the opinion. The court appears to find the respondent’s arguments to be persuasive in a number of ways, but concludes that the arguments should be applied in assessing the credibility of the experts. “Realistically, in this case, the disparity between the value of the assets in the hands of the decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift.” [page 21]
After speaking with the attorneys for both sides after this decision, both were of the opinion that the court is saying two things: First, the court is likely to decline to rule that FLPs established consistent with state laws are invalid and that the discounts associated with FLPs should be ignored for gift or estate tax purposes; and second, the court is inclined to consider many of the arguments made by the respondent as strong evidence for limiting the discounts off of net asset value allowed by the court in such cases.

*Discussion of the Valuation Issues*

One important finding in this case is that the court ruled that the estate’s ownership of a 47% interest in the 1% general partner corporation, Stranco, and a 99% limited partnership interest should be valued together, not as separate assets. The court stated [page 23], “We agree with respondent that the relationship between the limited partnership interest and the interest in Stranco cannot be disregarded. The entities were created as a unit and operated as a unit and were functionally inseparable.”

Petitioner’s counsel is of the opinion that this conclusion was inappropriate under the law. It is an indirect means of the court considering intrinsic value, as opposed to fair market value. Intrinsic value is the value to a specific willing buyer or willing seller. Intrinsic value may greatly exceed fair market value in a valuation of a family limited partnership interest. I have heard debates on both sides regarding this issue and, as a valuation expert, have to rely on the advice of counsel about how to address this issue in a report prepared for estate and gift tax purposes and for trial.
One means of avoiding the aggregation of interests held by the estate is to gift away the general partnership shares entirely or to ensure that a substantially smaller percentage of the general partnership corporation remains in the estate. We typically prefer to see the gifts of minority equity interests in the corporation’s general partnership occurring at a separate time and as a separate event from other gifts and transactions involving the partnership. This will ensure that there will be no attribution of elements of control to the estate’s remaining interests in the partnership. In the alternative, we prefer to see limited partnership interest gifted away in sufficient amounts prior to the date of death to avoid the court arguing that the estate still owns most of the partnership and has the power to affect the affairs of the partnership or to remove the general partner.

The original valuation report and the valuation presented by taxpayer’s expert at trial were both weak in terms of substance, support, and analysis. The level and quality of the support for the 25% marketability discount, 25% minority interest discount, and 43.75% combined discount off of net asset value was limited. Respondent’s expert valued the 99% limited partnership interest with a 25% discount for lack of marketability and an 8% minority interest discount. Respondent’s expert valued the 47% interest in the general partnership with a 25% discount for lack of marketability and a 5% minority interest discount due to the relative size of the interest as a percentage of Stranco. [We often refer to this as a split-interest discount. A split interest discount recognizes that an equity interest representing less than 50% of the total voting interests may have elements of control due to the lack of a larger block of interests and the substantial size of the interest relative to the other equity interests.]
Our review of the expert reports concluded that the respondent’s expert was more correct in his determination of value. Neither report adequately considered the mix and type of assets in the determination of the marketability discounts, but the use of closed-end fund discounts by respondent’s expert for the determination of a minority interest discount was sound and standard valuation practice. Petitioner’s counsel was complimentary of respondent’s expert on this issue and relatively pleased with a combined discount in excess of 30%.

The court clearly implied that it would have chosen a lower discount had the respondent provided expert testimony for it. The court stated, “We believe that the result of respondent’s expert’s discount may still be overgenerous to petitioner, but that result is the one that we must reach under the evidence and under the applicable statutes.”

Conclusions

My understanding is that the respondent viewed this as a test case and litigating vehicle. The hope was to invalidate FLPs for valuation purposes in estate and gift tax cases. It is clear that the issues of economic substance, motive, and business purposes are fact specific and may continue to lead to challenges to the form of the FLP. In most of the FLPs I have been involved in valuing, I do believe the facts will support a finding of economic substance, business purpose, or other purpose beyond the mere reduction of estate and gift taxes. The majority of the court appears to be saying that the form will generally be respected and discounts will be allowed even when the motives appear to be primarily, if not exclusively, based on the reduction in estate taxes. The majority of the
court also appears to be of the view that the discounts that should be allowed in these cases must be moderate and limited by the facts and circumstances.

It should be noted that respondent is becoming more aggressive on the discount issue. As the Knight case will demonstrate, one approach is attack the petitioner's expert and leave the estate with no alternative. The other approach is a find an expert that believes that the discounts for lack of marketability are less than 25%. For example, one expert being used by the respondent is of the opinion that the appropriate marketability discount is only 7% to 8% of average. While his methodology and conclusions are flawed (and I have written rebuttals to that analysis), he is forcing some taxpayers in docketed cases to settle for lower discounts.

Ina F. Knight, Petitioner v. Commissioner of Internal Revenue, Respondent and Herbert D. Knight, Petitioner v. Commissioner of Internal Revenue, Respondent

This case was decided by Judge Colvin in an opinion filed on November 30, 2000, at 115 T.C. No. 36.

On December 28, 1994, the Petitioners established a trust with one of the donors as the trustees, a family limited partnership with the management trust as the general partner, and two trusts (one for each of the petitioners' two adult children). Three parcels of land and financial assets were transferred into the partnership and gifts of 22.3% each were made by each petitioner to each of their two children's trusts. The four gifts represented 89% of the partnership interests.

Counsel for the respondent was the same as in the Strangi case.
Petitioners transferred into the partnership $10,000 in cash, approximately $1.06 million worth of a municipal bond mutual funds, $460,000 in U.S. Treasury notes, an insurance policy worth $52,000, a ranch (with mineral rights) valued at $182,000, and two residential properties valued at $312,000.

The partnership was managed by the petitioner through a management trust. The partnership did not buy or sell significant assets (other than the roll-over investments as they matured in comparable securities), manage a business (other than a modest amount of cattle on the ranch), or rent property. The real property was primarily held and used for personal purposes. The Petitioners paid no rent for the use of the two residential properties until December 1998.

Discussion of the Legal Findings

The opinion in this case was issued at the same time as the Strangi opinion. The core of the respondent’s legal position was similar to that in the Strangi case (a case in which Judge Colvin concurred with Judge Cohen’s opinion).

The court agreed with the petitioners that the form of the partnership should be respected for valuation purposes. The court found that “the transferred interests are interests in a partnership under Texas law. Petitioners have burdened the partnership with restrictions that apparently are valid and enforceable under Texas law.” The court then applied a similar logic to the economic substance issues and did not discuss at length respondent’s arguments as to the lack of economic substance or the fact that certain
subsequent actions by the general partner (such as not requiring rent for the use of real property) established a lack of economic substance.

**Discussion of the Valuation Issues**

Given the common counsel of respondent as in the Strangi case, we were surprised to learn that no expert was offered by the respondent at trial. Petitioner's expert was, accordingly, unreasonably aggressive and arrived at certain conclusions that are outside of the accepted or common range of discounts commonly observed in practice.

First, petitioner's expert applied a 10% portfolio discount. This was based on an article that found that publicly traded conglomerates experienced a 10% to 15% discount off the value of their underlying subsidiaries due to the mix of entities and assets. The study was not accepted by the court as reasonably applicable to the situation in this instance. Furthermore, a conglomeration discount represents part of the minority interest discount. Thus, the expert double-counted the minority interest discount by applying a conglomeration discount.

Second, the petitioner's expert applied a 10% discount for lack of control based on the average discount observed in closed end bond funds. This is probably a lower than appropriate discount given the mix of assets in the partnership. The court, surprisingly, rejected the expert's analysis on the basis that the closed end bond funds are not reasonably comparable. I would concede that the market data relied on by the expert is not as comparable as one would like, but the information provides the best evidence of the minimum minority interest discount.
Third, petitioner's expert applied a 30% discount for lack of marketability based on a review of seven restricted stock studies. The court found that the expert did not demonstrate that the companies in those studies were reasonable comparable and did not explain sufficiently how he accounted for the information in those studies to arrive at his 30% discount.

Finally, the court concluded that the expert was an “advocate” and “not objective.” On that basis, the court largely disregarded the expert's testimony and arrived at a discount of 15% based on the closed end bond fund discount information provided by the expert.

Conclusion

It is interesting that the entire U.S. Tax Court reviewed this opinion and that there was only one dissenting opinion. Judge Foley wrote a concurring opinion indicating that he felt that economic substance issue is not appropriate in these types of cases and is misplaced. He concluded, “If taxpayers, however, are willing to burden their property with binding legal restrictions that, in fact, reduce the value of such property, we cannot disregard such restrictions.” Thus, all but one of the judges agreed with the result, but a few may differ on their respective approaches to some of the legal issues.

The Knight case appears to make clear that attacks on limited partnerships based on a lack of economic substance or lack of business purpose will generally fail. Only in the most extreme cases where the form of the partnership is not respected after the gifts and/or the estate planning is performed contemporaneously with (or even after) the
donor's death, is there much risk of a complete loss of discounts associated with the court disregarding the form of the partnership. The Knight and Strangi cases provide evidence that the court is inclined to be skeptical of large discounts and to favor more moderate or limited discounts with very detailed, asset specific, and partnership specific analyses applied to the specific facts.


The decision in this case was filed on March 6, 2001, at 116 T.C. No. 11.

The lead attorneys for both parties in this case were the same as in the Knight case, with the same counsel for respondent as in the Strangi case, as well.

Two family limited partnerships were formed. In the first (JBLP), decedent contributed real property (a ranch), cattle, and certain personal property in return for a 95.5389 percent limited partnership interest. A son contributed real property (a fractional interest in the same real property) in exchange for limited and general partnership interests in JBLP. In the second (AVLP), decedent transferred real property (surface rights to ranch land) and received an 88.178% limited partnership interest. Each daughter (four total) of the decedent transferred real property (fractional interests in various ranch properties) to AVLP in return for limited and general partnership interests.

Having established each partnership and contributed property on January 1, 1995, decedent then gifted to each of his four daughters a 16.915% limited partnership interest
in AVLP, retaining only 20.518% for himself. Decedent also gifted an 83.08% limited partnership interest in JBLP to his son.

Both partnerships contained restrictions of transferability of interests. JBLP required the written consents of 100% of the partnership interests. AVLP required the written consent of 75% of the limited partners and 100% of the general partners. The partnerships contain certain rights of first refusal with respect to the possible sale of partnership interests to unrelated persons.

Both partnerships also provided rights to remove the general partners. JBLP allowed the holders of at least 51% of the partnership interests to remove the general partner. AVLP allowed the holder of at least 75% of the partnership interests to remove the general partner.

Not surprisingly, respondents raised many of the same legal arguments as in Knight and Strangi as to why the form of the partnerships should be disregarded. Both the respondent and petitioner offered different valuation experts and testimony than was seen in Knight and Strangi.

Discussion of the Legal Findings

The respondent claimed that there was an implied gift upon formation. The court found that it did not enhance the value of the other partnership interests as a result of the contribution of property by the decedent and rejected the gift upon formation theory.

The court similarly rejected the application of section 2704(b) (lapsing restrictions and restrictions of liquidation beyond state law are to be ignored). The court found that
the restrictions were allowed by state law and not more generally restrictive than state law.

The most interesting finding of the court was that the large gift of an 83.08% limited partnership interest in JBLP to the son conferred effective control to the son. The court found that since 51% of the partnership interests could remove and appoint the general partner, this conferred elements of control to the interest gifted and negated most of the discounts that ordinarily would be allowed by the court.

Discussion of the Valuation Issues

The petitioner's expert opined that one should apply a 55% secondary market discount, a 20% lack of marketability discount, and an additional discount for built-in capital gains in evaluating the 83.08% limited partnership interest in JBLP. Respondent's expert opined that no discount was appropriate. The court denied the 55% secondary market discount, denied the built-in capital gains discount, and allowed only an 8% lack of marketability discount.

The petitioner argued that restrictions on approval of the transfers of partnership interests to the hypothetical willing buyers resulted in the requirement that the interest be discounted substantially. The court rejected this argument and found that "self-imposed limitations on the interest, created with the purpose of minimizing value for transfer tax purposes, are likely to be waived or disregarded when the owner of the interest becomes a hypothetical willing seller, seeking the highest price that the interest will bring from a willing buyer." The court found that only an 8% discount for the risk and difficulty
associated with potential litigation upon forced liquidation would be applicable in this instance. [page 25]

The court rejected the built-in capital gains argument by relying on the logic that a willing seller would not unnecessarily encumber a sale by denying the buyer a section 754 election. [pages 26-28] The court distinguished between the cases where a built-in capital gains discount was allowed for the sale of stock in a corporation from the sale of a partnership interest, where a section 754 election was available.

In the valuation of AVLP, petitioner's expert applied a 45% secondary market discount, a 20% discount for lack of marketability, and an additional discount for built-in capital gains. Respondent’s expert allowed for a 38% secondary market discount, a 7.5% lack of marketability discount, and no discount for built-in capital gains.

Both experts relied on average discounts for limited partnership interests quoted in same publication. Since the issue was not properly raised, the court missed the fact that the average discounts cited are highly inappropriate when applied to a specific partnership. First, one must adjust for differences in cash yields. Low cash yields result in substantially greater average discounts. Second, one must adjust for the presence of leverage (debt or more senior interests). Low levels of debt reduce significantly the appropriate discounts. Third, one must adjust for the characteristics of the underlying assets held by the partnership. Ranch land is not a desirable type of property to hold through a limited partnership. The low returns often provided by ranch land cause discounts to be substantially greater than average. Two of these three factors will generally cause discounts to be substantially greater than the average. The low cash
yields (close to zero) and the low returns associated with ranching properties and cattle ranching should typically cause the discounts to exceed 50%.

The court rightly criticized the petitioner’s expert for double discounting, noting that the secondary market discount already includes a discount for lack of marketability. The court, therefore, rejected the application of an additional 20% lack of marketability discount. The court also found that the petitioner’s expert’s “cumulation of discounts does not survive a sanity check.”

The court chose a 40% secondary market discount (rounding up the average discounts cited by the respondent’s expert) and added an additional 8% discount for lack of marketability associated with this partnership beyond the discount suggested by the secondary market discount data. The court, unlike the opinion in Strangi, did not criticize respondent’s expert for being too generous or indicate that respondent’s expert could have reached a lower conclusion as to the appropriate discount.

Conclusion

The court again indicated a tendency to respect the form of the partnership but to apply the specific aspects of each partnership to each interest being evaluated with a critical eye toward not allowing large discounts. The court will apply very strictly the willing seller test to assert that a group of interests in a single gift or single estate should be valued as a group when a willing seller would not logically divide or separate the interests received because those interests provide elements of control value. Arbitrary or extra provisions that appear to discourage or restrict willing buyers from paying full
value are not necessarily rejected outright, but, rather, emphasis is placed on what a reasonable willing seller would seek (in reducing or eliminating such restrictions) when attempting to sell an interest to a willing buyer.

The court is signaling a discomfort with large valuation discounts and a tendency to side with respondent’s experts. Petitioner’s experts that go to far or are too aggressive will be rejected.

**J. C. Shepherd, Petitioner v. Commissioner of Internal Revenue, Respondent**

The decision in this case was filed October 26, 2000, at 115 T.C. No. 30.

I was one of the experts on the valuation discounts (offered by respondent). The opposing expert suggested a discount relatively close to the discount suggested in my report and fell within the reasonable range of discounts found in my report. Upon the court’s suggestion, the discount issue was stipulated to at 33% (a 50/50 split between the experts).

In August 1991, the Shepherd Family Partnership (SFP) was created under the laws of the state of Alabama. The partnership involved the father (50%), as the managing partner, and two sons (25% each). The initial capitalization was $10 from the father and $5 from each son.

At or about the same time as the formation of the partnership, the petitioner and his wife each contributed a 50% interest in timberland to the partnership. The timberland had a long-term lease associated with it that effectively limited the use or sale of the land until the lease expired in 2023. The lessee paid a fixed annual rent per acre to the lessor,
increased each year based on a price index. One month later, the petitioner transferred stock in three small banks to the partnership.

Originally, the petitioner reported in 1991 a gift to each son based on the contribution of the leased land and bank stock to the partnership. Since each son owned 25% of the partnership, the gifts were valued at 25% of the value of the assets transferred to the partnership. Petitioner valued the bank stock with a 15% minority interest discount and valued the leased land using a relatively high discount rate. The valuation of the bank stock was not at issue in the notice of deficiency. The valuation of the timber interests was deemed to be too low in the original notice of deficiency.

The petitioner’s counsel argued that the notice of deficiency was in error and, further, that the petitioner should be entitled to claim greater discounts of 33.5% off the valuation of the assets contributed to the partnership. Respondent contended that the valuation of the timberland was proper and that the gifts were actually made to the sons as part of their respective contributions of capital to the partnership.

Discussion of the Legal Findings

The court found that the transfer by the donor was of the property and not an indirect gift to the sons through the partnership. The court further found that a gift could be direct or indirect. An indirect gift is taxable when “the transfer is not made for adequate and full consideration.” Thus, a taxable indirect gift of 25% of the value of the leased timberland and the bank stocks was made to the sons. It would seem to me that had the donors transferred the assets in the partnership at time when they owned 100% of
the partnership and then clearly gifted 25% partnership interests to each of the sons, the result would have been in the favor of the petitioner.

There are concurring, concurring in part, and dissenting opinions issued in connection with this opinion.

Discussion of the Valuation Issues

It is clear from reviewing the opinion and the expert reports that a lot of confusing issues were raised by real estate appraisers that lack understanding of the core concepts underlying the choice of discount rates. It did not help that petitioner offered three experts on the valuation issue (in a case with a notice of deficiency of only $168,577!!!). [Expect some additional comments on this during my presentation.]

I found the overall quality of the analysis by each expert to be deficient. First, the experts used an inflation rate of 1.5% to 1.87% based on historical averages. There are published market studies on inflation expectations that apparently none of the experts looked at. Second, the experts wandered off into a debate over taxable v. untaxable discount rates. It made little sense in the context of modern finance and in the context of timber properties being sold off to pass-through entities that avoid double-taxation in the late 1980s and 1990s. Third, the petitioner’s experts increased the discount rate for the lack of marketability associated with a fractional interest. The court essentially agreed with this concept, even though it is specifically and emphatically rejected in the academic literature. If one does increase the discount rate for the lack of marketability then an additional discount for lack of marketability would be inappropriate and a form of double...
discounting. The amazing thing is that these “experts” appeared to be unfamiliar with some of the discount rates and capitalization rates quoted for timberland in the relevant time period.

After all the confusing testimony, the court’s conclusion of value was $757,064 for the leased land. The court implicitly discounted the 100% valuation of the timberland for lack of marketability and gave too much credence to the pre-tax v. after-tax discussion. My own assessment of the timberland value would have been between $900,000 to $1,000,000, as compared with respondent’s expert’s valuation of $1,547,000 and petitioner’s experts’ valuations of $850,000 and $495,000, respectively.

The final issue was the discount for fractional interests. The court allowed 15% (probably appropriate). The respondent argued for the nominal cost to partition. The petitioner argued for discounts between 15% and 27%, depending on the expert.

Conclusion

The Shepherd case is an example of poor estate planning and overly aggressive claims by the petitioner. In contrast with the real estate experts, the valuation experts generally were in agreement and their issue was settled. The case illustrates how even relatively simple valuation issues can become confused by multiple experts and can confuse the court, as a result.
CASE CITATION LISTING

ESTATE OF ALBERT STRANGI, DECEASED, ROSALIE GULIG, INDEPENDENT EXECUTRIX, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4102-99
Filed November 30, 2000

115 T.C. No. 35 United States Tax Court

INA F. KNIGHT, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
HERBERT D. KNIGHT, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 11955-98, 12032-98
Filed November 30, 2000

115 T.C. No. 36 United State Tax Court

ESTATE OF W.W. JONES II, DECEASED, A.C. JONES IV, INDEPENDENT EXECUTOR, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 13926-98
Filed March 6, 2001

116 T.C. No. 11 United State Tax Court

J.C. SHEPHERD, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2574-97
Filed October 26, 2000

115 T.C. No. 30 United States Tax Court
ETHICAL GUIDELINES FOR THE ESTATES AND TRUST LAWYER

The ACTEC Commentaries On The Model Rules Of Professional Conduct And Notes On Ethics 2000

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SECTION I
ETHICAL GUIDELINES FOR THE ESTATES AND TRUSTS LAWYER:  
THE ACTEC COMMENTARIES ON THE MODEL RULES  
OF PROFESSIONAL CONDUCT AND NOTES ON ETHICS 2000

Bruce S. Ross

I. INTRODUCTION

A. The ACTEC Commentaries on the Model Rules of Professional Conduct

In October 1993, after four years of intensive study and debate, the Board of Regents of the American College of Trust and Estate Counsel ("ACTEC") unanimously adopted the ACTEC Commentaries on the Model Rules of Professional Conduct (the "Commentaries"). Originally authored by Professor John R. Price of the University of Washington School of Law pursuant to a grant from the nonprofit ACTEC Foundation, the Commentaries are designed to give "particularized guidance" to ACTEC Fellows, estates and trusts lawyers generally, and others regarding the professional responsibilities of lawyers engaged in a trusts and estates practice. The Commentaries reflect a concerted and thoughtful effort on the part of experienced probate practitioners to harmonize the "black letter" restrictions of the Model Rules of Professional Conduct (and the Comments thereto) with the ethical dictates of a generally non-adversarial and family oriented trusts and estates practice.

In March 1995 the ACTEC Board of Regents adopted the Second Edition of the ACTEC Commentaries which among other things dramatically expanded the annotations to relevant case law and ethics opinions. In March 1999 the ACTEC Board of Regents approved the Third Edition of the Commentaries (published in October 1999). Unlike the Second Edition, which included numerous substantive additions and editorial changes from the First Edition, the new Third Edition reflects far fewer departures from the prior Edition. The two main editorial additions are new Commentaries on Rule 1.16 (Declining or Terminating Representation) and Rule 3.7 (Lawyer as Witness). The Third Edition also includes many new Annotations to recent cases and ethics opinions and some very modest editorial changes from the Second Edition. In addition to the foregoing, to make the Commentaries even more user-friendly, the Third Edition includes a Table of Authorities, with citations, organized by state, to all relevant Rules of Professional Conduct, cases and ethics opinions cited in the ACTEC Commentaries. Simultaneously with the publication of the ACTEC Commentaries, the ACTEC Foundation published Engagement Letters: A Guide to Practitioners, a practice guide filled with engagement letter forms designed to be used in conjunction with the ACTEC Commentaries.
B. Ethics 2000

In 1997 the American Bar Association impaneled the Commission on Evaluation of the Rules of Professional Conduct, properly known as "Ethics 2000," under the chairmanship of Maryland Chief Justice E. Norman Veasey. Charged with making an intensive analysis and reevaluation of all Model Rules of Professional Conduct, after three years of study and public debate the Commission issued its Final Report in November 2000. The Commission Report, the recommended changes to the Model Rules of Professional Conduct (hereinafter "MRPC") and related materials are available on the Internet at http://www.abanet.org/cpr/e2k. The complete Commission Report is available for $40 from the Center for Professional Responsibility of the American Bar Association. (To order by phone call the ABA Service Center at (800) 285-2221 and ask for PC No. 5610159.)

According to Justice Veasey, the principal reasons driving the ABA's decision to revisit the MRPC were the growing disparity in state ethics codes and concerns about "some substantive shortcomings and lack of clarity in particular Rules, both exemplified and aggravated by dissonance between Rule text and Comment." The Commission nevertheless retained the basic architecture of the MRPC including "the primary disciplinary function of the Rules, resisting the temptation to preach aspirationally about 'best practices' or professionalism concepts." (Chair's Introduction and Executive Summary.) The Report will now generate further public comments and discussion and, ultimately, will be presented to the ABA House of Delegates for review, debate and approval. Additional changes, some no doubt significant, can be anticipated. Nevertheless, it is fair now to say that many of the recommendations for changes in the MRPC endorsed by the Commission reflect a positive response to long stated concerns of ACTEC that the present MRPC do not adequately address issues specific to different specialties in the profession, including the estates and trusts area.

The following Article selectively discusses and focuses upon the most important of the MRPC discussed by the ACTEC Commentaries. Following the discussion of each selected Commentary is appended a brief summary of any changes to the applicable Model Rule recommended by the Ethics 2000 Commission that appear to be directly relevant to the estates and trusts lawyer.

It is worth noting here that the Ethics 2000 Commission has proposed an addition of several new MRPC, including a new MRPC 1.0, entitled "Terminology", which will elevate the definitions of certain key terms to the status of a formal Rule. Proposed new MRPC 1.0 includes definitions of "confirmed in writing," "informed consent," and other key terms. The concept of "informed consent" replaces the current concept of "consent after
consultation. This proposed change is further discussed infra at the conclusion of the discussion of the ACTEC Commentary to MRPC 1.4.

II. OVERVIEW: THE COMMENTARIES' BASIC THEMES AND STRUCTURE

As stated in the Reporter's Note preceding the ACTEC Commentaries (authored by Professor Price and this author as Chair of ACTEC's Professional Standards Committee):

"Basic Themes of Commentaries. The main themes of the Commentaries are: (1) the relative freedom that lawyers and clients have to write their own charter with respect to a representation in the trusts and estates field; (2) the generally non-adversarial nature of the trusts and estate practice; (3) the utility and propriety, in this area of law, of representing multiple clients, whose interests may differ but are not necessarily adversarial; and (4) the opportunity, with full disclosure, to moderate or eliminate many problems that might otherwise arise under the MRPC." 1

As the Preface to the ACTEC Commentaries notes, "While the Commentaries are intended to provide general guidance, ACTEC recognizes and respects the wide variation in the rules, decisions, and ethics opinions adopted by the several jurisdictions with respect to many of the subjects." 2

The structure of the ACTEC Commentaries follows that of the Model Rules and the comments thereto: Each Model Rule with respect to which ACTEC has offered a Commentary is quoted in full, followed by the Commentary thereon, extensive annotations to relevant case law and ethics opinions from many jurisdictions and other secondary authorities. "The Annotations that follow each Commentary include references to a broad range of the cases, ethics opinions and articles that deal with the professional responsibility of trusts and estates lawyers. Reflecting various approaches taken in different jurisdictions, the cases and ethics opinions are often inconsistent and cannot be harmonized. The summaries of the cases and ethics opinions are not part of the ACTEC Commentaries. They are included for illustrative purposes only and do not necessarily reflect the judgment of the Reporter or ACTEC regarding the issues involved." 3


2 Preface to Commentaries.

3 Commentaries, p. 6.
III. COMMENTARIES ON SELECTED MODEL RULES

A. Commentary to MRPC 1.1: Competence

The most important contribution of the ACTEC Commentaries on Model Rule 1.1, dealing with competence, is the principle that the estate planning lawyer "is generally entitled to rely upon information supplied by the client unless the circumstances indicate that the information should be verified."4 Furthermore, although the ACTEC Commentaries emphasize that the estate planning lawyer should generally supervise the execution of all estate planning documents, if such supervision is not practical, then the lawyer may arrange for the documents to be delivered to the client with written instructions regarding the manner in which they should be executed. (Of course, this principle presupposes the client's ability to understand the instructions given.)

B. Commentary to MRPC 1.2: Scope of Representation

In General

The Commentaries emphasize that the client and the lawyer, "working together, are relatively free to define the scope and objectives of the representation, including the extent to which information will be shared among multiple clients and the nature and extent of the obligations that the lawyer will have to the client."5

Representing Fiduciaries

While recognizing that the lawyer for the fiduciary retained to assist the fiduciary in the administration of an estate or trust generally represents only the fiduciary, the Commentaries permit direct communication between the lawyer and the beneficiaries while noting that the fiduciary is primarily responsible for such communication.

"As a general rule, the lawyer for the fiduciary should inform the beneficiaries that the lawyer has been retained by the fiduciary regarding the fiduciary estate and that the fiduciary is the lawyer's client; that while the fiduciary and the lawyer will, from time to time, provide information to the beneficiaries regarding the fiduciary estate, the lawyer does not represent them; and that the beneficiaries may wish to retain independent counsel to represent their interests."6

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4 Id., p. 22.

5 Commentaries, p. 50.

6 Id., p. 52.
The Commentary to MRPC 1.2 notes that it may be permissible for the lawyer to represent the fiduciary both in a representative capacity and as a beneficiary provided that such representation is not otherwise proscribed by the dictates of MRPC 1.7 (Conflict of Interest: General Rule).

The Commentary notes:

"Example 1.2-1. Lawyer (L) drew a will for X in which X left her entire estate in equal shares to A and B and appointed A as executor. X died survived by A and B. A asked L to represent her both as executor and as beneficiary. L explained to A the duties A would have as personal representative, including the duty of impartiality toward the beneficiaries. L also described to A the implications of the common representation, to which A consented. L may properly represent A in both capacities. However, L should inform B of the dual representation and indicate that B may, at his or her own expense, retain independent counsel. In addition, L should maintain separate records with respect to the individual representation of A, who should be charged a separate fee (payable by A individually) for that representation. L may properly counsel A with respect to her interests as beneficiary. However, L may not assert A's individual rights on A's behalf in a way that conflicts with A's duties as personal representative. If a conflict develops that materially limits L's ability to function as A's lawyer in both capacities, L should withdraw from representing A in one or both capacities. See MRPC 1.7 (Conflict of Interest: General Rule) and MRPC 1.16 (Declining or Terminating Representation)."\(^7\)

The nature and extent of the duties, if any, owed by the lawyer for the fiduciary to the beneficiaries of an estate or trust is one of the most controversial topics touched upon by the Commentaries. The majority of the cases dealing with this issue have found that the attorney's duty to exercise reasonable care is owed only to the fiduciary client.\(^8\) As a California court has observed:

"Particularly in the case of services rendered for the fiduciary of a decedent's estate, we would apprehend great danger in finding stray duties in favor of beneficiaries. Typically in estate administration conflicting interests vie for

\(^7\) Commentaries, pp. 52-53.

recognition. The very purpose of the fiduciary is to serve the interests of the estate, not to promote the objectives of one group of legatees over the interests of conflicting claimants. [Citation omitted.] The fiduciary's attorney, as his legal adviser, is faced with the same task of disposition of conflicts. It is of course the purpose and obligation of both the fiduciary and his attorney to serve the estate. In such capacity they are obligated to communicate with, and to arbitrate conflicting claims among, those interested in the estate. While the fiduciary in the performance of this service may be exposed to the potential of malpractice (and hence is subject to surcharge when his administration is completed), the attorney by definition represents only one party: the fiduciary. It would be very dangerous to conclude that the attorney, through performance of his service to the administrator and by way of communication to estate beneficiaries, subjects himself to claims of negligence from the beneficiaries. The beneficiaries are entitled to even-handed and fair administration by the fiduciary. They are not owed a duty directly by the fiduciary's attorney. [Citations omitted.]

This principle is not accepted in all jurisdictions, however. For example, the Supreme Court of Nevada has ruled:

"[W]hen an attorney represents a trustee in his or her capacity as trustee, that attorney assumes a duty of care and fiduciary duties towards the beneficiaries as a matter of law."[9]

The Supreme Court of Washington has reversed itself on this issue. In 1985, in passing upon the reasonableness of an estate lawyer's fee request, the Court overturned decisions of a court commissioner, the trial court and an appellate court affirming the award of fees and, in so doing, observed:

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10 Charleson v. Hardesty, 839 P.2d 1303, at 1307 (Nev. 1992); see also, e.g., Fickett v. Superior Court, 558 P.2d 988 (Ariz. App. 1976) (held that the lawyer for a guardian owed fiduciary duties to the ward and that privity of contract between the lawyer and the ward was not required in order for the ward to pursue a claim for malpractice against the lawyer for the guardian). For a discussion of the Fickett decision and its implications, see Johns, Fickett's Thicket: The Lawyer's Expanding Fiduciary and Ethical Boundaries When Serving Older Americans of Moderate Wealth, 32 Wake Forest L. Rev. 445 (Summer 1997).
"The personal representative stands in a fiduciary relationship to those beneficially interested in the estate. He is obligated to exercise the utmost good faith and diligence in administering the estate in the best interests of the heirs. The personal representative employs an attorney to assist him in the proper administration of the estate. Thus, the fiduciary duties of the attorney run not only to the personal representative, but also to the heirs. [Citations omitted.]"

Nine years later, in 1994, the Supreme Court of Washington held that a multi-factor balancing test (first applied by the Supreme Court of California in *Binkanja v. Irving*, 320 P.2d 16 (1958)) should be applicable in deciding whether the beneficiary of a decedent's estate may bring an action against the lawyer who represented the executor in her fiduciary capacity. The court concluded:

"After analyzing our modified multi-factor balancing test, we hold that a duty is not owed from an attorney hired by the personal representative of an estate to the estate or to the estate beneficiaries." 12

With respect to this troubling issue of the duties arguably owed to the beneficiaries of the fiduciary estate by an attorney retained to represent the fiduciary generally (i.e., in the fiduciary's representative capacity), the Commentaries conclude:

"The nature and extent of the lawyer's duties to the beneficiaries of the fiduciary estate may vary according to the circumstances, including the nature and extent of the representation and the terms of any understanding or agreement among the parties (the lawyer, the fiduciary, and the beneficiaries). The lawyer for the fiduciary owes some duties to the beneficiaries of the fiduciary estate although he or she does not represent them. The duties, which are largely restrictive in nature, prohibit the lawyer from taking advantage of his or her position to the disadvantage of the fiduciary estate or the beneficiaries. In addition, in some circumstances the lawyer may be obligated to take affirmative action to protect the interests of the beneficiaries. Some courts have characterized the beneficiaries of a fiduciary estate as derivative or secondary clients of the lawyer for the fiduciary. The beneficiaries of a fiduciary estate are derivative clients of the estate of the executor, even though the executor is a separate entity. The estate of the executor is the only client in the proper sense of the term. The beneficiaries are not clients in the same sense, but may be derivative clients of the estate of the executor. The beneficiaries are not primary clients of the attorney but are derivative clients of the estate of the executor. The estate of the executor is the only client in the proper sense of the term. The beneficiaries are not primary clients of the attorney but are derivative clients of the estate of the executor."

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estate are generally not characterized as direct clients of the lawyer for the fiduciary merely because the lawyer represents the fiduciary generally with respect to the fiduciary estate."  

Although the duties undertaken by the lawyer for the fiduciary to the beneficiaries are constricted, it is clear that the lawyer may not make false and misleading statements to the beneficiaries and may, in some jurisdictions, be required to disclose to a court or to the beneficiaries acts or omissions by the fiduciary that might constitute a breach of fiduciary duty.

The Commentaries suggest that this problem may well be resolved by advanced planning with the scrivener of the document including a provision in the will that conditions the appointment of the fiduciary upon the fiduciary's agreement that the lawyer may disclose to the beneficiaries or to an appropriate court actions of the fiduciary that might constitute a breach of fiduciary duty.

The Commentaries include a helpful discussion of the distinction between representing a fiduciary generally and representing the fiduciary individually. Thus, in the latter case, the lawyer represents only the fiduciary when the lawyer is retained for the limited purposes of advancing the interests of the fiduciary and not necessarily the interests of the fiduciary estate or its beneficiaries. Common examples of this type of representation are the retention of an attorney to negotiate with the beneficiaries with respect to the fiduciary's compensation or to defend the fiduciary in litigation charging misadministration.

Comment re Ethics 2000: The Commission Report proposes changing the title of MRPC 1.2 to "Scope of Representation and Allocation of Authority between Client and Lawyer." The new Rule will expressly permit reasonable limitations on the scope of the lawyer's representation and will expressly acknowledge the lawyer's implied authority to take action to carry out the representation.

C. Commentary to MRPC 1.4: Communication

Recognizing that "[c]ommunication between the lawyer and client is one of the most important ingredients of an effective lawyer-client relationship," the Commentaries emphasize that the extent and nature of the communications by the lawyer are affected by numerous factors "including the

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13 Commentaries, p. 57.

14 Commentaries, p. 91.
age, competence, and experience of the client, the amount involved, the complexity of the matter, cost control and other relevant considerations."\(^{15}\)

One of the many important contributions of the Commentaries to the practice of the estate planning lawyer is the notion of the "Dormant Representation."

"The execution of estate planning documents and the completion of related matters, such as changes in beneficiary designations and the transfer of assets to the trustee of a trust, normally ends the period during which the estate planning lawyer actively represents an estate planning client. At that time, unless the representation is terminated by the lawyer or client, the representation becomes dormant, awaiting activation by the client. At the client's request the lawyer may retain the original documents executed by the client. See ACTEC Commentary on MRPC 1.7 (Conflicts). While the lawyer remains bound to the client by some obligation, including the duty of confidentiality, the lawyer's responsibilities are diminished by the completion of the active phase of the representation. As a service the lawyer may communicate periodically with the client regarding the desirability of reviewing his or her estate planning documents. Similarly, the lawyer may send the client an individual letter or a form letter, pamphlet, or brochure regarding changes in the law that might affect the client. In the absence of an agreement to the contrary, the lawyer is not obligated to send a reminder to a client whose representation is dormant or to advise the client of the effect that changes in the law or the client's circumstances might have on the client's legal affairs."\(^{16}\)

The Commentary gives the following helpful examples:

"Example 1.4-1: Lawyer (L) prepared and completed an estate plan for Client (C) in 1992. At C's request L retained the original documents executed by C. L performed no other legal work for C in 1993 or 1994 but has no reason to believe that C has engaged other estate planning counsel.

\(^{15}\) Id.

\(^{16}\) Commentaries, p. 93; see, Pizel v. Zuspann, 803 P.2d 205 (Kan. 1990), modifying 795 P.2d 42 (1990) (modification deleted language from earlier opinion indicating that lawyer had continuing duty to estate planning client to effectuate the client's plan), appeal after remand, 845 P.2d 37 (Kan. 1993).
L's representation of C is dormant. L may, but is not obligated to, communicate with C regarding changes in the law. If L communicates with C about changes in the law, but is not asked by C to perform any legal services, L's representation remains dormant. C is properly characterized as a client and not a former client for purposes of MRPCs 1.7 and 1.9.

"Example 1.4-2. Assume the same facts as in Example 1.4-1 except that L's partner (P) in 1993 and 1994 renders legal services to C in matters completely unrelated to estate planning, such as a criminal representation. L's representation of C with respect to estate planning matters remains dormant, subject to activation by C." 17

Comment re Ethics 2000: The Commission has placed great stress on the importance of clear communication between lawyer and client. Proposed new MRPC 1.0 (Terminology) requires that client consent must be "informed" which is defined to mean a client's agreement "after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." In many cases client consent will be required to be confirmed in writing (principally in situations involving conflict waivers). The Commission proposes to beef up MRPC 1.4 with language covering all aspects of a lawyer's duty to communicate with the client (which includes moving language from some other Rules such as in MRPC 1.2).

D. Commentary to MRPC 1.6: Confidentiality of Information

The nature of an attorney's representation of husband and wife in estate planning and the scope of the attorney-client privilege governing confidential communications in this context were the subject of considerable debate in the years leading up to the adoption of the Commentaries. The majority view is that the most common representation of husband and wife in estate planning is "joint" in nature. Generally, in a joint representation, all communications between either husband or wife to the attorney are confidential as to the outside world but not confidential (at least for evidentiary purposes) as between the husband and wife. Thus, the lawyer's receipt of information from one spouse that the communicating spouse clearly does not wish to share with the other spouse embroils the lawyer in a dilemma central to the lawyer's representation of both spouses. The Commentary to MRPC 1.6 recommends:

"As soon as practicable the lawyer should consider the relevance and significance of the information and decide

upon the appropriate manner in which to proceed. The potential courses of action include, inter alia, (1) taking no action with respect to communications regarding irrelevant (or trivial) matters; (2) encouraging the communicating client to provide the information to the other client or to allow the lawyer to do so; and, (3) withdrawing from the representation if the communication reflects serious adversity between the parties...

In order to minimize the risk of harm to the clients' relationship and, possibly, to retain the lawyer's ability to represent both of them, the lawyer may properly urge the communicating client himself or herself to impart the confidential information directly to the other client. . . . In doing so the lawyer may properly remind the communicating client of the explicit or implicit understanding that relevant information would be shared and of the lawyer's obligation to share the information with the other client. The lawyer may also point out the possible legal consequences of not disclosing the confidence to the other client, including the possibility that the validity of actions previously taken or planned by one or both of the clients may be jeopardized. In addition, the lawyer may mention that the failure to communicate the information to the other client may result in a disciplinary or malpractice action against the lawyer.

If the communicating client continues to oppose disclosing the confidence to the other client, the lawyer faces an extremely difficult situation with respect to which there is often no clearly proper course of action. In such cases the lawyer should have a reasonable degree of discretion in determining how to respond to any particular case. In fashioning a response the lawyer should consider his or her duties of impartiality and loyalty to the clients; any express or implied agreement among the lawyer and the joint clients that information communicated by either client to the lawyer regarding the subject of the representation would be shared with the other client; the reasonable expectations of the clients; and the nature of the confidence and the harm that may result if the confidence is, or is not, disclosed. In some instances the lawyer must also consider whether the situation involves such adversity that the lawyer can no longer effectively represent both clients and is required to withdraw from representing one or both of them. See ACTEC Commentary on MRPC 1.7 (Conflict of Interest: General Rule). A letter of withdrawal that is sent to the other client
may arouse the other client's suspicions to the point that the communicating client or the lawyer may ultimately be required to disclose the information."\(^{18}\)

The Commentary supports the suggestion of the ABA Special Probate and Trust Division Study Committee on Professional Responsibility\(^{19}\) emphasizing the importance of having an agreement between the husband and wife and the lawyer, preferably in writing, that sets out the ground rules of the representation.

The New Jersey Supreme Court in *A v. B v. Hill Wallack*, 726 A.2d 924 (N.J. 1999), cited extensively and approvingly to the Commentary to MRPC 1.6 as well as to the Report of the ABA Special Probate and Trust Division Study Committee on Professional Responsibility. In this case, construing New Jersey's broad client-fraud exception to the New Jersey version of MRPC 1.6, the court held that a law firm that was jointly representing a husband and wife in the planning of their estates was entitled to disclose to the wife the existence (but not the identity) of husband's child born out of wedlock. The court reasoned that the husband's deliberate failure to mention the existence of this child when discussing his estate plan with the law firm constituted a fraud on the wife which the firm was permitted to rectify under MRPC 1.6(c). Interestingly, the law firm learned about the child born out of wedlock not from the husband but from the child's mother who had retained the law firm. The court also based its decision permitting disclosure on the existence of a written agreement between the husband and wife, on the one hand, and the law firm, on the other, waiving any potential conflicts of interest. The court suggested that the letter reflected the couple's implied intent to share all material information with each other in the course of the estate planning.

The Commentary to MRPC 1.6 also suggests that with full disclosure and the consent of the clients it may be possible to represent husbands and wives as separate clients and thereby guarantee the confidentiality of unilateral

\(^{18}\) *Commentaries*, pp. 120-122. Compare *Advisory Opinion* 95-4 (State Bar of Florida May 1997) ("In a joint representation between husband and wife in estate planning, an attorney is not required to discuss issues regarding confidentiality at the outset of representation. The attorney may not reveal confidential information to the wife when the husband tells the attorney that he wishes to provide for a beneficiary that is unknown to the wife. The attorney must withdraw from the representation of both husband and wife because of the conflict presented when the attorney must maintain the husband’s separate confidences regarding the joint representation.")

\(^{19}\) *See*, Moore & Hilker, "Representing Both Spouses: The New Section Recommendations," 7 *Probate & Property* 26, 30 (July/Aug. 1993). The Committee produced three Reports: Comments and Recommendations on the Lawyer's Duties in Representing Husband and Wife; Preparation of Wills and Trusts that Name Drafting Lawyer as Fiduciary; and Counseling the Fiduciary, 28 *Real Property Probate and Trust Journal* (No. 4, Winter 1994).
communications to the lawyer by either spouse if the communicating spouse does not wish to impart them to the other spouse. Although this concept has met with a nearly unanimous negative reaction among academicians in the estate and trust field, ACTEC recognized that several sophisticated, experienced and ethical practitioners follow this practice and deemed it inappropriate to condemn the practice.

With respect to the lawyer's duty of confidentiality to a fiduciary client and the possible disclosure by the lawyer of a fiduciary's breach of duty, the Commentary to MRPC 1.6 emphasizes the importance of the agreement between the lawyer and the fiduciary recommended in the Commentary to MRPC 1.2 and, absent such an agreement, adherence to the applicable law (see text accompanying fns. 6-12, supra).

The Commentary continues:

"Whether or not the lawyer and fiduciary enter into such an agreement, the lawyer for the fiduciary ordinarily owes some duties to the beneficiaries of the fiduciary estate. See ACTEC Commentary on MRPC 1.2 (Scope of Representation). The existence of those duties alone may qualify the lawyer's duty of confidentiality with respect to the fiduciary. Moreover, the fiduciary's retention of the lawyer to represent the fiduciary generally in the administration of the fiduciary estate may impliedly authorize the lawyer to make disclosures in order to protect the interests of the beneficiaries. In addition, the lawyer's duties to the court may require the lawyer for a court-appointed fiduciary to disclose to the court any acts of misconduct committed by the fiduciary. See MRPC 3.3(b) (Candor toward the Tribunal), which requires disclosure to the court 'even if compliance requires disclosure of information otherwise protected by Rule 1.6.' In any event, the lawyer may not knowingly provide the beneficiaries or the court with false or misleading information. See MRPCs 4.1-4.3 (Truthfulness in Statements to Others; Communications with Person Represented by Counsel; Dealing with Unrepresented Person)."

Example 1.6-1 is illustrative:

"Lawyer (L) was retained by Trustee (T) to advise T regarding the administration of the trust. T consulted L regarding the consequences of investing trust funds in

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20 Commentaries, pp. 125-126.
commodity futures. L advised T that neither the governing instrument nor the local law allowed the trustee to invest in commodity futures. T invested trust funds in wheat futures contrary to L's advice. The trust suffered a substantial loss on the investments. Unless explicitly or implicitly required to do so by the terms of the representation, L was not required to monitor the investments made by T or otherwise to investigate the propriety of the investments. The following alternatives extend the subject of this example:

(1) L, in preparing the annual accounting for the trust, discovered T's investment in wheat futures, and the resulting loss. T asked L to prepare the accounting in a way that disguised the investment and the loss. L may not participate in a transaction that misleads the court or the beneficiaries with respect to the administration of the trust—which is the subject of the representation. L should attempt to persuade T that the accounting must properly reflect the investment and otherwise be accurate. If T refuses to accept L's advice, L must not prepare an accounting that L knows to be false or misleading. If T does not properly disclose the investment to the beneficiaries, in some states L may be required to disclose the investment to them. In states that neither require nor permit such disclosures the lawyer should resign from representing T. See ACTEC Commentary on MRPC 1.6 (Confidentiality).

(2) L first learned of T's investment in commodity futures when L reviewed trust records in connection with the preparation of the trust accounting for the year. The accounting prepared by L properly disclosed the investment, was signed by T, and was distributed to the beneficiaries. L's investment advice to T was proper. L was not obligated to determine whether or not T made investments contrary to L's advice. L may not give legal advice to the beneficiaries but may recommend that they obtain independent counsel. In jurisdictions that permit the lawyer for a fiduciary to make disclosures to the beneficiaries regarding the fiduciary's possible breaches of trust, L should consider whether to make such a disclosure.\textsuperscript{21}

\textsuperscript{21 Commentaries, pp. 126-127.}
The recently published *Restatement of The Law (Third), The Law Governing Lawyers*, in dealing with the duty of care owed by a lawyer to certain non-clients, observes:

"For purposes of liability under §48 [Professional Negligence - - Elements and Defenses Generally], a lawyer owes a duty to use care within the meaning of §52 [Standard of Care]:

(4) To a nonclient when and to the extent that:

(a) "the lawyer's client is a trustee, guardian, executor, or fiduciary acting primarily to perform similar functions for the nonclient;"

(b) the lawyer knows that appropriate action by the lawyer is necessary with respect to a matter within the scope of the representation to prevent or rectify the breach of a fiduciary duty owed by the client to the nonclient, where (i) the breach is a crime or fraud or (ii) the lawyer has assisted or is assisting the breach;

(c) The nonclient is not reasonably able to protect its rights; and

(d) Such a duty would not significantly impair the performance of the lawyer's obligations to the client."

The *Restatement* elucidates the foregoing principles with three relevant illustrations:

"5. Lawyer represents Client in Client's capacity as trustee of an express trust for the benefit of Beneficiary. Client tells Lawyer that Client proposes to transfer trust funds into Client's own account, in circumstances that would constitute embezzlement. Lawyer informs Client that the transfer would be criminal, but Client nevertheless

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makes the transfer, as Lawyer then knows. Lawyer takes no steps to prevent or rectify the consequences, for example by warning Beneficiary or informing the court to which Client as trustee must make an annual accounting. The jurisdiction's professional rules do not forbid such disclosures (see § 67). Client likewise makes no disclosure. The funds are lost, to the harm of Beneficiary. Lawyer is subject to liability to Beneficiary under this Section.

6. Same facts as in Illustration 5, except that Client asserts to Lawyer that the account to which Client proposes to transfer trust funds is the trust's account. Even though lawyer could have exercised diligence and thereby discovered this to be false, Lawyer does not do so. Lawyer is not liable to the harmed Beneficiary. Lawyer did not owe Beneficiary a duty to use care because Lawyer did not know (although further investigation would have revealed) that appropriate action was necessary to prevent a breach of fiduciary duty by Client.

7. Same facts as in Illustration 5, except that Client proposes to invest trust funds in a way that would be unlawful, but would not constitute a crime or fraud under applicable law. Lawyer's services are not used in consummating the investment. Lawyer does nothing to discourage the investment. Lawyer is not subject to liability to Beneficiary under this Section."

Comment re Ethics 2000: Revisions to MRPC 1.6 proposed by the Ethics 2000 Commission include, as previously noted, the concept of a client's "informed consent". The Rule will also permit disclosure of information related to the representation to prevent the client from committing a crime or fraud that is reasonably certain to result in "substantial injury to the financial interest or property of another in furtherance of which the client has used or is using the lawyer's services," thus adopting the formulation of the Restatement. Also consistently with the Restatement formulation, the revised Rule permits (but not mandates) disclosure of information related to the representation to "prevent, mitigate or rectify substantial injury to the financial interest or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services." These proposed changes are expected to be controversial.

23 Id., §51, Illustrations 5-7.
E. Commentary to MRPC 1.7: Conflict of Interest: General Rule

One of the Commentaries' most salutary contributions to the literature on the subject of representing multiple client interests is the assertion that, given the generally non-adversarial nature of an estates and trusts practice, in appropriate cases the representation of multiple clients should be positively encouraged.

"It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plans, more than one beneficiary with common interests in an estate or trust administration matter, or more than one of the investors in a closely held business. See ACTEC Commentary on MRPC 1.6 (Confidentiality of Information). In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. The fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them: Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the 'family'. Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. Recognition should be given to the fact that estate planning is fundamentally non-adversarial in nature and estate administration is usually non-adversarial."²⁴

Of course, the Commentaries emphasize the importance of making complete disclosure to all of the affected clients and obtaining the clients' fully informed consent to the representation and urge consideration by the lawyer of possible withdrawal whenever a potential conflict of interest ripens into an actual conflict or controversy.²⁵

Again, the examples given by the Commentaries are instructive:

First, in the estate planning context:

²⁴ Commentaries, pp. 149-150.

²⁵ Id., pp. 151-152.
Example 1.7-1. Lawyer (L) was asked to represent Husband (H) and Wife (W) in connection with estate planning matters. L had previously not represented either H or W. At the outset L should discuss with H and W the terms upon which L would represent them. Many lawyers believe that it is only appropriate to represent a husband and wife as joint clients, between whom the lawyer could not maintain the confidentiality of any information relevant to the representation. However, some experienced estate planners believe that it is appropriate to represent a husband and wife as separate clients, each of whom is entitled to presume the confidentiality of information disclosed to the lawyer in connection with the representation. If permitted by the jurisdiction in which the lawyer practices, the lawyer may properly represent a husband and wife as separate clients. Whether the lawyer represents the husband and wife jointly or separately, the lawyer should do so only with their consent after disclosure of the implications of doing so. The same requirements apply to the representation of others as joint or separate multiple clients, such as the representation of other family members, business associates, etc.\textsuperscript{26}

Two additional examples deal with the representation of multiple clients in a fiduciary administration:

Example 1.7-2. Lawyer (L) represents Trustee (T) as trustee of a trust created by X. L may properly represent T in connection with other matters that do not involve a conflict of interest, such as the preparation of a will or other personal matters not related to the trust. L should not charge the trust for any personal services that are performed for T. Moreover, in order to avoid misunderstandings, L should charge T for any substantial personal services that L performs for T.\textsuperscript{27}

Example 1.7-3. Lawyer (L) represented Husband (H) and Wife (W) jointly with respect to estate planning matters. H died leaving a will that appointed Bank (B) as executor and as trustee of a trust for the benefit of W that meets the QTIP requirements under I.R.C. §2056(b)(7). L has agreed to represent B and knows that W looks to him as her lawyer. L may represent both B and W if the requirements of MRPC

\textsuperscript{26} Commentaries, p. 152.

\textsuperscript{27} Id., p. 153.
1.7 are met. If a serious conflict arises between B and W, L may be required to withdraw as counsel for B or W or both. L may inform W of her elective share, support, homestead or other rights under the local law without violating MRPC 1.9 (Conflict of Interest: Former Client). However, without the informed consent of all affected parties L should not represent W in connection with an attempt to set aside H's will or to assert an elective share."28

The issue of whether or not an attorney may represent both parties to a prenuptial agreement or "other matter with respect to which [the parties'] interests directly conflict to a substantial degree" generated much controversy. In the end, the Commentary to MRPC 1.7 adopts a qualified view:

"[A] lawyer is almost always precluded from representing both parties to a pre-nuptial agreement or other matter with respect to which their interests directly conflict to a substantial degree... On the other hand, if the actual or potential conflicts between competent, independent parties are not substantial, their common interests predominate, and it otherwise appears appropriate to do so, the lawyer and the parties may agree that the lawyer will represent them jointly pursuant to MRPC 1.7 (Conflict of Interest: General Rule) or act as an intermediary pursuant to MRPC 2.2. See MRPC 2.2 (Intermediary). Note, however, that in some states unless each party to a pre-nuptial agreement is independently represented the agreement may be invalidated."29

The Commentaries also support the arguably controversial position that an individual should be free to select and appoint whomever he/she wishes to a fiduciary office and that "[a]s a general proposition lawyers should be permitted to assist adequately informed clients who wish to appoint their lawyers as fiduciaries."30 The Commentary to MRPC 1.7 finds this conclusion to be consistent with ABA Ethical Consideration 5-6, which states:

"A lawyer should not consciously influence a client to name him as an executor, trustee, or a lawyer in an


29 Id., p. 154. Although the representation of both parties to a contract (such as a pre-nuptial agreement) may be ethical in limited cases, from a malpractice avoidance perspective such a representation should never be undertaken.

30 Id., p. 156.
instrument. In those cases where a client wishes to name his lawyer as such, care should be taken by the lawyer to avoid the appearance of impropriety.\textsuperscript{31}

The Commentary to MRPC 1.7 cites the case of \textit{Estate of Koch}, 849 P.2d 977 (Kan. App. 1993), for the proposition that balance is required in determining conflict of interest questions. In \textit{Koch} the court upheld a will that was drafted for the testator by a lawyer who also represented the testator and two of her sons in litigation involving a charitable foundation brought by her other two sons. Her will, which left the bulk of her estate to her four sons, included a no-contest clause and a provision that conditioned the gifts on the dismissal by a beneficiary of any litigation that was pending against her within 60 days following her death. The lawyer did not discuss the testator's will with her sons, including the two sons who were clients of the firm in the litigation. The sons were all unaware of the terms of their mother's will, which was prepared "without any evidence of extraneous considerations." The Court observed:

"The scrivener's representation of clients who may become beneficiaries of a will does not by itself result in a conflict of interest in the preparation of the will. Legal services must be available to the public in an economical, practical way, and looking for conflicts where none exist is not of benefit to the public or the bar."\textsuperscript{32}

\textbf{Comment re Ethics 2000:} The Ethics 2000 Report proposes changing the title of MRPC 1.7 to "Conflict of Interest: General Rule" and would reorganize the Rule to clarify it and to better educate lawyers regarding conflict of interest subjects. Thus, there will be a single paragraph defining "conflict of interest" and a single paragraph dealing with consentible waivers and informed consent. As with virtually all of the MRPCs under discussion the Comment is substantially revised to provide greater guidance to lawyers with respect to application of the MRPC in particular contexts.

\textbf{F. Commentary on MRPC 1.8: Conflict of Interest: Prohibited Transactions}

This Commentary's most significant contribution to the literature is the principle that under some circumstances and at the client's fully informed request the lawyer "may properly include an exculpatory provision in the document drafted by the lawyer for an unrelated client that appoints the lawyer to a fiduciary office. ... An exculpatory clause is often desired by a client who

\textsuperscript{31} ABA Ethical Consideration 5-6, cited at Commentaries, p. 157.

\textsuperscript{32} \textit{Estate of Koch}, supra, 849 P.2d 977, at 998.
wishes to appoint an individual non-professional or family member as fiduciary.\textsuperscript{33}

However, the Commentary to MRPC 1.8 correctly takes a dim view of the drafting of a document or testamentary instrument designating any particular lawyer or law firm to serve as counsel to the fiduciary or directing the fiduciary to retain a particular lawyer.

"Before drawing a document in which a fiduciary is directed to retain the scrivener as counsel, the scrivener should advise the client that it is neither necessary nor customary to include such a direction in a will or trust. A client who wishes to include such a direction in a document should be advised as to whether or not such a direction is binding on the fiduciary under the governing law. In most states such a direction is usually not binding on a fiduciary, who is generally free to select and retain counsel of his or her own choice without regard to such a direction."\textsuperscript{34}

This Commentary also supports the concept of a lawyer's retention of a client's executed originals if it is the client's desire, while noting that any lawyer retaining a client's documents should acknowledge that the documents are held subject to the client's direction. Further, the Commentary suggests that the mere retention of the client's original estate planning documents "does not itself make the client an 'active' client or impose any obligation on the lawyer to take steps to keep informed regarding the client's management of property and family status. Similarly, sending a client periodic letters encouraging the client to review the sufficiency of the client's estate plan or calling a client's attention to subsequent legal developments do not increase the lawyer's obligations to the client."\textsuperscript{35}

\textbf{Comment re Ethics 2000:} If the Ethics 2000 Commission Report is adopted, MRPC 1.8's title will be changed to "Conflict of Interest: Current Clients: Specific Rules." Among other changes to this Rule clients will have to be advised in writing of the desirability of seeking the advice of independent legal counsel before entering into business transactions with a lawyer and the client must give informed consent, in a writing \textit{signed by the client}, to the

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\textsuperscript{33} Commentaries, p. 189.
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\textsuperscript{34} Commentaries, p. 190. \textit{See also}, Fred Hutchinson Cancer Research Center \textit{v. Holman}, 732 P.2d 974 (Wash. 1987) ("As the attorney engaged to write the decedent's will [defendant] is precluded from reliance on the clause intended to limit his own liability when the testator did not receive independent advice as to its meaning and effect.")
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\textsuperscript{35} \textit{Id.}, p. 191; see the concept of "Dormant Representation" in the ACTEC Commentary on MRPC 1.4 (Communication), discussed, \textit{supra}, at text accompanying fn. 16.
\end{flushright}
essential terms of the transaction and the lawyer's role therein. The concept of "informed consent" replaces the concept of "consent after consultation." Lawyers will be expressly prohibited from soliciting substantial gifts and the definition of those relationships that fall within the exception for lawyers related to the client or the donee will be modified. Extensive changes are also made to the Comment to MRPC 1.8.

G. Commentary on MRPC 1.14: Client Under a Disability

With respect to a lawyer's representation of the client whose competence is questionable, the Commentary on MRPC 1.14 adopts the majority view:

"The lawyer for a client who appears to be disabled may have implied authority to make disclosures and take actions that the lawyer reasonably believes are in accordance with the client's wishes that were clearly stated during his or her competency. If the client's wishes were not clearly expressed during competency, the lawyer may make disclosures and take such actions as the lawyer reasonably believes are in the client's best interests. It is not improper for the lawyer to take actions on behalf of an apparently disabled client that the lawyer reasonably believes are in the best interests of the client." 36

In this regard, the Commentary criticizes the result reached in California Ethics Opinion 1989-112 (1989), which held that, without the consent of the client, a lawyer may not initiate conservatorship proceedings on the client's behalf even if the lawyer has concluded it is in the best interests of the client. The Commentary finds the preferable view to be as expressed in ABA Informal Opinion 89-1530:

"[T]he disclosure by the lawyer of information relating to the representation to the extent necessary to serve the

36 Id., pp. 217-218. In February 1997 the Comment to MRPC 1.14 was amended to include recommendations with respect to a lawyer's disclosure of the client's condition and the rendering of emergency legal assistance. Specifically, Comment 6 provides: "In an emergency where the health, safety or a financial interest of a person under a disability is threatened with imminent and irreparable harm, a lawyer may take legal action on behalf of such a person even though the person is unable to establish a client-lawyer relationship or to make or express considered judgments about the matter, when the disabled person or another acting in good faith on that person's behalf has consulted the lawyer. Even in such an emergency, however, the lawyer should not act unless the lawyer reasonably believes that the person has no other lawyer, agent or other representative available." MRPC 1.14, Comment 6. In such cases the lawyer should only act "to the extent reasonably necessary to maintain the status quo or otherwise avoid imminent and irreparable harm." In addition, the lawyer "should keep the confidences of the disabled person as if dealing with a client, disclosing them only to the extent necessary to accomplish the intended protective action." MRPC 1.14, Comment 7.
best interests of the client reasonably believed to be disabled
is *impliedly authorized* within the meaning of Model Rule 1.6.
Thus, the inquirer may consult a physician concerning the
suspected disability."37 [Emphasis added by Commentary.]

This Commentary has been praised in a recent work on the legal and
medical aspects of mental capacity:

"The approach taken by the *Commentaries* is
pragmatic and reflects a real world approach to handling the
disabled or incompetent client. After all, lawyers usually
attempt to assist a client in implementing the client's wishes,
as opposed to the wishes of others. It is important to
remember, as the *Commentaries* point out, that it is not the
decision that is made, but the rational and functional
process by which the client makes the decision that is
paramount. The *Commentaries* encourage the lawyer to
implement the client's wishes as expressed by the client
during the client's competency. Thus, knowing how to
assess the client's competency becomes very important.

"If the lawyer cannot follow the client's wishes as
expressed during a period of competency, perhaps because
no legal authority has been granted to a surrogate decision-
maker or agent and the client lacks sufficient capacity to
undertake the contemplated act, the lawyer should act in
such a way that the client's best interests are being served.
The best interest test is also a pragmatic real world approach
to solving the needs of the client."38

The Commentary on MRPC 1.14 also emphasizes the importance of
testamentary freedom and the lawyer's obligation to assist clients whose
testamentary capacity, although extant, appears to be borderline. The
Commentary suggests that in those cases involving a client's doubtful
testamentary capacity the lawyer may wish to consider any available
procedures for obtaining court supervision of the proposed estate plan (so
called "substituted judgment" proceedings).39

37 *Commentaries*, p. 218.

38 Walsh, Brown, Kaye & Grigsby, *Mental Capacity: Legal and Medical Aspects of
Assessment and Treatment*, p. 1-15 (Shepard's 2d Ed. 1994)

39 *Commentaries*, pp. 218-219; see, e.g., Cal. Probate Code § 2580, et seq. *See also,
Restatement*, §51, Illustration 4 (Lawyer who has drafted a will for client subsequently found to
lack testamentary capacity, as a result of which client's will is set aside, is not subject to
liability to heir in heir's suit for expenses incurred in the successful will contest: "Recognizing a
Comment re Ethics 2000: The Commission has recommended changing the title of MRPC 1.14 to "Client with Diminished Capacity", a welcome revision. The Rule's terminology is also changed to reflect the change of focus in the Rule to the continuum of a client's capacity. Additional language is added regarding those protective measures a lawyer may take short of requesting a guardian or conservator for a client and clarifying when it is appropriate to take such protective action.

H. Commentary on MRPC 3.3: Candor Toward the Tribunal

This Commentary reaches the not unsurprising conclusion that "[a] lawyer may not mislead the court with regard to any matter before it, including ex parte applications. In particular, a lawyer may not assist a client by presenting to the court any petition, accounting, or other document or evidence that is false or fails to disclose a material fact if disclosure is necessary to avoid assisting a criminal or fraudulent act by the client."40

The mere fact that most jurisdictions regard the lawyer who represents the fiduciary as owing no direct duty to the beneficiaries of fiduciary estates will not insulate the lawyer who intentionally aids and abets the fiduciary in the commission of fraud or other breach of trust.41

Comment re Ethics 2000: Proposed changes to MRPC 3.3 include clarifying the lawyer's obligation of candor to the tribunal with respect to testimony given and actions taken by the client and other witnesses, amplifying the lawyer's duty not to make false statements to a tribunal, adding an obligation to correct false statements previously made and clarifying Rule language to reflect that the lawyer must take remedial measures when the lawyer comes to know that material evidence previously offered by the client or a witness called by the lawyer is false.

duty by lawyers to heirs to use care in not assisting incompetent clients to execute wills would impair performance of lawyers' duty to assist clients even when the clients' competence might later be challenged."

For further discussion of the lawyer's duties to a client with diminished capacity, See Restatement, § 24.

40 Commentaries, p. 250.

41 See, e.g., Pierce v. Lyman, 3 Cal.Rptr.2d 236 (1991): The beneficiary may state a direct cause of action against the trustee's lawyer when the lawyer is alleged to have actively participated in the trustee's breach of fiduciary duty. "Active concealment, misrepresentations to court, and self dealing for personal financial gain are described. We find this is sufficient to state a cause of action for breach of fiduciary duty [against the lawyer for the trustee]." See also, Wolf v. Mitchell, Silberberg & Knupp (1999) 76 Cal.App.4th 1030, 90 Cal.Rptr.2d 792 (Trust beneficiary has standing to bring direct action against the previous trustee's attorneys and other third parties where the beneficiary alleges that the attorneys and third parties actively participated in the previous trustee's breaches of trust).
IV. CONCLUSION

In the years leading up to the ACTEC Commentaries’ adoption, a common concern voiced by many concerned Fellows of the College was that the ACTEC Commentaries, if adopted, would become weapons in the hands of disgruntled clients and beneficiaries and other parties suing estates and trusts lawyers. The contrary view, to which ACTEC ultimately subscribed, was that, as "the best and brightest" members of the estates and trusts profession the Fellows of ACTEC had a duty to their colleagues, their clients and the general public to promote competent and ethical representation in the estates and trusts arena by adopting ethical guidelines in harmony with the Model Rules but responsive to the unique requirements of an estates and trusts practice and the reasonable expectations of clients and beneficiaries. A concomitant benefit of the ACTEC Commentaries’ adoption will be raising the level of the debate and improving the quality of decisions made by triers of fact (whether judges or juries) in actions involving alleged legal malpractice or attorney misconduct.

The ACTEC Commentaries’ emphasis on the generally non-adversarial nature of the trusts and estates practice, the encouragement of the representation of multiple clients, particularly in the family context, and an emphasis on informed communication between lawyer and client will ultimately improve the quality of legal representation in our field and increase the confidence of both clients and the general public in the legal profession. The ACTEC Commentaries are appropriately dedicated to that worthwhile goal.

The American College of Trust and Estate Counsel closely followed the deliberations of the Ethics 2000 Commission and will continue to observe and comment upon the Commission’s Report as it is discussed and debated in the months ahead. Assuming the American Bar Association ultimately adopts revisions to the Model Rules of Professional Conduct (together with the Comments thereto) the next edition of the ACTEC Commentaries will cover all aspects of the changes in the MRPC that are relevant to the trusts and estates practitioner. Thus, the ACTEC Commentaries will continue to serve as an ethical beacon for all estates and trusts practitioners interested in competently and ethically representing their clients and following the highest dictates of our profession.
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PLANNING FOR THE GENERATION-SKIPPING TRANSFER TAX

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SECTION J
PLANNING FOR THE GENERATION-SKIPPING TRANSFER TAX

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I. Overview -- Transfers Which Trigger GST
The generation-skipping transfer tax (hereafter, “GST”), chapter 13 of the Internal Revenue Code\(^1\), was enacted by Congress in 1986 as a means of preventing wealthy families from creating large trusts which would escape gift or estate taxation for multiple generations. Transfers which are not exempt from GST are taxed at the maximum Federal estate rate, currently 55% (I.R.C. § 2641(a)(1)).

A. Basic Terms
The GST tax applies to transfers of property to persons who are two or more generations below that of the person transferring the property. Therefore, a clear understanding of the identity of the parties to the transfer is imperative.

1. Transferor. The transferor is the person who disposes of the property transferred, either during life or at death (I.R.C. § 2652(a)). If the transfer is subject to gift tax, the transferor is the donor. If the transfer is subject to estate tax, the transferor is the decedent.

If a married couple elects to split gifts under section 2513, both the donor and the donor’s spouse are treated as the transferor of one half of the transferred property (I.R.C. § 2652(a)(2)).

Note: In order to split gifts, both spouses must make an affirmative election to do so (I.R.C. § 2513(a)(2)). A gift tax return must be filed to make this election (Treas. Reg. § 25.2513-2).

An individual possessing a general power of appointment under section 2041 over property held in trust will become the transferor of such property when the power is exercised, released or lapsed (Treas. Reg. § 26.2652-1(a)).

2. Skip Person. A skip person is a person assigned to a generation which is two or more generations below that of the transferor, e.g., a grandchild (I.R.C. § 2613(a)).

For relatives, generations are assigned along family lines and are traced back to the transferor’s grandparents (I.R.C. § 2651(b)(1)). The transferor’s spouse is always assigned to the same generation as the transferor regardless of the spouse’s age (I.R.C. § 2651(c)). The generation assignment for family members of the transferor’s

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\(^1\) All references to the “Code” refer to the Internal Revenue Code of 1986, as amended. All references to “sections” refer to sections of the Code.
spouse is determined by reference to the spouse’s grandparents (I.R.C. § 2651(b)(2)).

For non-relatives, an individual is assigned to the same generation as the transferor if such individual is not more than 12 1/2 years younger than the transferor (I.R.C. § 2651(d)(1)). An individual is assigned to the first generation younger than the transferor if such individual is more than 12 1/2 years but not more than 37 1/2 years younger than the transferor (I.R.C. § 2651(d)(2)). Succeeding generations are assigned under similar rules in 25-year increments (I.R.C. § 2651(d)(3)).

A trust for the benefit of only skip persons is also deemed to be a skip person. A trust will be deemed to be a skip person if: (1) all beneficiaries who are currently entitled to receive income and principal are skip persons; or (2) no person is currently entitled to receive income and principal and at no time may distributions (including distributions upon termination) be made to a non-skip person (I.R.C. § 2613(a)(2)).

3. **Non-Skip Person.** A non-skip person is any person or trust that is not a skip person, e.g., a child (I.R.C. § 2613(b)).

### B. Transfers and Taxable Events

Once the identities of the parties to the transfer have been established, it is necessary to determine the type of transfer. Three types of transfers are subject to GST: (1) a taxable termination, (2) a taxable distribution, and (3) a direct skip. The determination of the type of transfer will control the amount of tax due, the person liable for the payment of the tax, and whether certain exemptions apply.

1. **Taxable Termination.** A taxable termination occurs when an interest in a trust terminates unless (1) immediately after the termination, a non-skip person has an interest in the trust property, or (2) at no time after the termination may a distribution be made from the trust to a skip person (I.R.C. § 2612(a)).

   **Example.** The transferor, T, creates an irrevocable trust which pays income to T’s child, C, for life, and the remainder to T’s grandchild, GC, if then living. A taxable termination occurs when C dies because immediately after the termination of C’s interest, all interests in the trust are held by skip persons (GC).

2. **Taxable Distribution.** A taxable distribution is any distribution from a trust to a skip person (I.R.C. § 2612(b)).

   **Example.** T creates an irrevocable trust which provides for the payment of income and principal to C and GC, at the trustee’s discretion. A taxable distribution occurs each time there is a distribution to GC.
3. **Direct Skip.** A direct skip is a transfer to a skip person (I.R.C. § 2612(c)). A direct skip may take one of two forms: (1) an outright gift or bequest; or (2) a gift or a transfer at death to a trust where all of the current beneficiaries are skip persons.

**Example.** T transfers 100 shares of ABC Corporation stock to GC.

**Example.** T transfers $40,000 to a trust for the benefit of T’s grandchildren (all skip persons).

**Case Study:** T’s will provides for pecuniary bequests to T’s son, daughter, and son-in-law, with the remainder passing to a testamentary trust. The will directs the trustee to administer the trust primarily to provide for the care and maintenance of T’s dogs according to their station in life when T was living. To the extent the net income is not used for the care and maintenance of T’s dogs, the trustee in its sole discretion may provide for the education of T’s issue per stirpes, as if T’s children are not then living. At the earlier of the death of the last surviving dog or 20 years, the remaining trust assets will be divided among T’s then living issue, per stirpes.

**Query:** Are the dogs skip persons or non-skip persons? See Priv. Ltr. Rul. 9036043 (June 13, 1990).

Only one direct skip occurs when a single transfer of property skips two or more generations (Treas. Reg. § 26.2612-1(a)).

**Example.** T transfers Blackacre to T’s great-grandchild. Only one GST tax is imposed although two generations are skipped. (Treas. Reg. § 26.2612-1(f), Ex. 2).

4. **Predeceased Ancestor Rule.** As originally enacted, section 2612(c)(2) created what came to be known as the “predeceased child exception.” The purpose of section 2612(c)(2) was to close the gap between the transferor and the oldest living descendant of a particular line.

If, at the time of a transfer subject to GST, a child of the transferor (or the transferor’s spouse) had died, the child’s children would be treated as having moved up a generation for purposes of determining whether a direct skip occurred. The child’s grandchildren also moved up a generation. This benefit existed only for direct skips and disclaimers could not be used to create a “predeceased” child.

**For Transfers After January 1, 1998.** The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34, 111 Stat. 788 (1997)), replaced section 2612(c)(2) with section 2651(e), and expanded the application of the exemption beyond direct skips to include taxable
terminations and taxable distributions, provided that the parent of the relevant transferee was deceased at the time of the original transfer (I.R.C. § 2651(e)(1)). TRA 1997 further expanded the predeceased child exception to include a transferor’s grandnieces and grandnephews where the transferor has no descendants and the transferor’s sibling has died (I.R.C. § 2651(e)(2)).

5. **90 Day Survivorship Rule.** Treas. Reg. § 26.2612-1(a)(2) provides that if a living descendant dies within 90 days after the GST transfer, then such descendant is treated as having predeceased the transferor to the extent so provided by the terms of the trust instrument or applicable state law. Note that former section 2612(c)(2) was replaced by section 2651(e); however, no policy reason exists why the 90 day survivorship rule would not be applied under the new statute.

6. **Comparison of Types of GST Transfers.** On a taxable termination, the taxable amount is the value of all property with respect to which the taxable termination has occurred, reduced by certain deductions relating to expenses, indebtedness, and taxes (I.R.C. § 2622). The trustee is responsible for payment of the tax (I.R.C. § 2603(a)(2)).

On a taxable distribution, the taxable amount is the value of the property received by the transferee, reduced by any expense incurred by the transferee associated with the payment or refund of tax (I.R.C. § 2621(a)). The transferee is responsible for payment of the tax (I.R.C. § 2603(a)(1)). If the tax is paid out of the trust, this payment is also a taxable distribution (I.R.C. § 2603(b)).

In the case of a direct skip, the taxable amount is the value of the property received by the transferee (I.R.C. § 2623). The transferor is the person liable for the payment of tax (I.R.C. § 2603(a)(3)). Note, however, that under section 2515, by paying the tax, the transferor is making an additional gift.

Taxable distributions and taxable terminations have the GST calculated on a tax-inclusive basis. Direct skips, on the other hand, have the GST calculated on a tax-exclusive basis. As a result, the “effective rate” on a direct skip is less than that assessed against a taxable distribution or taxable termination.

**Illustration.** Assume a $1,000,000 transfer which is charged with paying the GST. If the transfer is a taxable distribution or taxable termination, the GST is $550,000 ($1,000,000 x 55%). If the transfer is a direct skip, the GST is $354,839 ($645,161 x 55%). The effective rate for direct skips is about 35.5% rather than 55% for taxable distribution and taxable termination.

For a discussion of why it is always advantageous to prepay wealth transfer taxes regardless of whether it is the gift, estate, or GST tax, see Jeffrey N. Pennell and R.

Caveat: In light of the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836), it is no longer advisable in most situations to prepay wealth transfer taxes, especially gift tax, because of the scheduled repeal of the estate and GST taxes in 2010.

7. **Multiple Skips.** Under section 2653, if property remains in trust after a generation skipping transfer occurs, for the purposes of subsequent transfers, the transferor will be deemed to be assigned to one generation above that of the oldest beneficiary then having an interest in the trust. (I.R.C. § 2653(a)). The purpose of section 2653 is to convert the oldest beneficiary and all others assigned to this generation level from skip persons to non-skip persons so that future distributions to them will not trigger GST. However, if the property continues to be held in trust after a GST transfer has occurred, it will continue to be subject to the GST tax for future generations.

**Example.** T’s child is living and T creates an irrevocable trust for the benefit of T’s grandchild, GC, and T’s great-grandchild, GGC, which provides for the payment of income and principal to GC and GGC, at the trustee’s discretion. At GC’s death, the trust property will be distributed to GGC. The transfer by T to the trust is a direct skip, and the property is held in trust immediately after the transfer. After the direct skip, the transferor is treated as being one generation above GC, therefore, GC is no longer a skip person and distributions to GC are not taxable distributions. However, because GGC is assigned to a generation that is two generations below T’s deemed generation, GGC is a skip person and distributions of trust income to GGC are taxable distributions.

**Example.** T creates an irrevocable trust for the benefit of T’s child, C, for life. At C’s death, the trust property will continue in trust for the benefit of T’s grandchild, GC, for life. At GC’s death, the trust property will be distributed to T’s great-grandchild, GGC. A taxable termination occurs at C’s death and then again at GC’s death unless the property is included in their estates by a general power of appointment under section 2041.

8. **Transfers Excluded from GST Tax.** Excluded from generation-skipping transfers are transfers which would not be treated as taxable gifts under section 2503(e) (i.e., payment of tuition and medical expenses) (I.R.C. § 2611(b)(1)). Also excluded are annual exclusion gifts which are direct skips (I.R.C. § 2642(c)). This exclusion also applies to direct skips made in trust but only if the trust is for a single beneficiary and the trust property will be included in the beneficiary’s gross estate should the
beneficiary die before the trust terminates (I.R.C. § 2642(c)(2)).

C. The GST Exemption

1. **Amount of Exemption.** Every individual is allowed a $1,000,000 GST exemption which may be allocated to transfers made by that individual (I.R.C. § 2631(a)). Beginning January 1, 1999, the GST exemption will be adjusted for inflation in $10,000 increments (I.R.C. § 2631(c)).

For transfers made after December 31, 1998, the GST exemption is $1,010,000 (Rev. Proc. 98-61, 1998-51 IRB 180); for transfers made after December 31, 1999, the exemption is $1,030,000 (Rev. Proc. 99-42, 1999-46 IRB 568); and for transfers made after December 31, 2000, the exemption is $1,060,000 (Rev. Proc. 2000-13, 2001-3 IRB 1).

2. **Allocation of Exemption.** Every individual (or his or her executor) may allocate all or part of the individual’s GST exemption to property transferred by such individual at any time (I.R.C. § 2631(a)). Use of the exemption is entirely discretionary. However, once made, an allocation is irrevocable (I.R.C. § 2631(b)).

**Automatic Allocation.** The GST exemption is automatically allocated to direct skips made during the transferor’s lifetime unless the transferor elects otherwise on a timely filed gift tax return (I.R.C. § 2632(b)). Any unused GST exemption at the transferor’s death is automatically allocated, first to testamentary direct skips, and then proportionately among trusts created by the transferor from which a taxable distribution or taxable termination may occur (I.R.C. § 2632(c)).

3. **Scope of Exemption.** Once property has been designated as exempt from GST, the property, the income generated by it, and its future appreciation are permanently immune from the GST tax as long as the identity of the transferor does not change.

D. Calculating the GST Tax.
The GST tax is calculated by multiplying the “taxable amount” of the transfer by the “applicable rate” (I.R.C. § 2602).

1. **Applicable Rate.** The applicable rate is the maximum federal estate tax rate (currently 55%) multiplied by the inclusion ratio (I.R.C. § 2641).

   \[
   \text{Applicable Rate} = 0.55 \times \text{Inclusion Ratio}
   \]

2. **Inclusion Ratio.** The inclusion ratio is 1 minus the “applicable fraction” (I.R.C. §§ 2602, 2641).
3. **Applicable Fraction.** The applicable fraction is a fraction, the numerator of which equals the amount of GST exemption allocated to the trust (or to the assets in the case of a direct skip not in trust) and the denominator equals the value of the property transferred in trust (or transferred in a direct skip not in trust) reduced by the sum of federal estate and state death tax incurred by and recovered from the trust or assets, and the amount of charitable deduction allowed, if any (I.R.C. § 2642(a)(2)).

\[
\frac{\text{GST Exemption Allocated}}{\text{Value of Transferred Property}}
\]

4. **Equation.** In other words, the GST tax equals:

\[
\text{Taxable amount} \times 55\% \times 1 - \left(\frac{\text{GST Exemption Allocated}}{\text{Value of Transferred Property}}\right)
\]

5. **Example.** T transfers $1,000,000 to an irrevocable trust for the benefit of T's child, C, for life, with the remainder to T's grandchild, GC. T allocates $600,000 of T's GST exemption to the trust on a timely-filed gift tax return. The applicable fraction with respect to the trust is .60 ($600,000 (the amount of GST exemption allocated to the trust) over $1,000,000 (the value of the property transferred to the trust)). The inclusion ratio is .40 (1 - .60). If the maximum federal estate tax rate is 55 percent at the time of a GST, the rate of tax applicable to the transfer (applicable rate) will be .22 (55 percent (the maximum estate tax rate) x .40 (the inclusion ratio)).

6. **Desirable Inclusion Ratios.** It is always desirable to have an inclusion ratio of either one or zero. If the applicable fraction is one, the inclusion ratio will be zero, and the property transferred to the trust will be exempt from GST. If the applicable fraction is zero, the inclusion ratio will be one, and the property transferred to the trust will be subject to GST.

The inclusion ratio applies to all assets of the trust. If a trust is partially exempt from generation skipping tax, then every generation skipping transfer from the trust will be partially exempt and partially taxable. This situation occurs when the trust's inclusion ratio is between one and zero, and has the effect of wasting the transferor’s GST exemption. Thus, it is always preferable to create two trusts, one which is entirely subject to the GST tax and another that is entirely exempt.

7. **Credit for State GST Taxes.** Section 2604 allows a credit not to exceed 5% of the Federal GST tax imposed by section 2601 for GST taxes paid to any state (I.R.C. § 2604). Among the states that impose GST taxes are Indiana (Ind. Code Ann. § 6-4.1-11.5-7 (West 2001)), Florida (Fla. Stat. Ann. § 198.021 (West 2001)), Maryland
Effective Date Rules.
The provisions of chapter 13 of the Code apply to all lifetime GST transfers made after September 25, 1985, and to all testamentary GST transfers made after October 22, 1986 (Treas. Reg. § 26.2601-1(a)). However, chapter 13 does not apply to transfers from trusts which were irrevocable on September 25, 1985 (Treas. Reg. § 26.2601-1(b)).

A transfer under a trust that was irrevocable on September 25, 1985 will be exempt from GST to the extent that the transfer is not made out of additions made to the trust after that date (Treas. Reg. § 26.2601-1(b)(1)). A trust is considered irrevocable on that date if it would not be included in the grantor’s estate under sections 2038 or 2042 if the grantor had died on September 25, 1985 (Treas. Reg. § 26.2601-1(b)(1)(ii)).

Great care must be taken when dealing with a grandfathered trust because subsequent transactions may cause the trust to lose its exempt status. If an addition is made after September 25, 1985 to an irrevocable trust which is exempt from GST, unless GST exemption is allocated to the addition, a portion of all subsequent distributions from the trust will be subject to GST. (Treas. Reg. § 26.2601-1(b)(1)(iv)). Of particular concern are transactions in which no actual property is added to the trust but are treated as a constructive addition nonetheless (e.g., a lapse of a power of appointment) (Treas. Reg. § 26.2601-1(b)(1)(v)).

Final Regulations Issued in 1995. The Service first issued final regulations regarding the effective date rules on December 27, 1995. Unfortunately, like the statutory provisions and the legislative history, these regulations did not define what is meant by an addition.

Given the exorbitant GST rate of 55%, taxpayers were reluctant to jeopardize the exempt status of existing trusts. As a result, the Service has issued hundreds of private letter rulings since 1989 regarding the effect of proposed changes to exempt trusts for GST purposes. The rulings have consistently held that a modification of an exempt trust that does not alter the quality, value, or timing of any powers, beneficial interests, rights, or expectancies originally provided for in the trust will not cause the trust to forfeit its exempt status. See, e.g., Priv. Ltr. Rul. 199915038 (Apr. 16, 1999).

However, the regulations did define what is meant by a constructive addition. Under the regulations, a constructive addition is any property remaining in trust after the release, exercise or lapse of any power of appointment, if the release, exercise or lapse is taxable to any extent (Treas. Reg. § 26.2601-1(b)(1)(v)). Nontaxable powers such as limited powers of appointment or wholly non-taxable general powers of
appointment (e.g., “five and five” powers or pre-1942 general powers which lapse) will not subject an exempt trust to GST tax.

2. **Simpson v. United States.** On July 23, 1999, in a surprising decision, especially for the Service, the Eighth Circuit Court of Appeals held that the exercise of a general power of appointment over a trust which became irrevocable in 1966 was not subject to GST at the death of the power holder in 1993 when the power was exercised to distribute the trust in favor of skip persons. *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999). The facts of the *Simpson* case are as follows.

Mr. Simpson died in 1966. His will created a traditional marital trust for the benefit of his wife. Mrs. Simpson later remarried and became Mrs. Bryan. The trust gave Mrs. Bryan a testamentary general power of appointment. When she died in 1993, she exercised this power in favor of her grandchildren. This transfer is subject to GST unless it is protected by the effective date rule.

The issue before the court was whether the exercise of the general power of appointment was a constructive addition. The Missouri District Court held that the effective date provisions did not apply to the transfer and, thus, the transfer was subject to GST. The Eighth Circuit Court of Appeals reversed.

In a literal reading of the statute, the Court held that the effective date rule of section 1433(b)(2)(A) of the Tax Reform Act of 1986 applied to transfer. According to section 1433(b)(2)(A) of the Act, the GST tax does not apply to any generation-skipping transfer under a trust which was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985. The Court reasoned that because the trust was irrevocable on September 25, 1985, the transfer was made possible by the trust; therefore, the transfer was made under the trust and not out of an addition made to the trust.

The Court distinguished *Simpson* from a contrary decision reached by the Second Circuit Court of Appeals on similar facts in *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795 (2d Cir. 1996). Mr. Peterson died in 1974. He created a similar trust for the benefit of his wife, including a general power of appointment. If the power was not exercised, the corpus was to be set aside for the Petikers’ grandchildren. Mrs. Peterson died in 1987. She did not exercise her general power of appointment so it lapsed. The Second Circuit held that the lapse of Mrs. Peterson’s general power of appointment was a constructive addition to the trust. The Eighth Circuit distinguished *Simpson* from *Peterson* on the grounds that unlike the exercise of Mrs. Bryan’s general power of appointment which caused nothing to remain in trust, the lapse of Mrs. Peterson’s power of appointment caused the property to remain in the trust and, therefore, was an addition to the trust.
On October 27, 2000, in a similar case, a California District Court held that the decedent’s partial exercise of a testamentary general power of appointment created upon the death of her husband in 1976 in favor of her grandchildren was subject to GST. *Bachler v. United States*, 126 F. Supp. 2d 1279 (N.D. Cal. 2000). Although the facts in *Bachler* were similar to those in *Simpson*, the court declined to follow the Eighth Circuit’s opinion in *Simpson* and instead chose to follow the Second Circuit’s decision in *Peterson*.

Shortly after issuing a notice that it would not acquiesce in the decision in *Simpson*, the Service released Proposed Regulations REG-103841-99 (the so called “Anti-Simpson regulations”) on November 18, 1999, to clarify that the transfer of property pursuant to the exercise, release, or lapse of a general power of appointment created in an exempt trust is not a transfer under the trust, but rather is a transfer by the power holder upon the exercise, release or lapse of such power (Treas. Reg. § 26.2601-1(b)(1)(i)). After incorporating several changes suggested by practitioners in written comments and at a public hearing, the Service issued final regulations on the effective date rules on December 20, 2000.

3. **New Effective Date Regulations.** The new regulations create four safe harbors for modifications to exempt trusts that occur through (1) certain discretionary trustee powers, (2) court-approved settlements, (3) judicial constructions, and (4) other changes (Treas. Reg. § 26.2601-1(b)(4)(i)). The four safe harbors are not mutually exclusive and a failure to qualify under a specific safe harbor does not mean necessarily that a modification will result in a loss of exempt status. However, Example 4 in the regulation is troublesome and suggests that the a failure to comply with any of the safe harbors will result in the loss of exempt status (Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 4).

These safe harbors apply only for GST purposes and do not apply for gift, estate, or income tax purposes (Treas. Reg. § 26.2601-1(b)(4)(i)).

a. **Trustee’s Discretionary Powers.** Under the first safe harbor, a trust will not lose its exempt status when a new trust is created or property is retained in a continuing trust if (1) the trustee is authorized to make distributions to a new trust or to retain the property in a continuing trust without the consent or approval of any beneficiary or court by either the terms of the governing instrument or the state law in existence at the time the trust became irrevocable, and (2) the terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period measured by any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation,
or 90 years, if shorter (Treas. Reg. § 26.2601-1(b)(4)(i)(A)).

b. **Court-Approved Settlements.** The second safe harbor provided in the regulations is a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to GST if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement (Treas. Reg. § 26.2601-1(b)(4)(i)(B)). The regulations further state that a settlement that results in a compromise between the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes. See Priv. Ltr. Rul. 200112038 (Mar. 3, 2001).

c. **Judicial Construction.** The third safe harbor provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to GST if (1) the judicial action involves a bona fide issue; and (2) the judicial construction is consistent with the applicable state law that would be applied by the highest court of the state (Treas. Reg. § 26.2601-1(b)(4)(i)(C)). See Priv. Ltr. Rul. 200114026 (Apr. 6, 2001) (construction to correct a scrivener’s error); and Priv. Ltr. Rul. 200116031 (Apr. 20, 2001) (construction to clarify an ambiguity in a trust’s terms).

d. **Other Changes.** Under the fourth and final safe harbor, a modification of the governing instrument of a trust (including a modification through a trustee’s exercise of a power of distribution, a court-approved settlement, or a judicial construction that does not satisfy one of the three safe harbors described above), will not cause an exempt trust to be subject to GST if: (1) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification, and (2) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust (Treas. Reg. § 26.2601-1(b)(4)(i)(D)).

A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is
measured against the effect of the instrument in existence immediately before
the modification. If the effect of the modification cannot be immediately
determined, a shift to a lower generation is deemed to have occurred. A
modification that is administrative in nature that only indirectly increases the
amount transferred (for example, by lowering administrative costs or income
taxes) will not be considered to be a shift of a beneficial interest in the trust
(Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2)).

(The Final Regulations are reproduced in Appendix A.)

II. Use of the GST Exemption
The most important planning tool provided by chapter 13 is the GST exemption. Once property is
exempt from GST, all subsequent transfers of the property, the income therefrom, and the
appreciation thereof, are also exempt. Because the amount of the GST exemption is the same for
both lifetime and testamentary transfers, it is more desirable for the transferor to make a lifetime
allocation of GST exemption, if the value of the trust to which the exemption is allocated is
anticipated to increase.

A. Division of Trusts
It is very desirable when designing an estate plan never to create a trust with an inclusion
ratio of other than zero or one. Once the transferor’s GST exemption has been allocated to
a trust thereby creating an inclusion ratio of between zero and one, the trustee cannot later
divide the trust into separate trusts -- one with an inclusion ratio of zero and the other with
an inclusion ratio of one -- in order to segregate the exemption (I.R.C. § 2654(b)). However,
if the trust is divided prior to the time that the GST exemption is allocated, two trusts with
inclusion ratios of zero and one can be established.

1. Separate Shares and Trusts. Section 2654(b) sets forth two circumstances in which
separate trusts will be recognized: (1) the portions of a trust attributable to transfers
from different transferors will be treated as separate trusts; and (2) substantially
separate and independent shares of different beneficiaries in a trust will be treated as
separate shares (I.R.C. § 2654(b)).

a. Separate and Independent Shares. If a trust consists of substantially
separate and independent shares for different beneficiaries, each share will be
treated as a separate trust for purposes of chapter 13. In general, the separate
share rules provided in § 1.663(c)-3 for income tax purposes will apply for
purposes of chapter 13. However, a portion of a trust will not be treated as
a separate share unless such share exists from and at all times after the
creation of the trust (Treas. Reg. § 26.2654-1(a)(1)(i)).

b. Multiple Transferors. If there is more than one transferor of property to a
trust, the portions of the trust attributable to the different transferors will be
treated as separate trusts. (Treas. Reg. § 26.2654-1(a)(2)).

c. **Severance of Trust.** A single trust which is treated as separate trusts under section 2654(b) may be divided into separate trusts at any time to reflect that treatment (Treas. Reg. § 26.2654-1(a)(3)).

2. **Separate Trusts Allowed by Regulations.** The regulations will also recognize separate trusts created under a single trust included in the transferor’s gross estate (or created under the transferor’s will) if severance is mandated or granted by the governing instrument or granted under local law (Treas. Reg. § 26.2654-1(b)(1)).

   a. **Authority to Divide the Trust.** Authorization to divide the trust must be given by the instrument itself or by applicable state law. (Treas. Reg. § 26.2654-1(b)(1)). If the applicable state law does not provide such authority, a court order is necessary. The severance must occur (or the reformation proceeding must begin) prior to the time the federal estate tax return is due (including extensions actually granted) (Treas. Reg. § 26.2654-1(b)(1)(ii)(B)).

   If severance is not mandated by the governing instrument, each of the new trusts must provide the same succession of interests and beneficiaries as in the original trust (Treas. Reg. § 26.2654-1(b)(1)(ii)(A)).

   (See Appendix B for sample generation skipping provisions for trusts.)

   b. **Division of Assets.** Typically, assets are divided on a fractional basis. If so, the assets need not be divided pro rata, provided funding is based on either the fair market value of the assets at the date of funding or in a manner that fairly reflects the net appreciation and depreciation in the value of the assets from the date of the transfer (e.g., the transferor’s date of death) and the date of funding (Treas. Reg. § 26.2654-1(b)(1)(C)).

   If the governing instrument directs severance using a pecuniary amount, interest must be paid on the pecuniary share or the assets must fairly reflect appreciation and depreciation (Treas. Reg. § 26.2654-1(b)(1)(ii)(C)(2) and § 26.2654-1(a)(1)(ii)).

B. **Marital Deduction Planning and Reverse QTIP Election**

As a general rule, estate planning will take precedence over GST planning. It is impossible to coordinate the estate tax and GST tax perfectly because the applicable exclusion amount (formerly, the unified credit amount) will always be smaller than the GST exemption amount. Even if the applicable exclusion amount increases to $1,000,000 in 2006, the GST exemption will be greater than $1,000,000 due to indexing. As a result, although exempt
from GST tax, some transfers will be subject to gift or estate tax.

Most marital planning hinges on a marital deduction formula which divides the decedent’s assets into two funds: (1) the nonmarital trust which equals the decedent’s remaining applicable exclusion amount; and (2) the marital trust which equals the remaining assets of the decedent’s estate and is structured to qualify for the marital deduction. The effect of this planning is to minimize the overall taxes of the couple, and to defer estate taxes until the death of the surviving spouse.

The problem with this plan is that it does not fully use the first spouse’s GST exemption. If the decedent died in 2001, only $675,000 would be allocated to the nonmarital trust, leaving $385,000 of the decedent’s GST exemption unused. Because the marital trust will be taxed to the surviving spouse, the surviving spouse will become the transferor of those assets for GST purposes (I.R.C. § 2652(a)).

Reverse QTIP Election. Fortunately, chapter 13 provides a solution to this problem. The executor of the decedent’s estate may make a “reverse QTIP” election for property transferred to a QTIP marital trust (I.R.C. § 2652(a)(3)). The effect of this election is to treat the deceased spouse and not the surviving spouse as the transferor of the QTIP trust for GST purposes although the QTIP assets are still included in the surviving spouse’s estate for estate tax purposes.

When making a reverse QTIP election, the election must be made for the entire QTIP trust. A partial elections is not allowed. If the value of the QTIP trust exceeds the amount of the decedent spouse’s available GST exemption, as it often will, the trust must be divided so that the reverse QTIP election may be made for one part of trust but not for the other.

The reverse QTIP election is only available to marital deduction trusts described under section 2056(b)(7), i.e., QTIP trusts. It is not available for the general power of appointment marital deduction trust described under section 2056(b)(5). Therefore, before a reverse QTIP election can be made for such a trust, the general power of appointment must be eliminated (e.g., by a disclaimer of the power by the surviving spouse).

(Appendix C illustrates how to make a reverse QTIP election on the Federal estate tax return (Form 706).)

Section 9100 Relief. A reverse QTIP election must be made on a timely filed Federal estate tax return to be effective (Treas. Reg. § 26.2652-2(b)). However, if the executor fails to make the election on the return, the executor may request an extension of time to make the election under Treas. Reg. § 301.9100-3.

Treasury Regulations § 301.9100-1, §301.9100-2, and § 301.9100-3 set forth the standards the Commissioner will use to determine whether to grant an extension of time to make a
regulatory election. Regulatory elections are those elections which have due dates prescribed by a regulation, revenue ruling, revenue procedure, notice or announcement (Treas. Reg. § 301.9100-1(b)).

Under Treas. Reg. § 301.9100-3, the Commissioner has the discretion to grant an extension of time (not to exceed 6 months) to make a regulatory election if the taxpayer can demonstrate to the satisfaction of the Commissioner that: (1) the taxpayer acted reasonably and in good faith; and (2) the grant of relief will not prejudice the interests of the government (Treas. Reg. § 301.9100-3(a)). A taxpayer is deemed to have acted in good faith if the taxpayer requests relief before the failure to make the election is discovered by the Service and the taxpayer either failed to make the election because of intervening events beyond the taxpayer’s control, failed to make the election because the taxpayer was unaware of the necessity for the election, relied on written advice from the Service, or relied on the advice of a qualified tax professional (Treas. Reg. § 301.9100-3(b)(1)).

The request for an extension of time under Treas. Reg. § 301.9100-3 must be submitted as a request for a private letter ruling and must include affidavits from the taxpayer and all other parties with knowledge of the relevant facts (Treas. Reg. § 301.9100-3(e)).

Case Study: The decedent’s will provided that a QTIP marital trust was to be divided into a GST exempt trust and a GST non-exempt trust. Although a QTIP election was made on Schedule M of Form 706, the estate failed to indicate that the marital trust would be divided. In addition, although the estate allocated the decedent’s GST exemption to the marital trust on Schedule R, the estate failed to make a reverse QTIP election. The Service granted the estate a 30-day extension of time under Treas. Reg. § 301.9100-3 to file an amended Schedule M and Schedule R to make a reverse QTIP election because the estate acted reasonably and in good faith and granting such relief did not prejudice the interests of the government. Priv. Ltr. Rul. 200005030 (Feb. 4, 2000).


(Private Letter Ruling 200125040, which was obtained by Ogden Newell & Welch, PLLC, is reproduced in Appendix D.)
III. Allocating GST Exemption to Lifetime Transfers

A. GST Annual Exclusion
As discussed earlier, annual exclusion gifts which are direct skips are excluded from the GST tax (I.R.C. § 2642(c)). This exclusion applies to outright direct skips as well as to direct skips made in trust but only if the trust is for a single beneficiary and the trust property will be included in the beneficiary’s gross estate should the beneficiary die before the trust terminates (I.R.C. § 2642(c)(2)). Only section 2503(c) trusts and single beneficiary Crummey trusts in which the skip person is given a general power of appointment qualify for this exclusion.

B. Allocating GST Exemption to Lifetime Gifts
A major advantage of making a lifetime transfer is the ability to exclude the future income and appreciation on the property from the transferor’s estate. For gifts made in trust, an allocation of GST exemption to the trust will also protect such income and appreciation from GST tax.

Section 2632 provides automatic rules for the allocation of GST exemption for transfers made both during the transferor’s lifetime and at death. Reliance on the statute is undesirable in that it may produce unintended results. Instead, the transferor (or the transferor’s executor) should allocate GST exemption specifically.

1. Timely Allocation. For lifetime direct skips, GST exemption is automatically allocated unless the transferor elects otherwise (I.R.C. § 2632(b)(3)). For other transfers, an allocation of GST exemption to property transferred during the transferor’s lifetime is made on a timely filed gift tax return, Form 709 (Treas. Reg. § 26.2632-1(b)(2)). If the allocation is made on a timely filed gift tax return, the allocation is effective as of the date of the transfer (e.g., the date of the gift) (Treas. Reg. § 26.2632-1(b)(2)(ii)).

To be an effective allocation, the allocation must clearly identify the trust to which the allocation is being made and the amount of GST exemption allocated to it. If the allocation is late or if an inclusion ratio greater than zero is claimed, the allocation must also identify the value of the trust assets at the effective date of allocation. The allocation should also state the inclusion ratio of the trust after the allocation (Treas. Reg. § 26.2632-1(b)(2)(i)).

If the transferor allocates more of the transferor’s GST exemption to a trust than is needed to produce an inclusion ratio of zero, the excess allocation is void (except as provided in Treas. Reg. § 26.2642-3 relating to charitable lead annuity trusts). An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of allocation. Note, however, that a trust has GST potential even if the possibility of a
generation skipping transfer is so remote as to be negligible (Treas. Reg. § 26.2632-1(b)(2)(i)).

**Special Rule for CLATs:** With a charitable lead annuity trust ("CLAT"), a taxpayer’s GST exemption is never effectively allocated until the end of the charitable term. Instead, the GST exemption allocated to the trust at the time of its creation grows annually by the section 7520 rate in effect at the creation of the trust until the charitable interest terminates. This enhanced or "adjusted GST exemption" is then compared to the then value of the trust to determine what part of the trust is exempt from GST (Treas. Reg. § 26.2642-3). Note, however, that this rule does not apply to charitable lead unitrusts ("CLUTs").

There are three possible remedies available to a taxpayer if a timely allocation is not made: (1) substantial compliance; (2) nominal interest rule; and (3) automatic 6 month extension of time to make a statutory election under Treas. Reg. § 301.9100-2.

**a. Substantial Compliance.** Literal compliance with procedural instructions is not always required to make an election. Compliance with the essential requirements of a regulation may be sufficient for the Service to deem that an allocation has been made.

*Case Study:* The taxpayer created an irrevocable trust for the benefit of his spouse and two children. The taxpayer’s spouse timely renounced any interest that she had in the trust. Over a two-year period, the taxpayer transferred cash and marketable securities to the trust. The taxpayer and his spouse elected to split gifts, and in each year the couple allocated a portion of their GST exemptions to the gifts. Although the taxpayer and the taxpayer’s spouse correctly completed Schedules A and C of their gift tax returns (Forms 709), they failed to attach a notice of GST allocation. The Service found that the couple had provided enough information on their gift tax returns to show that they intended to allocate GST exemption to the trust (Priv. Ltr. Rul. 200017013 (Apr. 28, 2000)).

*See also* Priv. Ltr. Rul. 199919027 (May 14, 1999); Priv. Ltr. Rul. 200040013 (Oct. 6, 2000). *But see* Priv. Ltr. Rul. 199937026 (Sept. 17, 1999) (a decedent’s trust was subject to the automatic allocation rules because the executor did not elect the method allocating exemption on the Federal estate tax return and the trust language was insufficient to constitute substantial compliance).

**b. Nominal Interest Rule.** The purpose of the nominal interest rule is to
prevent the use of certain interests to postpone a taxable termination. Section 2652(c)(2) provides that an interest which is used primarily to postpone or avoid the GST tax will be disregarded for purposes of chapter 13. An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax (Treas. Reg. § 26.2612-1(e)(ii)).

The effect of the nominal interest rule is to disregard the nominal interests of certain non-skip persons in determining whether the GST tax should be imposed on certain transfers. In certain situations, the taxpayer may be able to use the nominal interest rule to the taxpayer’s advantage.

Example. T creates an irrevocable trust for the benefit of T’s descendants. The trustee has the discretion to pay income and principal to T’s descendants for the health, education, maintenance, and support. T’s children are independently wealthy, so they would not be entitled to distributions from the trust. Under the nominal interest rule, the interests of T’s children (i.e., non-skip persons) would be disregarded. Therefore, T’s gift to the trust would be a direct skip and there would be an automatic allocation of T’s GST exemption.

But see Priv. Ltr. Rul. 9811044 (Mar. 13, 1998), and Priv. Ltr. Rul. 9825020 (June 19, 1998), where the interests of non-skip persons were not disregarded.

c. Section 9100 Relief. Treasury Regulation § 301.9100-2 provides an automatic 6-month extension for regulatory and statutory elections where the due dates for such elections are the due date of a return including extensions. If a taxpayer files a timely filed gift tax return and discovers that the taxpayer failed to make an election to allocate GST exemption, the taxpayer has 6 months from the due date of the return excluding extensions to file an amended gift tax return and make the allocation (Treas. Reg. § 301.9100-2(b)).

Example. T timely files a gift tax return on April 15, 2001 but fails to allocate GST exemption to T’s gift. T has until October 15, 2001 to file an amended gift tax return and make the election.

The Service has taken the position that the election to allocate GST exemption is a statutory election under section 2632. Therefore, discretionary relief under Treas. Reg. § 301.9100-3 is not available. See Priv. Ltr. Rul. 9226014 (June 26, 1992).
2. **Late Allocation.** For allocations made after the due date for filing a gift tax return (a late allocation), the allocation is effective on the date the return is filed (i.e., the date it is postmarked to the Internal Revenue Service Center), and is deemed to have preceded any taxable event occurring on the same date (Treas. Reg. § 26.2632-1(b)(2)(ii)).

However, when a transferor makes a late allocation of GST exemption to a trust, for the purposes of determining the value of the trust assets, the transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made.

**Example.** If the transferor files a late gift tax return on March 15, the trust assets may be valued on March 1 for the purposes of allocating GST exemption.

This prevents the necessity of valuing the assets on the same day that a return needs to be filed. The election is not applicable to life insurance if the insured dies before the gift tax return is filed (Treas. Reg. § 26.2632-1(c)(2)).

3. **Formula Allocations.** Unless provided otherwise in the regulations, an allocation of GST exemption may be made by a formula; e.g., the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero (Treas. Reg. § 26.2632-1(b)(2)(i)). In general, all allocations of GST exemption, other than to cash gifts, should be made by a formula. A typical formula is as follows:

   *Taxpayer allocates to the transfer the smallest amount of GST exemption necessary to produce an inclusion ratio of zero. Taxpayer believes that the amount necessary to create an inclusion ratio of zero is $________. This is a formula allocation which will change if values are changed on audit.*

4. **Estate Tax Inclusion Period (ETIP).** Treasury Regulation § 26.2632-1(c) sets forth special allocation rules for certain lifetime transfers which are treated as “incomplete” for gift tax purposes. Section 2642(f) prohibits the transferor from making an allocation of GST exemption during to a lifetime transfer before the close of the estate tax inclusion period (“ETIP”). An ETIP is the period during which the value of the property transferred would be included (other than by reason of section 2035) in the gross estate of the transferor (or in limited cases, the gross estate of the transferor’s spouse) if death occurred. (Treas. Reg. § 26.2632-1(c)(1)).

**Example.** On January 1, 2001, T transfers $500,000 to an irrevocable trust for the benefit of T’s descendants. T is the trustee. According to the trust provisions, the trustee, in its sole and absolute discretion, may pay income and principal to T’s descendants. Undistributed income will added to
principal. If T were to die on February 1, 2001, the value of the trust assets would be included in T’s estate under section 2036. Therefore, T cannot allocate GST exemption to the trust until the ETIP terminates. On January 1, 2002, when the value of the trust assets is $1,000,000, T resigns as trustee and releases T’s right to be appointed trustee again in the future. If T were to die on February 1, 2002, the value of the trust assets would be included in T’s estate under section 2035 not section 2036. As a result, the ETIP has terminated and T may now allocate GST exemption to the trust based on the value of the assets on January 1, 2002.

ETIPs usually arise in the context of a grantor retained annuity trust (“GRAT”) or a qualified personal residence trust (“QPRT”).

Example. T transfers T’s personal residence to a QPRT. T retains the right to the use residence for a period of 5 years. If T were to die during the 5-year period, the assets of the trust would be included in the T’s estate. Therefore, T cannot allocate GST exemption to the QPRT until the ETIP terminates (in this instance, when the property would no longer be included in T’s estate -- at the end of the QPRT term).

ETIPs also arise in irrevocable Crummey trusts where the transferor’s spouse has a withdrawal right which is greater than $5,000 or 5 percent of the trust corpus (Treas. Reg. § 26.2632-1(c)(2)(ii)(B)).

If an ETIP exists, any allocation made during that period is not effective until the ETIP closes. Where an allocation has not been made prior to the termination of the ETIP, the allocation will be effective as of the termination of the ETIP if it is made on a timely filed gift tax return (Treas. Reg. § 26.2632-1(c)). An ETIP will terminate on the first to occur the death of the transferor, a generation skipping transfer, or the time at which no portion of the property is includible in the transferor’s gross estate (Treas. Reg. § 26.2632-1(c)(3)).

(Appendix E contains sample notices of GST allocation for timely allocations, late allocations, and allocations made at the close of an ETIP period. Appendix F contains a sample of a timely filed gift tax return including a notice of allocation.)

5. Allocation at Death. A decedent’s unused GST exemption is automatically allocated on the due date for filing the federal estate tax return (Form 706) to the extent it is not otherwise allocated by the decedent’s executor on or before that date. The automatic allocation occurs whether a return is actually required to be filed (Treas. Reg. § 26.2632-1(d)(2)).

As discussed earlier, the decedent’s unused GST exemption is allocated first to direct
skips treated as occurring at the transferor’s death, and then proportionately among trusts from which a taxable distribution or taxable termination may occur (Treas. Reg. § 26.2632-1(d)(2)).

An executor may allocate generation skipping tax exemption either on a gift tax return for property that was given during the transferor’s lifetime, or on the federal estate tax return (Treas. Reg. § 26.2632-1(d)(1)). Once again, an allocation is void if the allocation is made for a trust that has no GST potential with respect to the transferor for whom the allocation is being made, as of the transferor’s date of death. See Priv. Ltr. Rul. 199908024 (Feb. 26, 1999). The executor should be given authority to allocate the decedent’s GST exemption in a provision similar to the following:

*Generation Skipping Tax Elections.* To allocate any part of my generation skipping tax exemption to any property of which I was the transferor and including property transferred by me during life as to which I did not make an allocation prior to my death. I desire Personal Representative to allocate said exemption in a manner which, in Personal Representative’s opinion, will most likely produce the least overall generation skipping tax and/or delay the payment of any such tax for as long a period as possible, for I realize that this tax may be eliminated or modified in the future. Personal Representative will make no compensating adjustments as a result of Personal Representative’s decision regarding allocation of my generation skipping tax exemption.

C. Irrevocable Crummey Trusts Involving Insurance

Certain issues exist which make GST planning more complicated when the underlying asset of an irrevocable Crummey trust is life insurance.

1. **Intentional Late Allocation.** Special planning opportunities arise when considering whether to allocate GST exemption to life insurance. Generally, GST exemption should not be allocated to the premiums paid to an irrevocable trust funded solely with term insurance because most term insurance polices lapse prior to the insured’s death. On the other hand, premiums paid on permanent insurance, such as whole life, which is likely to remain in force until the insured’s death are more appropriate candidates for the allocation of GST exemption.

For new policies, the value of the policy while it is relatively new but older than one year will generally be less than the amount of the premiums paid. Therefore, a late allocation of GST exemption may require less GST exemption to be allocated than would have been allocated otherwise. If the insured dies, however, prior to the allocation, GST exemption must be allocated to the full value of the insurance proceeds. In addition, there may administrative difficulties when filing a late
allocation, including the need to obtain from the insurance company the interpolated terminal reserve of the policy (reported on Form 712) for a specific future date.

2. **Spousal ETIP.** As indicated earlier, the ETIP rules also apply to trusts in which the transferor’s spouse has certain rights. If the transferor’s spouse is a beneficiary a possessing Crummey withdrawal power, an ETIP will occur unless the spouse’s withdrawal right is limited to the greater of $5,000 or 5 percent of the trust corpus, and such withdrawal right terminates no later than 60 days after the transfer to the trust (Treas. Reg. § 26.2632-1(c)(2)(ii)(B)). If an ETIP occurs, no GST exemption may be allocated until the ETIP terminates. The ETIP will terminate at the first to occur of the death of the transferor’s spouse or the time at which no portion of the property transferred would be includible in the spouse’s gross estate (e.g., when the spouse’s withdrawal rights lapse) (Treas. Reg. § 26.2632-1(c)(3)).

IV. **Modifications of GST Tax under H.R. 1836**


The most notable effect of the Act is that it will repeal the estate and GST taxes in 2010 before it expires December 31, 2010. However, prior to repeal (and reinstatement in 2011), the GST rate, like the Federal estate tax rate, will from 55% to 45% by 2009. The GST exemption will continue to be indexed for inflation until December 31, 2003, at which time it will track the applicable exclusion amount for estate taxes, increasing from $1.5 million in 2004 to $3.5 million in 2009 (§ 521 of the Act).

The Act makes six modifications to the GST tax. These are as follows.

A. **Deemed Allocation of Exemption.**

Section 561 of the Act provides that for all transfers made after December 31, 2000, the transferor’s unused GST exemption will be allocated automatically to all inter vivos transfers in trust that are indirect skips to the extent necessary to produce the lowest possible inclusion ratio. An “indirect skip” is any transfer of property (other than a direct skip) subject to GST tax that is made to a GST trust.

A “GST trust” is a trust that could have a generation-skipping transfer with respect to the transferor unless:

1. the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons: (a) before the date that the individual attains age 46, (b) on or before one or
more dates specified in the trust instrument that will occur before the date that such
individual attains age 46, or (c) upon the occurrence of an event that, in accordance
with the regulations, may reasonably be expected to occur before the date that such
individual attains age 46;

(2) the trust instrument provides that more than 25 percent of the trust corpus must be
distributed to or may be withdrawn by one or more individuals who are non-skip
persons and who are living on the date of death of another person identified in the
instrument (by name or by class) who is more than 10 years older than such
individuals;

(3) the trust instrument provides that if one or more individuals who are non-skip
persons die on or before a date or event described in (1) or (2) above, more than 25
percent of the trust corpus either must be distributed to the estate or estates of one or
more of such individuals or is subject to a general power of appointment exercisable
by one or more of the individuals;

(4) the trust is a trust any portion of which would be included in the gross estate of a
non-skip person (other than the transferor) if that person died immediately after the
transfer;

(5) the trust is a charitable lead annuity trust, a charitable remainder annuity trust, or a
charitable remainder unitrust; or

(6) the trust is a trust with respect to which a deduction was allowed under section 2522
for the amount of an interest in the form of the right to receive annual payments of
a fixed percentage of the net fair market value of the trust property (determined
yearly) and which is required to pay principal to a non-skip person if that person is
alive when the yearly payments for which the deduction was allowed terminate.

The transferor may elect not to have the automatic allocation rules apply to an indirect skip.
The election will be deemed to be timely if filed on a timely filed gift tax return for the
calendar year in which the transfer was made or deemed to have been made. The transferor
may also elect not to have the automatic allocation rules apply to any or all transfers made
to a particular trust and may elect to treat any trust as a GST trust (§ 561 of the Act).

B. Retroactive Allocation of GST Exemption.
Under the Act, a transferor may make a retroactive allocation of GST exemption when there
is an unnatural order of death. If a lineal descendant of the transferor who is a non-skip
person predeceases the transferor, the transferor may make an allocation of any unused GST
exemption to previous transfers to the trust on a chronological basis. The allocation,
applicable fraction and inclusion ratio will be determined based on the value of the property
on the date it was transferred to the trust. This provision is effective for deaths of non-skip
persons after December 31, 2000 (§ 561 of the Act).

C. Severing of Trusts.
Under the Act, a trust may be severed into separate trusts through a qualified severance. A "qualified severance" automatically is a division of a single trust and the creation under the governing instrument or local law of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In that case, the trust receiving the fractional share will have an inclusion ratio of zero and the other trust will have an inclusion ratio of one. A severance may be made at any time after December 31, 2000 (§ 562 of the Act).

D. Modification of Valuation Rules.
For timely and automatic allocations of GST exemption to transfers made after December 31, 2000, the value of the property transferred for purposes of determining the inclusion ratio is its value as finally determined for Federal gift or estate tax purposes. For allocations of exemption deemed to be made at the close of an ETIP, the value of the property for purposes of determining the inclusion ratio is its value at the close of the ETIP (§ 563 of the Act).

E. Relief for Late Elections.
The Act authorizes the Secretary of the Treasury to grant extensions of time to make an election to allocate GST exemption to a transfer to a trust, and to grant exceptions to the time requirement for such extensions, without regard to whether any limitations period has expired. If such relief is granted, the allocation would be made using the gift tax or estate tax value of the transfer to the trust at the time of the transfer. The Service will consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer, in determining whether to grant relief. This provision is effective retroactively for requests pending on December 31, 2000 (§ 564 of the Act).

F. Substantial Compliance.
For transfers made after December 31, 2000, if a transferor demonstrates an intent to make an allocation of GST exemption under section 2632, the transferor will be deemed to have allocated so much of the transferor’s unused GST exemption as is necessary to produce the lowest possible inclusion ratio. The Service will consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer, in determining whether there has been substantial compliance (§ 564 of the Act).
APPENDIX A

Final Regulations on the Effective Date Rules

T.D. 8912,
65 Fed. Reg. No. 245,
pp. 79735-79740

Released December 20, 2000
(4) Retention of trust's exempt status in the case of modifications, etc. -- (i) In general.
This paragraph (b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in this paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001.

(A) Discretionary powers. The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if --

(I) Either --

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) Settlement. A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if --

(I) The settlement is the product of arm's length negotiations;
The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

(C) Judicial construction. A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if --

(1) The judicial action involves a bona fide issue; and
(2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

(D) Other changes. (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

(E) Examples. The following examples illustrate the application of this paragraph (b)(4). In each example, assume that the trust established in 1980 was irrevocable for purposes of paragraph (b)(1)(ii) of this section and that there have been no additions to any trust after September 25, 1985. The examples are as follows:

Example 1. Trustee's power to distribute principal authorized under trust instrument. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of A, A's spouse or
A's issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of A, A's spouse, or A's issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of A to die who was alive at the time Trust was executed. Trust will terminate on the death of A, at which time the remaining principal will be distributed to A's issue, per stirpes. In 2002, the trustee distributes part of Trust's principal to a new trust for the benefit of B and C and their issue. The new trust will terminate 21 years after the death of the survivor of B and C, at which time the trust principal will be distributed to the issue of B and C, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 2. Trustee's power to distribute principal pursuant to state statute. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time, the trust principal will be distributed to A's issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. Under state law prior to the enactment of the state statute, the trustee did not have the authority to make distributions in trust. In 2002, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to A for life and further provides that, at A's death, one-half of the trust remainder will pass to B or B's issue and one-half of the trust will pass to C or C's issue. Because the state statute was enacted after Trust was created and requires the consent of all of the parties, the transaction constitutes a modification of Trust. However, the modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. The new trust will terminate at the same date.
Example 3. Construction of an ambiguous term in the instrument. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 4. Change in trust situs. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

Example 5. Division of a trust. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems
appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 6. Merger of two trusts. In 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 7. Modification that does not shift an interest to a lower generation. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A who is a member of the same generation as B and C. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust as modified will not be subject to the provisions of chapter 13 of the Internal Revenue Code. However, the modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes.
**Example 8. Conversion of income interest into unitrust interest.** In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

**Example 9. Allocation of capital gain to income.** In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to the income. The modification does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to A, and decreasing the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

**Example 10. Administrative change to terms of a trust.** In 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) **Effective date.** The rules in this paragraph (b)(4) are applicable on and after December 20, 2000.
APPENDIX B

Sample Generation Skipping Provisions For Trusts
ARTICLE _
Generation Skipping Provisions

_1 Regardless of other provisions herein to the contrary, whenever a trust would have an inclusion ratio of other than zero, after any intended allocation to the trust of generation skipping tax ("GST") exemption, on account of an allocation or addition of assets to the trust, then, prior to such allocation or addition (and any intended application of GST exemption), Trustee will divide the trust (and/or the assets to be allocated or added to it) into two separate parts, each to be administered as a separate trust upon terms identical with those of the original trust. One separate trust (after any intended allocation of GST exemption) will have an inclusion ratio of zero (the "GST Exempt Trust") and the other separate trust will have an inclusion ratio of more than zero (the "GST Non-Exempt Trust"). The GST Exempt Trust and GST Non-Exempt Trust created from an original trust will be referred to as "related trusts."

_2 In addition, and regardless of other provisions herein to the contrary, Trustee will have authority to:

A. Make distributions of income and principal from related trusts, including upon the termination of related trusts, from a GST Exempt Trust to skip persons and from a GST Non-Exempt Trust to non-skip persons, so as to maximize the total assets from the related trusts which the beneficiaries of the related trusts eventually will receive after payment of all applicable transfer taxes; and

B. Pay federal and state transfer taxes payable from or on account of one or both of the related trusts from a GST Non-Exempt Trust to the extent possible.

_3 The definitions of "inclusion ratio," "GST exemption," "skip persons," and "non-skip persons" will be those set forth for such terms by Chapter 13 of the Internal Revenue Code of 1986, as amended.
APPENDIX C

Sample United States Estate (and Generation-Skipping Transfer) Tax Return

Form 706
Sample Form 706 — Notice of GST Allocation and Reverse QTIP Election

Francis J. Smith 2001 Form 706

Assume:

1. Francis J. Smith dies on May 1, 2001 with a net estate of 2,000,000 and without having used any of his GST Exemption during his lifetime.

2. According to the terms of Francis’ will, the residue of his estate is added to his revocable trust agreement. The trust contains a marital deduction formula which provides for a fixed Fund A with the residue to Fund B.

3. The trust authorizes the trustee to divide the trust into separate trusts, one with an inclusion ratio of 0, and one with an inclusion ratio of 1.

4. The estate tax return is timely filed.
### Schedule R—Generation-Skipping Transfer Tax

**Note:** To avoid application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under section 2612 even if the form is not required to be filed to report estate or GST tax.

The GST tax is imposed on taxable transfers of interests in property located outside the United States as well as property located inside the United States.

See instructions beginning on page 19.

#### Part 1.—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) (Special QTIP) Election

You no longer need to check a box to make a section 2652(a)(3) (special QTIP) election. If you list qualifying property in Part 1, line 9, below, you will be considered to have made this election. See page 21 of the separate instructions for details.

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td></td>
<td>1,060,000</td>
</tr>
<tr>
<td>1</td>
<td>Maximum allowable GST exemption</td>
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<tbody>
<tr>
<td>2</td>
<td>Total GST exemption allocated by the decedent against decedent's lifetime transfers</td>
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<tr>
<td>3</td>
<td>Total GST exemption allocated by the executor, using Form 709, against decedent's lifetime transfers</td>
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<thead>
<tr>
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<tbody>
<tr>
<td>4</td>
<td>GST exemption allocated on line 6 of Schedule R, Part 2</td>
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<tr>
<td>5</td>
<td>GST exemption allocated on line 6 of Schedule R, Part 3</td>
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<tbody>
<tr>
<td>6</td>
<td>Total GST exemption allocated on line 4 of Schedule(s) R-1</td>
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<th></th>
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<tbody>
<tr>
<td>7</td>
<td>Total GST exemption allocated to intervivos transfers and direct skips (add lines 2-6)</td>
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<tr>
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<tbody>
<tr>
<td>8</td>
<td>GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1)</td>
</tr>
</tbody>
</table>

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<tr>
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<tbody>
<tr>
<td>9</td>
<td>Allocation of GST exemption to trusts (as defined for GST tax purposes):</td>
</tr>
</tbody>
</table>

| A | Name of trust | B | Trust's EIN (if any) | C | GST exemption allocated on lines 2-6, above (see instructions) | D | Additional GST exemption allocated (see instructions) | E | Trust's inclusion ratio (optional—see instructions) |
|---|---|---|---|---|---|---|---|---|
| Francis J. Smith Trust U/A dated 6/1/95 - Fund B | 61-0000001 | 675,000 | 0.000 |
| Francis J. Smith Trust U/A dated 6/2/95 - Fund A Reverse QTIP | 61-0000002 | 385,000 | 0.000 |

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<tr>
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<tbody>
<tr>
<td>9D</td>
<td>Total. May not exceed line 8, above</td>
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</table>

<table>
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<tr>
<th></th>
<th>1,060,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>GST exemption available to allocate to section 2032A interests received by individual beneficiaries (subtract line 9D from line 8). You must attach special use allocation schedule (see instructions)</td>
</tr>
</tbody>
</table>

|   | 0 |

(See instructions to Schedule R are in the separate instructions.)
A. Francis J. Smith Revocable Trust

Article 4 of the Francis J. Smith Revocable Trust under agreement dated June 1, 1995, divides the trust into two separate trusts, Fund A and Fund B, both for the primary benefit of his wife, Kelly S. Smith, who survived him. At the death of Kelly S. Smith, the remaining assets of the Fund A trust and the Fund B trust will be divided into equal shares, one for each then living child of Francis J. Smith and one for each deceased child with descendants then living. Francis J. Smith had three children living on the date of his death, and no child predeceased him. Each child's share will continue in trust through the child's life and will terminate after the child's death when the youngest then living child of the deceased child is 25.

Pursuant to the executor's authority, the executor hereby makes the following allocation of GST exemption (as defined above) to the Fund B Trust:

1. The executor hereby allocates to the Fund B Trust the smallest amount of GST exemption necessary to produce an inclusion ratio that is as close as possible to 0 or if possible, that is equal to 0. Based on the values as returned, the amount of GST exemption allocated hereby is $675,000. This is a formula allocation that will change if values are changed on audit.

B. Francis J. Smith Revocable Trust Fund A

Paragraph 12.1 authorizes the trustee to divide the Fund A trust into two separate trusts: one of these trusts (to be known as the Fund A Reverse QTIP Trust) will be exempt from the generation-skipping transfer tax because GST exemption is being allocated to it on Part 1 of Schedule R to derive an inclusion ratio of "0" for that trust, and one of these trusts (to be known as the Fund A
Trust) will not be exempt from the generation-skipping transfer tax and will have an inclusion ratio of “1”.

Pursuant to the trustee’s authority, the Fund A trust will be divided as follows:

1. On the date of division, a “fraction” (as defined in 2 below) of the property in the trust at the time of division will be designated for the Fund A Reverse QTIP Trust.

2. The “fraction” will have as its numerator the balance of Francis J. Smith’s Available GST Exemption (as defined below in 5) on his date of death less the amount of such exemption allocated to the Fund B Trust. The fraction will have as its denominator the date of death value (for purposes of the federal estate tax) of the trust minus any federal estate tax and any state death tax incurred by reason of the death of Francis J. Smith that is chargeable to the trust and actually recovered from such trust.

3. The rest of the property in the trust on the date of division will be designated for the Fund A Trust.

4. Each of the two trusts will be funded with a fractional share of each and every substantial interest and right held by the trust.

5. “Available GST Exemption” refers to the amount equal to the GST exemption provided in section 2631(a) of the Internal Revenue Code of 1986, as amended, that has not been allocated by Francis J. Smith, by his executor (as provided in A. and B. above) or by operation of law, to property transferred by Francis J. Smith during his lifetime.

6. The executor hereby allocates to the Fund A Reverse QTIP Trust the smallest amount of GST exemption necessary to produce an inclusion ratio that is as close as possible to 0 or if possible, that is equal to 0. Based on the values as returned, the amount of GST exemption allocated hereby is $385,000. This is a formula allocation that will change if values are changed on audit.
APPENDIX D

Private Letter Ruling 200125040

Issued: June 22, 2001
Legend:

Decedent

Spouse/Executrix

A

Trust 1

Trust 2

Trust 3

Trust 4

Date 1

Date 2

Date 3

Date 4

Date 5
Dear

We received your submissions dated November 21, 2000 and December 12, 2000, requesting (1) a ruling that the severance of Trust 1 into two separate trusts pursuant to § 26.2654-1(b)(1) of the Generation Skipping Transfer (GST) Tax Regulations will be recognized for GST tax purposes; and (2) an extension of time under § 301.9100 of the Procedure and Administration Regulations to make a "reverse" qualified terminable interest property (QTIP) election under § 2652(a)(3) of the Internal Revenue Code with respect to the assets in Trust 3. This letter responds to your request.

Decedent executed a trust agreement on Date 1 and amended the terms of the trust agreement on Date 2, Date 3, and Date 4. Decedent executed a will on Date 5. Decedent died testate on Date 6, survived by Spouse. Decedent's estate timely filed the Federal Estate and Generation Skipping Transfer Tax Return (Form 706) on Date 7.

Article 5.1 of Decedent's will directs that the residue of Decedent's estate, including all lapsed legacies (but excluding property over which Decedent has a power of appointment), is to be bequeathed to the then acting trustee, as trustee, to be added to and administered under the terms of the trust agreement signed by Decedent on Date 1, and as amended to the date of Decedent's death.

Article 4.2 of the trust agreement provides that the trustee will allocate to Trust 2 a sum equal to the largest amount that can pass free of federal estate tax by reason of the unified credit, after taking account of any adjusted taxable gifts made by Decedent, and the state death tax credit allowable to Decedent's estate but no other credit, reduced by the following:

(a) payments from or charges to the principal of Decedent's estate or this trust that are not allowed as deductions in computing the amount of federal estate taxes on Decedent's estate; and

(b) the value of any other property interests that are included in
Decedent’s gross estate which pass in a manner that will not qualify for the marital or charitable deductions.

The remaining trust property, or all of the trust property if there is no property allocated to Trust 2, will be allocated to Trust 1. In making the computation to separate the trust property, values as finally determined for federal estate tax purposes will control.

Article 5.5 of the trust agreement provides that upon Spouse’s death, any remaining income [from Trust 1] will be paid to Spouse’s estate and the remaining principal [of Trust 1] will be added to the principal of Trust 2.

Article 11.1 of the trust agreement provides that regardless of other provisions herein to the contrary, the trustee will divide property held in any trust with a generation skipping inclusion ratio of less than 100% into separate fractional trusts, each to have an inclusion ratio of 100% or zero. Each such trust will be administered as a separate trust.

On Schedule M of Decedent’s Form 706, Executrix made a QTIP election for Trust 1. However, Executrix did not make a reverse QTIP election with respect to Trust 1 and did not allocate Decedent’s GST exemption. At the death of Decedent, Trust 2 was not funded because Decedent’s unified credit was exhausted otherwise. Trust 1 was not severed prior to the date prescribed for filing the Form 706 and the Form 706 did not contain a statement that Trust 1 would be severed.

Executrix, who had no knowledge or experience with estate tax matters, hired a certified public accounting (“CPA”) firm to file the Form 706 and accompanying schedules. The CPA firm spends a significant amount of its practice in estate planning and tax administration. The CPA firm was aware of all relevant facts regarding the estate tax matters of Decedent’s estate. The CPA firm admitted that it completed the Form 706, Schedule M, but failed to prepare Schedule R to make the reverse QTIP election, even though the estate intended to make the reverse QTIP election.

It is represented that Decedent allocated $a of Decedent’s GST exemption against Decedent’s lifetime transfers. In addition, because Decedent bequeathed $b to Decedent’s grandson A, $b of Decedent’s GST exemption is deemed allocated to that direct skip to Decedent’s grandson A. Therefore, it is represented that $c of Decedent’s GST exemption is available for further allocation.

You now propose to sever Trust 1 into two trusts, Trust 3 and Trust 4. Trust 3 will be funded with an amount equal to $g. Trust 4 will be funded with the balance.
You have requested (1) a ruling that a severance of Trust 1 into Trust 3, a trust with an inclusion ratio of zero, and Trust 4, a trust with an inclusion ratio of one, will be recognized for GST tax purposes; and (2) an extension of time to make a reverse QTIP election for Trust 3.

Section 2001(a) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is determined, except as limited by § 2056(b), by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(7)(A) provides that in the case of qualified terminable interest property –

(i) for purposes of § 2056(a), such property is treated as passing to the surviving spouse, and

(ii) for purposes of § 2056(b)(1)(A), no part of such property is treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) provides that, in general, the term “qualified terminable interest property” means property –

(I) which passes from the decedent,

(II) in which the surviving spouse has a qualifying income interest for life, and

(III) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2044(a) provides that the value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life.

Section 2044(b)(1) provides that § 2044 applies to any property if a deduction was allowed with respect to the transfer of such property to the decedent under § 2056(b)(7).
Section 2044(c) provides that for purposes of chapter 11 and chapter 13, property includible in the gross estate of the decedent under § 2044(a) shall be treated as property passing from the decedent.

Section 2601 imposes a tax on every generation-skipping transfer, defined in § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Section 2652(a) provides in part that for purposes of this chapter –

(1) Except as provided in this subsection or § 2653(a), the term “transferor” includes, in the case of any property subject to the tax imposed by chapter 11, the decedent.

An individual shall be treated as transferring any property with respect to which such individual is the transferor.

(3) In the case of any trust with respect to which a deduction is allowed to the decedent under § 2056(b)(7), the estate of the decedent may elect to treat all of the property in such trust for purposes of this chapter as if the election to be treated as qualified terminable interest property had not been made.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual is allowed a GST exemption of $1,000,000 which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2631(b) provides that any allocation under § 2631(a), once made, is irrevocable.

Section 2632(a)(1) provides that any allocation by an individual of his GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual’s estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(c)(1) provides that any portion of an individual’s GST exemption that has not been allocated within the time prescribed by § 2632(a) is deemed to be allocated as follows –

(A) first, to property which is the subject of a direct skip occurring at such individual’s death, and
(B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Section 26.2632-1(d)(2) of the Generation-Skipping Transfer Tax Regulations provides that a decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 or Form 706NA to the extent not otherwise allocated by the decedent's executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust. In addition, no automatic allocation of GST exemption is made to a trust if, during the nine month period ending immediately after the death of the transferor –

(i) No GST has occurred with respect to the trusts; and

(ii) At the end of such period no future GST can occur with respect to the trust.

Section 26.2652-2(b) provides in part that a reverse QTIP election is made on the return on which the QTIP election is made.

Section 26.2654-1(b)(1) provides in part that the severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if –

(i) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or

(ii) The governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and
(A) The terms of each of the new trusts provide in the aggregate fractions for the same succession of interests and beneficiaries as are provided in the original trust;

(B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and

(C) (1) The new trusts are severed on a fractional basis. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a nonpro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.

Section 301.9100-1(c) of the Procedure and Administration Regulations provides that the Commissioner in exercising the Commissioner's discretion may grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Internal Revenue Code except subtitles E, G, H, and I.

Section 301.9100-2 provides automatic extensions of time for certain elections.

Section 301.9100-3(a) provides that, in general, requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100-2 must be made under the rules of § 301.9100-3. Requests for relief subject to this section will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Section 301.9100-3(b)(1) provides that except as provided in paragraphs (b)(3)(i) through (iii) of this section, a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer –

(i) Requests relief under this section before the failure to make the regulatory election is discovered by the Internal Revenue Service (IRS);

(ii) Failed to make the election because of intervening events beyond the taxpayer's control;
(iii) Failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;

(iv) Reasonably relied on the written advice of the Internal Revenue Service (IRS); or

(V) Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

Section 301.9100-3(b)(2) provides that a taxpayer will not be considered to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the professional was not (i) Competent to render advice on the regulatory election; or (ii) Aware of all relevant facts.

Section 301.9100-3(c)(1)(i) provides in part that the interests of the Government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money).

Based on the facts submitted and representations made, we conclude that the requirements of §26.2654-1 have been met in this case. Therefore, we conclude that the severance of Trust 1 into Trust 3 and Trust 4, as provided, will be recognized for GST tax purposes. We grant an extension of time to sever Trust 1 into Trust 3 and Trust 4 within 60 days after the date of this letter. Based on the facts submitted and representations made, we conclude that the requirements of §301.9100-3 have been met in this case. We grant an extension of time to make a reverse QTIP election for Trust 3 under §2652(a)(3) until 30 days after the date of this letter. The extension of time to make the reverse QTIP election under §2652(a)(3) does not extend the time to make an allocation of any remaining GST exemptions. Consequently, Decedent's remaining GST exemption is allocated under the deemed allocation rules of §2632(c).
Except as specifically ruled herein, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provisions of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Paul F. Kugler

Paul F. Kugler
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: Copy for § 6110 purposes
APPENDIX E

Sample Notices of GST Exemption Allocation
Sample Notice for a Timely Allocation

DONOR’S NAME
SS# 000-11-2222
2000 FORM 709

NOTICE OF GST EXEMPTION ALLOCATION
2000 GIFT TAX RETURN

The taxpayer is timely filing a Form 709 for gifts made in 2000 and allocates GST Exemption of $________ to those gifts. The taxpayer hereby states the following regarding his 2000 GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on values set forth in the 2000 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $________. The taxpayer hereby allocates to the Trust Name (EIN #-----) listed on Form 709, Schedule A, Part 1, Items __________, the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
Sample Notice for a Timely Allocation

SPouse’s Name
SS# 333-44-555
2000 FORM 709

NOTICE OF GST EXEMPTION ALLOCATION
2000 GIFT TAX RETURN

The taxpayer is timely filing a Form 709 for gifts made in 2000 and allocates GST Exemption of $________ to those gifts. The taxpayer hereby states the following regarding her 2000 GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on values set forth in the 2000 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $________. The taxpayer hereby allocates to the Trust Name (EIN #-----) listed on Form 709, Schedule A, Part 1, Items __________, of the 2000 Form 709 filed by Donor’s Name, the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
Sample Notice for a Late Allocation

DONOR’S NAME
SS# 000-11-2222
FORM 709

NOTICE OF LATE GST EXEMPTION ALLOCATION
199__ (- 199__) GIFT TAX RETURN(S)

The taxpayer is filing a Form 709 for gifts made in 199__, (199__ and 199__) and allocates GST Exemption of $_______ to those gifts. The taxpayer hereby states the following regarding his GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on the present value of the gifts set forth in the 199__ Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $_______ . The taxpayer hereby allocates to the Trust Name (EIN #-----) listed on his 199__ Form 709, Schedule A, Part 1, Items _________ the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
Sample Notice for a Late Allocation

SPOUSE'S NAME
SS# 333-44-5555
FORM 709

NOTICE OF LATE GST EXEMPTION ALLOCATION
199__ (- 199__) GIFT TAX RETURN(S)

The taxpayer is filing a Form 709 for gifts made in 199__, (199__ and 199__) and allocates GST Exemption of $_________ to those gifts. The taxpayer hereby states the following regarding her GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on the present value of the gifts set forth in the 199__ Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $_________. The taxpayer hereby allocates to the Trust Name (EIN #-----) listed on Form 709, Schedule A, Part 1, Items ____________ of the 199__ Form 709 filed by Donor’s Name, the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
Sample Notice for a Late Allocation to Insurance Trust in Year Where Gifts Made to Trust

FRANCIS J. SMITH
SS# 000-11-2222
FORM 709

NOTICE OF LATE GST EXEMPTION ALLOCATION
1998 - 1999 GIFT TAX RETURNS

The taxpayer is filing a Form 709 for gifts made in 1998 and 1999 and allocates GST Exemption of $0 to those gifts. The taxpayer hereby states the following regarding his GST Exemption allocation:

Francis J. Smith Irrevocable Trust dated September 1, 1998

Worthy National Bank, Trustee
1000 Main Street
Louisville, Kentucky 40200

EIN #61-0000004

The allocation of GST Exemption on Schedule C, Part 2 is based on the present value of the gifts set forth in the 1998 and 1999 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $474. The taxpayer hereby allocates to the trust listed on his 1998 and 1999 Form 709, Schedule A, Part 1, Item 1 the smallest amount of the taxpayer's GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.

I. Total Transfers to Trust

Gifts to this trust by the taxpayer were made on October 1, 1998 of $1,000, October 1, 1999 of $1,000, and October 1, 2000 of $1,000. The allocation on this Notice to the trust will only include the portion of the trust’s property attributable to property added to the trust in 1998 and 1999. GST exemption is not allocated on this return to the trust property attributable to the transfer to the trust in 2000. Such allocation will be made on a timely filed return in 2001.

The portion of the trust attributable to the 1998 and 1999 gifts (which are all of the transfers made before 2000) is a fraction of the trust valued on the date of the GST exemption allocation,
December 1, 2000. The numerator of the fraction is the value of the trust immediately before the 2000 gift was made, and the denominator of the fraction is the value of the trust immediately after the 2000 gift was made.

II. Calculation of Fraction Attributable to pre-2000 Transfers

The numerator of the fraction is the sum of the value of the assets of the trust immediately before the 2000 gift was made on October 1, 2000. The asset then in the trust was XYZ Life Insurance Company whole life insurance policy number 1234567 (the "policy"). The value of the policy on October 1, 2000 was $500. The numerator is $500.

The denominator is the sum of the numerator, $500, and the value of the addition to the trust of $1,000 on October 1, 2000, or $1,500. The fraction is $500 / $1,500, or 0.333.

III. Value of Trust on Date of GST Allocation

For purposes of valuing the trust assets, the taxpayer elects under Treasury Regulation § 26.2642-2(a)(2) to treat the allocation as having been made on December 1, 2000. The trust asset on December 1, 2000 is the life insurance policy. The value of the policy and, therefore, the total value of the trust on the date of allocation is $1,422. (A copy of Form 712 is attached hereto.)

IV. Calculation of GST Allocated Based on Values as Returned

Based on values as returned, applying the fraction, 0.333 to the value of the trust on the date of allocation, $1,422, the value of the portion of the trust attributable to the 1998 and 1999 gifts is $474.
Sample Notice for a Late Allocation to Trust Where Timely Allocation Was Made in Prior Years

FRANCIS J. SMITH
SS# 000-11-2222
FORM 709

NOTICE OF LATE GST EXEMPTION ALLOCATION
1997 - 1999 GIFT TAX RETURNS

The taxpayer is filing a Form 709 for gifts made in 1997, 1998 and 1999 and allocates GST Exemption of $6,728 to those gifts. The taxpayer hereby states the following regarding his GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on the present value of the gifts set forth in the 1996 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $6,728. The taxpayer hereby allocates to the Francis J. Smith Irrevocable Trust Agreement dated August 1, 1996 (EIN #61-0000004) listed on his 1996 Form 709, Schedule A, Part 1, Item 1 the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.

CALCULATION OF ADDITIONAL GST EXEMPTION ALLOCATED

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total contributions made to Trust in 1996:</td>
<td>$18,000</td>
</tr>
<tr>
<td>GST Exemption allocated on 1996 Gift Returns</td>
<td>$18,000</td>
</tr>
<tr>
<td>Annual exclusion gifts made to Trust after 1996:</td>
<td></td>
</tr>
<tr>
<td>Cash gifts for 1997</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cash gifts for 1998</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash gifts for 1999</td>
<td>2,000</td>
</tr>
<tr>
<td>GST Exemption allocated for 1997-99:</td>
<td>$0</td>
</tr>
</tbody>
</table>
Total contributions as of October 1, 2000:
 GST Exempt (75.0%)  $18,000
 GST Non-Exempt (25.0%)  6,000

Value of Trust as of October 1, 2000:
 GST Exempt Amount:  $24,000
   $30,000 x 75.0% =  $22,500
 GST Non-Exempt Amount
   $30,000 x 25.0% =  $7,500

Additional GST Allocated to Trust:  $7,500
Sample Timely Allocation at Close of ETIP

KELLY S. SMITH
SS# 333-44-5555
2000 FORM 709

CLOSE OF ESTATE TAX INCLUSION PERIOD
FOR 1992 GIFT

Kelly S. Smith Irrevocable Trust dated September 1, 1992
(Grantor Retained Annuity Trust)

Grantor: Kelly S. Smith
SSN: 333-44-5555

Trustee: Francis J. Smith, Jr., Trustee
100 Oak Tree Lane
Louisville, Kentucky 40200

On September 1, 1992, the taxpayer created a grantor retained annuity trust ("GRAT"). The taxpayer reported her gift to this trust on Schedule A, Part 1, Item 4 of the taxpayer’s timely filed Form 709 for 1992. According to the terms of the trust, the taxpayer received an annuity payment equal to 18.55% of the initial fair market value of the trust assets for a period of 8 years. The taxpayer’s interest in this trust terminated on September 1, 2000, due to the expiration of the eight-year period, and the trust assets were distributed in fee among the taxpayer’s descendants, including her granddaughter, Maria A. Smith.

Pursuant to section 2642(f)(2)(B) of the Internal Revenue Code, the value for purposes of allocating the taxpayer’s GST exemption is the value of the trust on the date of the close of the estate tax inclusion period, in this case, September 1, 2000. On that date, the trust assets consisted of a 50% undivided interest in real estate located in Louisville, Kentucky valued at $500,000. (An appraisal of the real estate is attached hereto.)

The taxpayer’s granddaughter received 20% of these assets, or a 10% undivided interest in the real estate as a whole. This 10% interest is valued at $50,000 ($500,000 x 10%). The amount of GST Exemption being allocated to this gift is $50,000.
APPENDIX F

Sample United States Gift (and Generation-Skipping Transfer) Tax Return

Form 709
Sample Form 709 — Timely Allocation of GST Exemption to Trust

Francis J. and Kelly S. Smith 2000 Form 709

Assume:

1. Three children, C. D. Smith, Francis J. Smith, Jr., and Katharine E. Smith; and three grandchildren, Maria A. Smith, Lourdes E. Smith, and Andrew C. Smith.

2. Francis makes all gifts and Kelly consents to split gifts. No previous taxable gifts have been made by either spouse.

3. Gift of $10,000 in cash to three children, Maria, Lourdes, and section 2503(c) trust for Andrew.

4. Gift of $65,000 of marketable securities to irrevocable trust which is subject to the withdrawal rights of Kelly ($5,000) and descendants. Trustee has the discretion to pay income and principal among Kelly and descendants pursuant to ascertainable standards. GST exemption will be allocated to the trust.

5. Timely filed gift tax return for 2000 gifts.
Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return

(Section 6019 of the Internal Revenue Code) (For gifts made during calendar year 2000)

Department of the Treasury Internal Revenue Service

See separate instructions.

Donor's first name and middle initial: Francis J.

Donor's last name: Smith

Donor's social security number: 000-11-2222

Address (number, street, and apartment number):

100 Oak Tree Lane

City, state, and ZIP code:

Louisville, Kentucky 40200

Legal residence (domicile) (county & state):

Jefferson Co., KY

Citizenship:

United States

If you received an extension of time to file this Form 709, check here and attach the Form 4868, 2688, 2350, or extension letter.

If the donor died during the year, check here and enter date of death.

If you received an extension of time to file this Form 709, check here and attach the Form 4868, 2688, 2350, or extension letter.

If the donor died during the year, check here and enter date of death.

Signature of donor Date

ON&W 1700 PNC Plaza / KSH

Louisville, KY 40202

Phone no. (502) 582-1601

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 11 of the separate instructions for this form.

Form 709 (2000)
### Part 1. Gifts Subject Only to Gift Tax

<table>
<thead>
<tr>
<th>Item number</th>
<th>Donee's name and address</th>
<th>Donor's adjusted basis of gift</th>
<th>Date of gift</th>
<th>Value at date of gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>C. D. Smith (Son)</td>
<td>Cash</td>
<td>10,000</td>
<td>06/01/00</td>
</tr>
<tr>
<td></td>
<td>200 Maple Leaf Drive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Louisville, Kentucky</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>40200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total from continuation schedule (s):**

- 85,000

**Total of Part 1 (add amounts from Part 1, column E):**

- 95,000

### Part 2. Gifts That are Direct Skips and are Subject to Both Gift Tax and Generation-Skipping Transfer Tax

<table>
<thead>
<tr>
<th>Item number</th>
<th>Donee's name and address</th>
<th>Donor's adjusted basis of gift</th>
<th>Date of gift</th>
<th>Value at date of gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Maria A. Smith (Grandchild)</td>
<td>Cash</td>
<td>10,000</td>
<td>06/01/00</td>
</tr>
<tr>
<td></td>
<td>200 Maple Leaf Drive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Louisville, Kentucky</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>40200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total from continuation schedule (s):**

- 20,000

**Total of Part 2 (add amounts from Part 2, column E):**

- 30,000

### Part 3. Taxable Gift Reconciliation

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total value of gifts of donor (add totals from column E of Parts 1 and 2)</td>
<td>1</td>
<td>125,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>One-half of items from Part 1, line 3, attributable to spouse</td>
<td>2</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Balance (subtract line 2 from line 1)</td>
<td>3</td>
<td>65,000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Gifts of spouse to be included (from Schedule A, Part 3, line 2 of spouse’s return)</td>
<td>4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Deductions (see instructions):**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Gifts of interests to spouse for which a marital deduction will be claimed, based on items of Schedule A</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Exclusions attributable to gifts on line 8</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Marital deduction—subtract line 9 from line 8</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Charitable deduction, based on items less exclusions</td>
<td>11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Total deductions—add lines 10 and 11</td>
<td>12</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Subtract line 12 from line 7</td>
<td>13</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)</td>
<td>14</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Taxable gifts (add lines 13 and 14). Enter here and on line 1 of the Tax Computation on page 1</td>
<td>15</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Item number</td>
<td>Donee's name and address</td>
<td>Relationship to donor (if any)</td>
<td>Description of gift</td>
<td>Donor's adjusted basis of gift</td>
</tr>
<tr>
<td>-------------</td>
<td>--------------------------</td>
<td>-------------------------------</td>
<td>---------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>2</td>
<td>Francis J. Smith, Jr. (Son)</td>
<td></td>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>3</td>
<td>Katharine E. Smith (Daughter)</td>
<td></td>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td>4</td>
<td>Worthy National Bank, Trustee of the Francis J. Smith Irrevocable Trust U/A dated 6/1/95</td>
<td></td>
<td></td>
<td>65 shares of ABC Corporation common stock at $1,000/share</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CUSIP: 12345678ABC</td>
</tr>
<tr>
<td></td>
<td>A. Kelly S. Smith (Spouse)</td>
<td></td>
<td></td>
<td>Withdrawal right</td>
</tr>
<tr>
<td></td>
<td>B. C. D. Smith (Son)</td>
<td></td>
<td></td>
<td>Withdrawal right</td>
</tr>
</tbody>
</table>

TOTAL (Carry forward to main schedule): 10,000 06/01/00 10,000
Donor: Francis J. Smith

CONTINUATION SCHEDULE

Continuation of Schedule A - PART 1

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item number</td>
<td>Donee's name and address</td>
<td>Donor's adjusted basis of gift</td>
<td>Date of gift</td>
<td>Value at date of gift</td>
</tr>
<tr>
<td></td>
<td>Relationship to donor (if any)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Description of gift</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the gift was made by means of a trust, enter trust's EIN and attach a description or copy of the trust instrument (see instructions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the gift was of securities, give CUSIP number</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Francis J. Smith, Jr.</td>
<td>(Son) 300 Azalea Court Louisville, Kentucky 40200 Withdrawal right</td>
<td>5,000 06/01/00</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>D. Katharine E. Smith</td>
<td>(Daughter) 400 Tea Rose Way Louisville, Kentucky 40200 Withdrawal right</td>
<td>5,000 06/01/00</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>E. Maria A. Smith</td>
<td>(Grandchild) 200 Maple Leaf Drive Louisville, Kentucky 40200 Withdrawal right</td>
<td>5,000 06/01/00</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>F. Lourdes E. Smith</td>
<td>(Grandchild) 200 Maple Leaf Drive Louisville, Kentucky 40200 Withdrawal right</td>
<td>5,000 06/01/00</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>G. Andrew C. Smith</td>
<td>(Grandchild) 300 Azalea Court Louisville, Kentucky 40200 Withdrawal right</td>
<td>5,000 06/01/00</td>
<td>10,000</td>
<td></td>
</tr>
</tbody>
</table>

TOTAL (Carry forward to main schedule) .................................................. 85,000
## CONTINUATION SCHEDULE

**Continuation of Schedule A - PART 2**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item number</td>
<td>Donee's name and address</td>
<td>Donor's adjusted basis of gift</td>
<td>Date of gift</td>
<td>Value at date of gift</td>
</tr>
<tr>
<td>2</td>
<td>Lourdes E. Smith (Grandchild) 200 Maple Leaf Drive Louisville, Kentucky 40200</td>
<td>Cash</td>
<td>10,000</td>
<td>06/01/00</td>
</tr>
<tr>
<td>3</td>
<td>Francis J. Smith, Jr., Trustee of the Francis J. Smith Irrevocable §2503(c) Trust Agreement f/b/o Andrew C. Smith dated 7/22/96 EIN: 61-0000005</td>
<td>Andrew C. Smith (Grandchild) 300 Azalea Court Louisville, Kentucky 40200</td>
<td>Cash</td>
<td>10,000</td>
</tr>
</tbody>
</table>

**TOTAL** (Carry forward to main schedule.) .................................................. 20,000
16 Terminable Interest (QTIP) Marital Deduction. (See instructions for line 8 of Schedule A.)
If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and
a. The trust (or other property) is listed on Schedule A, and
b. The value of the trust (or other property) is entered in whole or in part as a deduction on line 8, Part 3 of Schedule A,
then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Part 1 of Schedule A is entered as a deduction on line 8, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on line 10 of Part 3, Schedule A. The denominator is equal to the total value of the trust (or other property) listed in Part 1 of Schedule A.

If you make the QTIP election (see instructions for line 8 of Schedule A), the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax (see Transfer of Certain Life Estates on page 3 of the instructions).

17 Election out of QTIP Treatment of Annuities
☐ < Check here if you elect under section 2523(f)(6) NOT to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). (See instructions.)
Enter the item numbers (from Schedule A) for the annuities for which you are making this election ▶

Gifts From Prior Periods
If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C, if applicable).

<table>
<thead>
<tr>
<th>A Calendar year or calendar quarter (see instructions)</th>
<th>B Internal Revenue office where prior return was filed</th>
<th>C Amount of unified credit against gift tax for periods after December 31, 1976</th>
<th>D Amount of specific exemption for prior periods ending before January 1, 1977</th>
<th>E Amount of taxable gifts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Totals for prior periods (without adjustment for reduced specific exemption)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>2 Amount, if any, by which total specific exemption, line 1, column D, is more than $30,000.</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Total amount of taxable gifts for prior periods (add amount, column E, line 1, and amount, if any, on line 2). (Enter here and on line 2 of the Tax Computation on page 1.)</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(If more space is needed, attach additional sheets of same size.)
### Part 1. Generation-Skipping Transfers

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

If you elected gift splitting and your spouse was required to file a separate Form 709 (see the instructions for "Split Gifts"), you must enter all of the gifts shown on Schedule A, Part 2, of your spouse's Form 709 here.

In column C, enter the item number of each gift in the order it appears in column A of your spouse's Schedule A, Part 2. We have preprinted the prefix "S-" to distinguish your spouse's item numbers from your own when you complete column A of Schedule C, Part 3.

In column D, for each gift, enter the amount reported in column C, Schedule C, Part 1, of your spouse's Form 709.

### Part 2. GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check box if you are making a section 2652(a)(3) (special QTIP) election (see instructions)

Enter the item numbers (from Schedule A) of the gifts for which you are making this election

<table>
<thead>
<tr>
<th>1</th>
<th>Maximum allowable exemption (see instructions)</th>
<th>1</th>
<th>1,030,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Total exemption used for periods before filing this return</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>Exemption available for this return (subtract line 2 from line 1)</td>
<td>3</td>
<td>1,030,000</td>
</tr>
<tr>
<td>4</td>
<td>Exemption claimed on this return (from Part 3, col. C total, below)</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>Exemption allocated to transfers not shown on Part 3, below. You must attach a Notice of Allocation. (See instructions.)</td>
<td>5</td>
<td>35,000</td>
</tr>
<tr>
<td>6</td>
<td>Add lines 4 and 5</td>
<td>6</td>
<td>35,000</td>
</tr>
<tr>
<td>7</td>
<td>Exemption available for future transfers (subtract line 6 from line 3)</td>
<td>7</td>
<td>995,000</td>
</tr>
</tbody>
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### Part 3. Tax Computation

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<td>55%(.55)</td>
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</table>

Total exemption claimed. Enter here and on line 4, Part 2, above. May not exceed line 3, Part 2, above. Total generation-skipping transfer tax. Enter here, on line 14 of Schedule A, Part 3, and on line 16 of the Tax Computation on page 1.

Form 709 (2000)
NOTICE OF GST EXEMPTION ALLOCATION
2000 GIFT TAX RETURN

The taxpayer is timely filing a Form 709 for gifts made in 2000 and allocates GST Exemption of $35,000 to those gifts. The taxpayer hereby states the following regarding his 2000 GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on values set forth in the 2000 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $35,000. The taxpayer hereby allocates to the Francis J. Smith Irrevocable Trust under Agreement dated June 1, 1995 (EIN #61-0000004) listed on Form 709, Schedule A, Part 1, Items 4A through 4F, the smallest amount of the taxpayer’s GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
United States Gift (and Generation-Skipping Transfer) Tax Return

Form 709

Date: 2000

1 Donor's first name and middle initial  
Kelly S.

2 Donor's last name  
Smith

3 Donor's social security number  
333-44-5555

4 Address (number, street, and apartment number)  
100 Oak Tree Lane

5 Legal residence (domicile) (county & state)  
Jefferson Co., KY

6 City, state, and ZIP code  
Louisville, Kentucky 40200

7 Citizenship  
United States

8 If the donor died during the year, check here □ and enter date of death

9 If you received an extension of time to file this Form 709, check here □ and attach the Form 4868, 2688, 2350, or extension letter

10 Enter the total number of separate donees listed on Schedule A—count each person only once □

11a Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If the answer is "No,” do not complete line 11b.

11b If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)? □

12 Gifts by husband or wife to third parties. — Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes", the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No,” skip lines 13-18 and go to Schedule A.) □

13 Name of consenting spouse  
Francis J. Smith

14 SSN  
000-11-2222

15 Were you married to one another during the entire calendar year? (see instructions) □

16 If the answer to line 15 is "No,” check whether □ married □ divorced or □ widowed, and give date (see instructions) □

17 Will a gift tax return for this calendar year be filed by your spouse? □

18 Consent of Spouse — I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.

Consenting spouse’s signature □

Date □

1 Enter the amount from Schedule A, Part 3, line 15

2 Enter the amount from Schedule B, line 3

3 Total taxable gifts (add lines 1 and 2)

4 Tax computed on amount on line 3 (see Table for Computing Tax in separate instructions)

5 Tax computed on amount on line 2 (see Table for Computing Tax in separate instructions)

6 Balance (subtract line 5 from line 4)

7 Maximum unified credit (nonresident aliens, see instructions)

8 Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)

9 Balance (subtract line 8 from line 7)

10 Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)

11 Balance (subtract line 10 from line 9)

12 Unified credit (enter the smaller of line 6 or line 11)

13 Credit for foreign gift taxes (see instructions)

14 Total credits (add lines 12 and 13)

15 Balance (subtract line 14 from line 6) (do not enter less than zero)

16 Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, Total)

17 Total tax (add lines 15 and 16)

18 Gift and generation-skipping transfer taxes prepaid with extension of time to file

19 If line 18 is less than line 17, enter balance due (see instructions)

20 If line 18 is greater than line 17, enter amount to be refunded

Paid Preparer’s Use Only

Signature of donor □

Date □

Preparer’s signature □

Date □

Check if self-employed □

Preparer’s name (or yours if self-employed), address, and ZIP code

ON&W 1700 PNC Plaza / KSH

Louisville, KY 40202

Phone no. (502) 582-1601

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 11 of the separate instructions for this form.
### Part 1—Gifts Subject Only to Gift Tax.

<table>
<thead>
<tr>
<th>Item number</th>
<th>Donee's name and address</th>
<th>Relationship to donor (if any)</th>
<th>Description of gift</th>
<th>Date of gift</th>
<th>Value of gift</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**NONE**

**Total of Part 1 (add amounts from Part 1, column E)**

### Part 2—Gifts That are Direct Skips and are Subject to Both Gift Tax and Generation-Skipping Transfer Tax.

<table>
<thead>
<tr>
<th>Item number</th>
<th>Donee's name and address</th>
<th>Relationship to donor (if any)</th>
<th>Description of gift</th>
<th>Date of gift</th>
<th>Value of gift</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**NONE**

**Total of Part 2 (add amounts from Part 2, column E)**

### Part 3—Taxable Gift Reconciliation

1. Total value of gifts of donor (add totals from column E of Parts 1 and 2)
2. One-half of items attributable to spouse (see instructions)
3. Balance (subtract line 2 from line 1)
4. Gifts of spouse to be included (from Schedule A, Part 3, line 2 of spouse's return—see instructions)
5. Total gifts (add lines 3 and 4)
6. Total annual exclusions for gifts listed on Schedule A (including line 4, above) (see instructions)
7. Total included amount of gifts (subtract line 6 from line 5)

**Deductions (see instructions)**

8. Gifts of interests to spouse for which a marital deduction will be claimed, based on items of Schedule A
9. Exclusions attributable to gifts on line 8
10. Marital deduction—subtract line 9 from line 8
11. Charitable deduction, based on items less exclusions
12. Total deductions—add lines 10 and 11
13. Subtract line 12 from line 7
14. Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)
15. Taxable gifts (add lines 13 and 14). Enter here and on line 1 of the Tax Computation on page 1

(If more space is needed, attach additional sheets of same size.)
16 Termination Interest (QTIP) Marital Deduction. (See instructions for line 8 of Schedule A.)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and

a. The trust (or other property) is listed on Schedule A, and

b. The value of the trust (or other property) is entered in whole or in part as a deduction on line 8, Part 3 of Schedule A,

then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Part 1 of Schedule A is entered as a deduction on line 8, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on line 10 of Part 3, Schedule A. The denominator is equal to the total value of the trust (or other property) listed in Part 1 of Schedule A.

If you make the QTIP election (see instructions for line 8 of Schedule A), the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). If your spouse disposes (by gift or otherwise) of all or part of the qualifying life interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax (see Transfer of Certain Life Estates on page 3 of the instructions).

17 Election out of QTIP Treatment of Annuities

☐ Check here if you elect under section 2523(f)(6) NOT to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). (See instructions.)

18 Gifts From Prior Periods

If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C, if applicable).

<table>
<thead>
<tr>
<th>Calendar year or calendar quarter (see instructions)</th>
<th>Internal Revenue office where prior return was filed</th>
<th>Amount of unified credit against gift tax for periods after December 31, 1976</th>
<th>Amount of specific exemption for prior periods ending before January 1, 1977</th>
<th>Amount of taxable gifts</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td>E</td>
</tr>
<tr>
<td>1 Totals for prior periods (without adjustment for reduced specific exemption)</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2 Amount, if any, by which total specific exemption, line 1, column D, is more than $30,000.</td>
<td>2</td>
<td></td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>3 Total amount of taxable gifts for prior periods (add amount, column E, line 1, and amount, if any, on line 2). (Enter here and on line 2 of the Tax Computation on page 1.)</td>
<td>3</td>
<td></td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

(If more space is needed, attach additional sheets of same size.)
Note: Inter vivos direct skips that are completely excluded by the GST exemption must still be fully reported (including value and exemptions claimed) on Schedule C.

### Part 1.—Generation-Skipping Transfers

<table>
<thead>
<tr>
<th>A</th>
<th>Value</th>
<th>Split Gifts</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
</table>

If you elected gift splitting and your spouse was required to file a separate Form 709 (see the instructions for "Split Gifts"), you must enter all of the gifts shown on Schedule A, Part 2, of your spouse's Form 709 here.

In column C, enter the item number of each gift in the order it appears in column A of your spouse's Schedule A, Part 2. We have preprinted the prefix "S-" to distinguish your spouse's item numbers from your own when you complete column A of Schedule C, Part 2.

In column D, enter the amount reported in column C, Schedule C, Part 1, of your spouse's Form 709.

#### Part 2.—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check box ☐ if you are making a section 2652(a)(3) (special QTIP) election (see instructions). Enter the item numbers (from Schedule A) of the gifts for which you are making this election.

<table>
<thead>
<tr>
<th>1</th>
<th>Maximum allowable exemption (see instructions)</th>
<th>1,030,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Total exemption used for periods before filing this return</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>Exemption available for this return (subtract line 2 from line 1)</td>
<td>1,030,000</td>
</tr>
<tr>
<td>4</td>
<td>Exemption claimed on this return (from Part 3, col. C total, below)</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>Exemption allocated to transfers not shown on Part 3, below. You must attach a Notice of Allocation. (See instructions.)</td>
<td>30,000</td>
</tr>
<tr>
<td>6</td>
<td>Add lines 4 and 5</td>
<td>30,000</td>
</tr>
<tr>
<td>7</td>
<td>Exemption available for future transfers (subtract line 6 from line 3)</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

#### Part 3.—Tax Computation

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
</tr>
</thead>
<tbody>
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<td>55%(55)</td>
</tr>
</tbody>
</table>

Total exemption claimed. Enter here and on line 4, Part 2, above. May not exceed line 3, Part 2, above. Total generation-skipping transfer tax. Enter here, on line 14 of Schedule A, Part 3, and on line 16 of the Tax Computation on page 1.
NOTICE OF GST EXEMPTION ALLOCATION
2000 GIFT TAX RETURN

The taxpayer is timely filing a Form 709 for gifts made in 2000 and allocates GST Exemption of $30,000 to those gifts. The taxpayer hereby states the following regarding her 2000 GST Exemption allocation:

The allocation of GST Exemption on Schedule C, Part 2 is based on values set forth in the 2000 Form 709. The taxpayer believes that the amount of GST Exemption necessary to create an inclusion ratio of zero is $30,000. The taxpayer hereby allocates to the Francis J. Smith Irrevocable Trust under Agreement dated June 1, 1995 (EIN #61-0000004) listed on Form 709, Schedule A, Part 1, Items 4B - 4F, of the 2000 Form 709 filed by Francis J. Smith, the smallest amount of the taxpayer's GST Exemption necessary to produce an inclusion ratio (IRC § 2642(a)) which is closest to, or if possible, equal to zero for the portion of each trust of which taxpayer is considered transferor. This is a formula allocation which will change if values are changed on audit.
APPENDIX G

Economic Growth and Tax Relief
Reconciliation Act of 2001

H.R. 1836

Enacted June 7, 2001
CONERENCE REPORT

The committee of conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 1836), to provide for reconciliation pursuant to section 104 of the concurrent resolution on the budget for fiscal year 2002, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendment of the Senate and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment, insert the following:

SECTION 1. SHORT TITLE; REFERENCES; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the “Economic Growth and Tax Relief Reconciliation Act of 2001”.

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal
of a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents of this Act is as follows:

Sec. 1. Short title; references; table of contents.

TITLE I—INDIVIDUAL INCOME TAX RATE REDUCTIONS

Sec. 101. Reduction in income tax rates for individuals.
Sec. 102. Repeal of phaseout of personal exemptions.
Sec. 103. Phaseout of overall limitation on itemized deductions.

TITLE II—TAX BENEFITS RELATING TO CHILDREN

Sec. 201. Modifications to child tax credit.
Sec. 202. Expansion of adoption credit and adoption assistance programs.
Sec. 203. Refunds disregarded in the administration of Federal programs and federally assisted programs.
Sec. 204. Dependent care credit.
Sec. 205. Allowance of credit for employer expenses for child care assistance.

TITLE III—MARRIAGE PENALTY RELIEF

Sec. 301. Elimination of marriage penalty in standard deduction.
Sec. 302. Phaseout of marriage penalty in 15-percent bracket.
Sec. 303. Marriage penalty relief for earned income credit; earned income to include only amounts includible in gross income; simplification of earned income credit.

TITLE IV—AFFORDABLE EDUCATION PROVISIONS

Subtitle A—Education Savings Incentives

Sec. 401. Modifications to education individual retirement accounts.
Sec. 402. Modifications to qualified tuition programs.

Subtitle B—Educational Assistance

Sec. 411. Extension of exclusion for employer-provided educational assistance.
Sec. 412. Elimination of 60-month limit and increase in income limitation on student loan interest deduction.
Sec. 413. Exclusion of certain amounts received under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program.

Subtitle C—Liberalization of Tax-Exempt Financing Rules for Public School Construction

Sec. 421. Additional increase in arbitrage rebate exception for governmental bonds used to finance educational facilities.
Sec. 422. Treatment of qualified public educational facility bonds as exempt facility bonds.

Subtitle D—Other Provisions

Sec. 431. Deduction for higher education expenses.

TITLE V—ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

Subtitle A—Repeal of Estate and Generation-Skipping Transfer Taxes

Sec. 501. Repeal of estate and generation-skipping transfer taxes.

Subtitle B—Reductions of Estate and Gift Tax Rates

Sec. 511. Additional reductions of estate and gift tax rates.

Subtitle C—Increase in Exemption Amounts

Sec. 521. Increase in exemption equivalent of unified credit, lifetime gifts exemption, and GST exemption amounts.

Subtitle D—Credit for State Death Taxes

Sec. 531. Reduction of credit for State death taxes.
Sec. 532. Credit for State death taxes replaced with deduction for such taxes.

Subtitle E—Carryover Basis at Death; Other Changes Taking Effect With Repeal

Sec. 541. Termination of step-up in basis at death.

Subtitle F—Conservation Easements

Sec. 551. Expansion of estate tax rule for conservation easements.

Subtitle G—Modifications of Generation-Skipping Transfer Tax

Sec. 561. Deemed allocation of GST exemption to lifetime transfers to trusts; retroactive allocations.
Sec. 562. Severing of trusts.
Sec. 563. Modification of certain valuation rules.
Sec. 564. Relief provisions.

Subtitle H—Extension of Time for Payment of Estate Tax

Sec. 571. Increase in number of allowable partners and shareholders in closely held businesses.
Sec. 572. Expansion of availability of installment payment for estates with interests qualifying lending and finance businesses.
Sec. 572. Clarification of availability of installment payment.

Subtitle I—Other Provisions

Sec. 581. Waiver of statute of limitation for taxes on certain farm valuations.
TITLE VI—PENSION AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS

Subtitle A—Individual Retirement Accounts

Sec. 601. Modification of IRA contribution limits.
Sec. 602. Deemed IRAs under employer plans.

Subtitle B—Expanding Coverage

Sec. 611. Increase in benefit and contribution limits.
Sec. 612. Plan loans for subchapter S owners, partners, and sole proprietors.
Sec. 613. Modification of top-heavy rules.
Sec. 614. Elective deferrals not taken into account for purposes of deduction limits.
Sec. 615. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations.
Sec. 616. Deduction limits.
Sec. 617. Option to treat elective deferrals as after-tax Roth contributions.
Sec. 618. Nonrefundable credit to certain individuals for elective deferrals and IRA contributions.
Sec. 619. Credit for pension plan startup costs of small employers.
Sec. 620. Elimination of user fee for requests to IRS regarding pension plans.
Sec. 621. Treatment of nonresident aliens engaged in international transportation services.

Subtitle C—Enhancing Fairness for Women

Sec. 631. Catch-up contributions for individuals age 50 or over.
Sec. 632. Equitable treatment for contributions of employees to defined contribution plans.
Sec. 633. Faster vesting of certain employer matching contributions.
Sec. 634. Modification to minimum distribution rules.
Sec. 635. Clarification of tax treatment of division of section 457 plan benefits upon divorce.
Sec. 636. Provisions relating to hardship distributions.
Sec. 637. Waiver of tax on nondeductible contributions for domestic or similar workers.

Subtitle D—Increasing Portability for Participants

Sec. 641. Rollovers allowed among various types of plans.
Sec. 642. Rollovers of IRAs into workplace retirement plans.
Sec. 643. Rollovers of after-tax contributions.
Sec. 644. Hardship exception to 60-day rule.
Sec. 645. Treatment of forms of distribution.
Sec. 646. Rationalization of restrictions on distributions.
Sec. 647. Purchase of service credit in governmental defined benefit plans.
Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts.
Sec. 649. Minimum distribution and inclusion requirements for section 457 plans.

Subtitle E—Strengthening Pension Security and Enforcement

PART I—GENERAL PROVISIONS

Sec. 651. Repeal of 160 percent of current liability funding limit.
Sec. 652. Maximum contribution deduction rules modified and applied to all defined benefit plans.
Sec. 653. Excise tax relief for sound pension funding.
Sec. 654. Treatment of multiemployer plans under section 415.
Sec. 655. Protection of investment of employee contributions to 401(k) plans.
Sec. 656. Prohibited allocations of stock in S corporation ESOP.
Sec. 657. Automatic rollovers of certain mandatory distributions.
Sec. 658. Clarification of treatment of contributions to multiemployer plan.

PART II—TREATMENT OF PLAN AMENDMENTS REDUCING FUTURE BENEFIT ACCRUALS

Sec. 659. Excise tax on failure to provide notice by defined benefit plans significantly reducing future benefit accruals.

Subtitle F—Reducing Regulatory Burdens

Sec. 661. Modification of timing of plan valuations.
Sec. 662. ESOP dividends may be reinvested without loss of dividend deduction.
Sec. 663. Repeal of transition rule relating to certain highly compensated employees.
Sec. 664. Employees of tax-exempt entities.
Sec. 665. Clarification of treatment of employer-provided retirement advice.
Sec. 666. Repeal of the multiple use test.

Subtitle G—Miscellaneous Provisions

Sec. 671. Tax treatment and information requirements of Alaska Native Settlement Trusts.

TITLE VII—ALTERNATIVE MINIMUM TAX

Sec. 701. Increase in alternative minimum tax exemption.

TITLE VIII—OTHER PROVISIONS

Sec. 801. Time for payment of corporate estimated taxes.
Sec. 802. Expansion of authority to postpone certain tax-related deadlines by reason of Presidential declared disaster.
Sec. 803. No Federal income tax on restitution received by victims of the Nazi regime or their heirs or estates.

TITLE IX—COMPLIANCE WITH CONGRESSIONAL BUDGET ACT

Sec. 901. Sunset of provisions of Act.
of the date of the contribution referred to in paragraph (8)(B)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after December 31, 2000.

**Subtitle G—Modifications of Generation-Skipping Transfer Tax**

SEC. 561. DEEMED ALLOCATION OF GST EXEMPTION TO LIFETIME TRANSFERS TO TRUSTS; RETRO-ACTIVE ALLOCATIONS.

(a) In General.—Section 2632 (relating to special rules for allocation of GST exemption) is amended by redesignating subsection (c) as subsection (e) and by inserting after subsection (b) the following new subsections:

“(c) DEEMED ALLOCATION TO CERTAIN LIFETIME TRANSFERS TO GST TRUSTS.—

“(1) In general.—If any individual makes an indirect skip during such individual’s lifetime, any unused portion of such individual’s GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the indirect skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.
“(2) UNUSED PORTION.—For purposes of paragraph (1), the unused portion of an individual’s GST exemption is that portion of such exemption which has not previously been—

“(A) allocated by such individual,

“(B) treated as allocated under subsection (b) with respect to a direct skip occurring during or before the calendar year in which the indirect skip is made, or

“(C) treated as allocated under paragraph (1) with respect to a prior indirect skip.

“(3) DEFINITIONS.—

“(A) INDIRECT SKIP.—For purposes of this subsection, the term ‘indirect skip’ means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust.

“(B) GST TRUST.—The term ‘GST trust’ means a trust that could have a generation-skipping transfer with respect to the transferor unless—

“(i) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn
by one or more individuals who are non-skip persons—

“(I) before the date that the individual attains age 46,

“(II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or

“(III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,

“(ii) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals,

“(iii) the trust instrument provides that, if one or more individuals who are
non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,

“(iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,

“(v) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or

“(vi) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay
principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

For purposes of this subparagraph, the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

"(4) AUTOMATIC ALLOCATIONS TO CERTAIN GST TRUSTS.—For purposes of this subsection, an indirect skip to which section 2642(f) applies shall be deemed to have been made only at the close of the estate tax inclusion period. The fair market value of such transfer shall be the fair market value of the trust property at the close of the estate tax inclusion period.

"(5) APPLICABILITY AND EFFECT.—

"(A) IN GENERAL.—An individual—

"(i) may elect to have this subsection not apply to—

"(I) an indirect skip, or
"(II) any or all transfers made by such individual to a particular trust, and

"(ii) may elect to treat any trust as a GST trust for purposes of this subsection with respect to any or all transfers made by such individual to such trust.

"(B) ELECTIONS.—

"(i) ELECTIONS WITH RESPECT TO INDIRECT SKIPS.—An election under subparagraph (A)(i)(I) shall be deemed to be timely if filed on a timely filed gift tax return for the calendar year in which the transfer was made or deemed to have been made pursuant to paragraph (4) or on such later date or dates as may be prescribed by the Secretary.

"(ii) OTHER ELECTIONS.—An election under clause (i)(II) or (ii) of subparagraph (A) may be made on a timely filed gift tax return for the calendar year for which the election is to become effective.

"(d) RETROACTIVE ALLOCATIONS.—

"(1) IN GENERAL.—If—
“(A) a non-skip person has an interest or a future interest in a trust to which any transfer has been made,

“(B) such person—

“(i) is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor’s spouse or former spouse, and

“(ii) is assigned to a generation below the generation assignment of the transferor, and

“(C) such person predeceases the transferor, then the transferor may make an allocation of any of such transferor’s unused GST exemption to any previous transfer or transfers to the trust on a chronological basis.

“(2) SPECIAL RULES.—If the allocation under paragraph (1) by the transferor is made on a gift tax return filed on or before the date prescribed by section 6075(b) for gifts made within the calendar year within which the non-skip person’s death occurred—

“(A) the value of such transfer or transfers for purposes of section 2642(a) shall be determined as if such allocation had been made on a
timely filed gift tax return for each calendar year within which each transfer was made,

“(B) such allocation shall be effective immediately before such death, and

“(C) the amount of the transferor’s unused GST exemption available to be allocated shall be determined immediately before such death.

“(3) FUTURE INTEREST.—For purposes of this subsection, a person has a future interest in a trust if the trust may permit income or corpus to be paid to such person on a date or dates in the future.”.

(b) CONFORMING AMENDMENT.—Paragraph (2) of section 2632(b) is amended by striking “with respect to a prior direct skip” and inserting “or subsection (c)(1)”.

(c) EFFECTIVE DATES.—

(1) DEEMED ALLOCATION.—Section 2632(c) of the Internal Revenue Code of 1986 (as added by subsection (a)), and the amendment made by subsection (b), shall apply to transfers subject to chapter 11 or 12 made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

(2) RETROACTIVE ALLOCATIONS.—Section 2632(d) of the Internal Revenue Code of 1986 (as added by subsection (a)) shall apply to deaths of non-skip persons occurring after December 31, 2000.
SEC. 562. SEVERING OF TRUSTS.

(a) IN GENERAL.—Subsection (a) of section 2642 (relating to inclusion ratio) is amended by adding at the end the following new paragraph:

“(3) SEVERING OF TRUSTS.—

“(A) IN GENERAL.—If a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for purposes of this chapter.

“(B) QUALIFIED SEVERANCE.—For purposes of subparagraph (A)—

“(i) IN GENERAL.—The term ‘qualified severance’ means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if—

“(I) the single trust was divided on a fractional basis, and

“(II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

“(ii) TRUSTS WITH INCLUSION RATIO GREATER THAN ZERO.—If a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance
only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

“(iii) REGULATIONS.—The term ‘qualified severance’ includes any other severance permitted under regulations prescribed by the Secretary.

“(C) TIMING AND MANNER OF SEVERANCES.—A severance pursuant to this paragraph may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Secretary.”.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to severances after December 31, 2000.

SEC. 563. MODIFICATION OF CERTAIN VALUATION RULES.

(a) GIFTS FOR WHICH GIFT TAX RETURN FILED OR DEEMED ALLOCATION MADE.—Paragraph (1) of section
2642(b) (relating to valuation rules, etc.) is amended to read as follows:

"(1) GIFTS FOR WHICH GIFT TAX RETURN FILED OR DEEMED ALLOCATION MADE.—If the allocation of the GST exemption to any transfers of property is made on a gift tax return filed on or before the date prescribed by section 6075(b) for such transfer or is deemed to be made under section 2632 (b)(1) or (c)(1)—

"(A) the value of such property for purposes of subsection (a) shall be its value as finally determined for purposes of chapter 12 (within the meaning of section 2001(f)(2)), or, in the case of an allocation deemed to have been made at the close of an estate tax inclusion period, its value at the time of the close of the estate tax inclusion period, and

"(B) such allocation shall be effective on and after the date of such transfer, or, in the case of an allocation deemed to have been made at the close of an estate tax inclusion period, on and after the close of such estate tax inclusion period."

(b) TRANSFERS AT DEATH.—Subparagraph (A) of section 2642(b)(2) is amended to read as follows:
“(A) TRANSFERS AT DEATH.—If property is transferred as a result of the death of the transferor, the value of such property for purposes of subsection (a) shall be its value as finally determined for purposes of chapter 11; except that, if the requirements prescribed by the Secretary respecting allocation of post-death changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned.”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers subject to chapter 11 or 12 of the Internal Revenue Code of 1986 made after December 31, 2000.

SEC. 564. RELIEF PROVISIONS.

(a) IN GENERAL.—Section 2642 is amended by adding at the end the following new subsection:

“(g) RELIEF PROVISIONS.—

“(1) RELIEF FROM LATE ELECTIONS.—

“(A) IN GENERAL.—The Secretary shall by regulation prescribe such circumstances and procedures under which extensions of time will be granted to make—
“(i) an allocation of GST exemption described in paragraph (1) or (2) of subsection (b), and

“(ii) an election under subsection (b)(3) or (c)(5) of section 2632.

Such regulations shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of this paragraph.

“(B) BASIS FOR DETERMINATIONS.—In determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

“(2) SUBSTANTIAL COMPLIANCE.—An allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of so much of the trans-
feror’s unused GST exemption as produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances shall be taken into account, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant.”.

(b) EFFECTIVE DATES.—

(1) RELIEF FROM LATE ELECTIONS.—Section 2642(g)(1) of the Internal Revenue Code of 1986 (as added by subsection (a)) shall apply to requests pending on, or filed after, December 31, 2000.

(2) SUBSTANTIAL COMPLIANCE.—Section 2642(g)(2) of such Code (as so added) shall apply to transfers subject to chapter 11 or 12 of the Internal Revenue Code of 1986 made after December 31, 2000. No implication is intended with respect to the availability of relief from late elections or the application of a rule of substantial compliance on or before such date.
IF IT'S BROKE, CAN YOU FIX IT?

A Panel Discussion

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IF IT'S BROKE, CAN YOU FIX IT?

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July 14, 2001

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PROBLEM: CHARITABLE REMAINDER TRUST DOES NOT QUALIFY FOR CHARITABLE DEDUCTION.

At her death Theresa Testatrix, a widow who had no living descendants, lived with her sister, Mary, also a widow, and her bachelor brother, George. In her Will, Theresa leaves her residuary estate to a trust from which Mary and George, aged 85 and 80, respectively, are to receive all of the net income in equal shares as long as both are living, and the survivor is to receive all of the net income until his/her death. The trustee is authorized to use the principal of the trust in its discretion to pay reasonable health care expenses of Mary and George.

At the death of the survivor, the principal of the trust is to be distributed outright in equal shares to the Kentucky Historical Society and the Kentucky Chapter of The Nature Conservancy. Theresa's Will did not contain any provision authorizing the trustee to amend the trust in order for it to qualify for more favorable tax treatment.

The trust as drafted did not qualify as a charitable remainder trust as defined in Code Section 664(d)(1), and Theresa's estate will not be entitled to an estate tax charitable deduction for the significant value of the remainder interests that will pass to the charitable organizations after her sister and brother are deceased. The estate tax that will have to be paid will not only reduce the amounts that will ultimately go to the charities, it will also reduce the assets from which her sister and brother will receive the income during their lives.

SOLUTION:

Code Section 2055(e)(3), as amended by the 1984 Tax Reform Act, sets out permanent rules governing the reformation of charitable remainder trusts that do not comply with the requirements first imposed by the 1969 Tax Reform Act. Subsection (e)(3)(J) was added in 1997 to allow reformation of a charitable remainder trust that does not meet the minimum charitable benefit rules imposed at that time.

In order to be eligible for reformation, the otherwise nonqualifying interest must constitute a "reformable interest." Section 2055(c)(3)(C)(i) states that "in general" a "reformable interest" is an interest for which an estate tax charitable deduction would have been allowed before enactment of the 1969 Act.

This "general rule" is subject to a number of qualifications:

1. Prior to the 1969 Act an estate tax charitable deduction was allowed even though the trustee could invade principal for the benefit of a life income beneficiary, if that power was limited by an ascertainable standard. However, the presence of any power of invasion will disqualify a trust as a charitable remainder trust under § 664(d). Consequently, before a qualified reformation may take place in such a situation the noncharitable beneficiary must execute a timely qualified disclaimer pursuant to § 2518 of his/her right to receive any principal distribution.
2. If the trustee is given completely discretionary authority (i.e., not limited by an ascertainable standard) to distribute principal to the noncharitable beneficiary, such beneficiary's interest would not have qualified for a charitable deduction prior to 1969 and, therefore, does not meet the definition of a "reformable interest." A timely qualified disclaimer by the noncharitable beneficiary of any right to receive principal distributions should transform such beneficiary's interest into a "reformable interest." (Section 2518(a) states that "If a person makes a qualified disclaimer with respect to any interest in property, this subtitle [Subtitle B-Estate and Gift Taxes] shall apply with respect to such interest as if the interest had never been transferred to such person.") However, there does not appear to be any specific authority for this position. In addition, prudence dictates that in both of these situations, the trustee should also execute a timely qualified disclaimer of the right to make discretionary distributions of principal.

3. Subsection 2055(e)(3)(C)(ii), added in 1978, provides that in order for an interest to be a "reformable interest" all payments to noncharitable beneficiaries must be expressed either in specific dollar amounts or a fixed percentage of the fair market value of the property (in other words, either as an annuity or a unitrust amount). Standing alone, this requirement would keep a substantial percentage of noncharitable interests from being "reformable interests." However, the statute itself contains two exceptions to the application of this requirement:

(a) Subsection 2055(e)(3)(C)(iv) provides that subsection 2055(e)(3)(C)(ii) shall not apply to any interest passing under a will executed before January 1, 1979, or under a trust created before such date, and there are still a few of those left around; and

(b) More importantly, subsection 2055(e)(3)(C)(iii) states that subsection 2055(e)(3)(C)(ii) shall not apply to an interest if a judicial proceeding is commenced to change such interest into a qualified interest not later than the 90th day after (1) the last date (including extensions) for filing the federal estate tax return, if one is required, or (2) if no federal estate tax return is required, the last date (including extensions) for filing the income tax return for the first taxable year for which such a return is required to be filed by the trust.

Consequently, the interests of Mary and George may be reformed if

(1) Timely qualified disclaimers of their ability to receive discretionary distributions of principal are executed by them (or effectively on their behalf), generally before they have received any benefit therefrom and within nine months after Theresa's death; and

(2) A judicial proceeding to reform their interests is commenced within the time limits set out in subsection 2055(e)(3)(C)(iii).

KRS 386.360 authorizes the "amendment" of the governing instrument of a charitable trust "to permit the trust to conform to the requirements of, or to obtain benefits available under, applicable provisions of the Internal Revenue Code." The efficacy of this statute is somewhat impaired by the fact that as used therein "Internal Revenue Code" is defined in KRS 386.350 to mean the Internal Revenue Code of 1954 in effect on January 1, 1970, including all appropriate provisions of the Tax Reform Act of 1969 exclusive of any amendments made subsequent to December 31, 1969. Nevertheless, on account of both KRS 386.360 and the general oversight of
charitable trusts vested in the Attorney General, the Attorney General should be joined as a respondent in any action to reform a charitable remainder trust pursuant to § 2055(e)(3).

Unless the reformation action is completed prior to the filing of the federal estate tax return, the personal representative is obliged to file the return on the basis of the unreformed trust, pay any tax due in a timely manner and then assert a claim for refund after reformation has been completed. A possible alternative is to obtain timely extensions both to file the return and to pay the tax, paying only the tax (if any) that will be due after the pending reformation. The personal representative will thereby assume the risk that the reformation will be completed before the extended due date of the return. If not, the personal representative may be liable for interest on any pre-reformation tax liability from the original due date of the return for which a refund should be obtainable once the reformation is completed.

A charitable remainder trust reformation pursuant to § 2055(e)(3) must also comply with the following requirements:

1. The reformation must be effective as of the date of the decedent's death.

2. The nonremainder interest must terminate at the same time before and after the reformation (except that a charitable remainder trust for a term in excess of twenty years may be reformed so as to have a twenty-year term).

3. Any difference between the date of death actuarial value of the reformed charitable remainder interest and the actuarial value of the charitable remainder interest prior to reformation may not exceed five percent of the actuarial value of the charitable remainder interest prior to reformation.

4. In any event the amount of the charitable deduction after reformation will not exceed the amount of the deduction that would have been generated under the pre-1970 rules.

Some additional noteworthy comments:

1. Non-qualifying charitable lead trusts may be reformed under § 2055(e)(3) in much the same manner as non-qualifying charitable remainder trusts.

2. Section 2522(c)(4) provides for the reformation for gift tax purposes of non-qualifying charitable remainder trusts and charitable lead trusts created by intervivos transfers and states that "rules similar to the rules of section 2055(e)(3) shall apply."

   (a) In this situation, the effective date of the reformation must be the date of the transfer (in lieu of the date of the decedent's death).

   (b) Since no federal estate tax return is involved, where payments to non-charitable beneficiaries are not expressed either as an annuity or as a unitrust amount, the judicial proceeding for the reformation must be commenced not later than the 90th day after the last date (including extensions) for filing the income tax return for the trust's first taxable year.
PROBLEM: TRANSFER TO NON-CITIZEN SPOUSE DOES NOT QUALIFY FOR MARITAL DEDUCTION.

In 1987 Harry Husband executed a will and a revocable trust agreement under which he established a classic QTIP marital deduction trust and a "credit shelter" nonmarital trust for the benefit of his spouse, Winifred Wife, whom he had met and married while he was stationed in England during World War II. Since no significant changes had taken place in their assets or family situation, these documents were in place when Harry died earlier this year. In addition, he and Winnie still lived in the residence that they had purchased with Harry's funds in 1982, taking title as joint tenants with right of survivorship. Despite the fact that Winnie had lived in this country for over 50 years and had mothered several children here, Winnie had remained a British subject.

Under § 2056(d)(1) enacted in 1988, since Winnie is not a U. S. citizen, the estate tax marital deduction will not be allowed for any property passing to Winnie by reason of Harry's death unless

(a) Winnie remains a resident of this country at all times after Harry's death and becomes a U. S. citizen before the federal estate tax return is filed or

(b) Such property passes to Winnie in a qualified domestic trust (QDOT) described in § 2056A.

The QTIP marital trust in Harry's 1987 will and trust agreement does not meet the QDOT requirements. Obviously, neither does the residence passing directly to Winnie by survivorship.

SOLUTION:

Winnie's becoming a U. S. citizen in a timely manner is an obvious solution, but one that is not always available for personal, technical or tax reasons. Moreover, complications may arise that delay the process beyond the due date of the return (even with extensions).

Fortunately, two other avenues are available to Winnie and Harry's estate:

1. Section 2056(d)(5) provides for the judicial reformation into a QDOT of a trust that would otherwise qualify for the marital deduction if Winnie were a U. S. citizen:

   (a) Such a proceeding must be commenced on or before the due date of the federal estate tax return (determined with regard to extension actually granted) regardless of the date that the return is actually filed.

   (b) The reformation "must result in a trust that is effective under local law."
(c) The reformed trust may be revocable by Winnie or subject to Winnie's
general power of appointment, except that neither Winnie nor anyone else may have the power to
amend the trust during its continued existence so that it would no longer qualify as a QDOT.

(d) Prior to the time that the judicial reformation is completed, the trust must be treated as a QDOT.

2. Section 2056(d)(2)(B), as expanded by Treas. Reg. § 20.2056A-4(b), sets out a "special rule" under which assets that passed directly to Winnie (such as the residence) in such a manner that they would otherwise qualify for a marital deduction will be regarded as having passed to Winnie in a QDOT if she either assigns or transfers the property to a QDOT before the estate tax return is filed and on or before the last date for making the QDOT election.

(a) This transfer or assignment may be made either by Winnie, by her guardian or conservator (if she is incapacitated) or by her personal representative (if she dies).

(b) The QDOT to which the property is transferred may have been created by the decedent or may be created by Winnie or her personal representative.

(c) Under Treas. Reg. § 20.2056A-10(a), if Winnie later becomes a U. S. citizen, any QDOT of which she is a beneficiary will no longer be subject to the special § 2056A estate tax on distributions of principal made to her if she either

(1) Was a U. S. resident at all times after Harry's death and before
becoming a citizen or

(2) No taxable distributions were made to her before she became a
citizen.

PROBLEM: EXERCISE OF POWER OF APPOINTMENT VIOLATES RULE AGAINST PERPETUITIES.

In 1940 Fred Father executed a revocable trust agreement setting up a modest trust for the
benefit of Daisy Daughter for her life, with remainder at her death to her surviving descendants,
per stirpes. Daisy then had a young daughter. Fred gave Daisy a special testamentary power of
appointment over the assets in the trust at her death exercisable in favor of her descendants.

The revocable trust agreement provided that no trust estate created by the exercise of
Daisy's power of appointment could extend for more than twenty-one years after the death of the
last survivor of Fred's descendants who were living at his death. Then in 1961 Fred amended the
trust agreement so as to make it irrevocable. When he died in 1965 he was survived by Daisy,
her daughter and two grandchildren, who were born in 1962 and 1964, respectively.

By her Will executed in 1986, Daisy appointed the trust assets to a trust for the benefit of
her descendants that she provided would terminate twenty-one years after the death of the last of
her descendants who was living at Fred's death. Daisy died late last year survived by her
daughter and the two grandchildren born in 1962 and 1964. Her daughter died four months after Daisy's death. The trust assets are now worth over $6 million.

Daisy's exercise of the power of appointment over the trust potentially violated the common law rule against perpetuities in that it extended the possible vesting of the trust's remainder interest beyond twenty-one years after the death of lives in being when the trust became irrevocable in 1961. If her exercise of the power is ineffective, the trust remainder will vest in her daughter and will be includible in the daughter's estate for federal estate tax purposes.

SOLUTION:

KRS 381.216 provides that in determining whether an interest violates the rule against perpetuities the period of perpetuities shall be measured by actual rather than possible events — the so-called "wait-and-see" doctrine. Under this doctrine Daisy's exercise of her power of appointment would not have violated the rule against perpetuities if Daisy's grandchildren who were born in 1962 and 1964 had predeceased Daisy's daughter. Since that did not actually occur, Daisy's exercise of her power of appointment will be ineffective unless it is reformed so as to approximate most closely Fred's intent within the limits of the rule. Presumably, this would involve reforming both Fred's trust agreement and Daisy's Will to provide that the trust created by Daisy's exercise of her power of appointment must terminate within twenty-one years after the death of the last survivor of Fred's descendants who were living in 1961 when the trust became irrevocable (that is, Daisy and Daisy's daughter).

Note that KRS 381.223 provides that KRS 381.216 applies only to intervivos instruments and wills taking effect after July 1, 1960, and to appointments made after July 1, 1960, including appointments under powers created before July 1, 1960.

PROBLEM: EFFECT OF TRUST REFORMATION ON GST TAX EXEMPT STATUS.

The question arises as to whether Daisy's exercise of her power of appointment, despite its reformation in accordance with KRS 386.216, will cause Fred's trust to cease to be exempt from the generation-skipping transfer tax (GSTT) imposed by the 1986 Tax Reform Act because it no longer complies with § 1433(b)(2)(A) of that Act.

Treas. Reg. § 26.2601-1(b)(1)(v)(B) states that the exercise of a nongeneral power of appointment will not be treated as an addition to an otherwise GSTT exempt trust if such power of appointment was created under such a trust and is not exercised in a manner that may postpone the vesting of an interest in property for a period extending beyond any life in being at the date of the trust's creation plus twenty-one years - the so-called "perpetuities period." Exercise of such a power of appointment that validly postpones vesting for a term of not more than ninety years (measured from the creation of the trust) will not be considered an exercise that postpones vesting beyond the perpetuities period.

In undertaking to determine if Daisy's exercise of her power of appointment causes Fred's trust to lose its GSTT exempt status, the following factors must be considered:
1. If Daisy had not exercised her power of appointment, its mere existence would not appear to have deprived Fred's trust of its GSTT exempt status. Treas. Reg. § 26.2601-1(b)(1)(v)(B) seems to say that the lapse of a nongeneral power of appointment created under an otherwise GSTT exempt trust will not be treated as a non-exempt addition to such trust.

2. It appears that for purposes of determining its GSTT exempt status, Fred's trust will be regarded as having been created when it became irrevocable in 1961. See Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2), which now provides that the distribution of trust principal from an exempt trust to a new trust will not cause the new trust to be subject to GSTT if the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust beyond the perpetuities period "measured from the date the original trust became irrevocable."

3. Example 7 in Treas. Reg. § 26.2601-1(b)(1)(v)(B) discusses a situation where a nongeneral power of appointment has been exercised that might extend the trust involved for longer than the perpetuities period "except local law provides that the effect of [the] exercise is to extend the trust until [a date that is within the perpetuities period]." Hopefully the IRS will regard KRS 381.216 (including a reformation thereunder) as "local law" that provides that the "effect" of Daisy's exercise of her power of appointment is to extend Fred's trust to a date that is within the perpetuities period as measured from the "creation" of the trust - namely, twenty-one years after the death of Daisy's daughter, who happens to have been in being both when the trust was originally set up in 1940 and when it became irrevocable in 1961.

4. In T.D. 8912, published on December 20, 2000, the IRS issued final regulations in which it undertook to provide guidance to taxpayers with respect to the type of trust modifications that will not affect a trust's GSTT exempt status. The avowed purpose of these regulations is to furnish "safe harbors" for many trust reformations and thereby avoid (or at least reduce) the need to obtain a private letter ruling in connection with such a reformation.

5. Treas. Reg. § 26.2601-1(b)(4)(i)(C) and (D) provide:

   (a) A judicial construction of a trust's governing instrument to resolve an ambiguity in its terms or to correct a scrivener's error will not cause the trust to lose its GSTT exempt status if

   (1) The judicial action involves a bona fide issue; and

   (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

   (b) A modification of the governing instrument of an exempt trust by judicial reformation will not cause the trust to lose its GSTT exempt status if

   (1) The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and
(2) The modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(c) A modification of a GSTT exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either

1. An increase in the amount of a generation-skipping transfer or
2. The creation of a new generation-skipping transfer.

(d) A trust modification which is administrative in nature that only indirectly increases the amount of a generation-skipping transfer (such as by reducing administrative expenses or income taxes) will not be considered to shift a beneficial interest in the trust.

6. The "modification" of Fred's trust resulting from the reformation of it and of Daisy's exercise of her power of appointment pursuant to KRS 381.216 does not appear to fall within any of the "safe harbors" delineated in the new regulations. Consequently, prudence dictates that a private letter ruling be obtained to the effect that such a reformation will not cause Fred's trust to lose its GSTT exempt status.

PROBLEM: TRUST FOR SURVIVING SPOUSE FAILS TO QUALIFY FOR MARITAL DEDUCTION

When Larry Lawyer was fresh out of law school, he drafted his own estate plan for the benefit of his spouse, Sally, and his infant son, Sam. He set up a trust from which Sally will receive all of the income for her life and the trustee (initially his law partner) can make discretionary distributions to Sally and Sam for their maintenance, support and education. Sally is given a general testamentary power of appointment over the assets in the trust at her death. If she does not exercise this power, the assets will remain in trust for Sam until he reaches age thirty, or if he dies before reaching thirty, for his descendants until they reach thirty.

Larry subsequently became so busy winning large verdicts in toxic tort cases that he "never got around" to updating his estate plan before he died suddenly, and prematurely, earlier this year, leaving a $4 million estate. Meanwhile, Sam had sense enough not to follow his father into the law. Instead, he established a dot.com company that he sold just in time, receiving $6 million after taxes. He is also the proud father of triplets.

Unfortunately, Larry's trust in its present form will not qualify for the estate tax marital deduction because of the trustee's authority to make discretionary distributions of principal to Sam during Sally's life. Equally unfortunately, the assets in the trust at Sally's death will be included in her estate for federal estate tax purposes, precluding use of Larry's effective exemption amount and GST exemption.
SOLUTION:

By effective use of qualified disclaimers in accordance with Code § 2518, Sam and Sally may modify Larry's trust so as to accomplish the following:

1. Enable the trust to qualify for the estate tax marital deduction;
2. Obtain the benefit of Larry's effective exemption amount; and
3. Obtain the benefit to the extent desired of Larry's GST exemption.

1. If Sam executes a qualified disclaimer of the possibility of receiving any discretionary distributions of principal from the portion of the trust for which a marital deduction is desired, that portion will otherwise qualify for the marital deduction.

2. If Sally effectively disclaims her general power of appointment over the portion of the trust for which the marital deduction is not taken (presumably because it is covered at least in part by Larry's effective exemption amount), to the extent of that exemption it will not be subject to tax at Larry's death and will also be excluded from Sally's estate at her death. However, if Sam survives Sally, no effective use will have been made of Larry's GST exemption, unless Sam now effectively disclaims his remainder interest in this portion, allowing it to pass to his descendants at Sally's death, either outright or in trust for their benefit, depending on their ages.

3. If Sally is willing to forego any interest in the nonmarital portion of the trust, both she and Sam may disclaim all of their interest in that portion, enabling it to pass at this time into trusts for Sam's triplets without any adverse estate, gift or GST tax consequences. This will also avoid the otherwise potentially tricky question of whether under Larry's trust agreement the trust may be divided into separate marital and nonmarital trusts, at least without court approval, in the absence of any Kentucky statute authorizing such a division. The provision of the 2001 Tax Act authorizing the severance of a trust into GST exempt and nonexempt trusts may offer some assistance in this effort.

Please note that there are a number of conditions that must be complied with in order to effectuate a qualified disclaimer, a detailed discussion of which is beyond the scope of this presentation.

PROBLEM: INABILITY TO COMPLY WITH TERMS OF CHARITABLE GIFT.

Donald Donor has given a large parcel of pristine woodland to the Kentucky Chapter of The Nature Conservancy. He also established a trust, which became irrevocable upon his death earlier this year, by which he created an endowment fund to be used for the maintenance and conservation of the woodland, including development of limited facilities so as to make it accessible to members of the public under controlled conditions. The trust also specifies that when the endowment fund reaches $5 million in value, the sum of $500,000.00 is to be used to construct an indoor interpretive exhibit on the edge of the woodland in accordance with plans
that Donald has thoughtfully had prepared. Following construction of this exhibit, a designated portion of the income from the endowment fund is to be devoted to maintenance of the exhibit.

At Donald's death, the value of the endowment fund was well in excess of $5 million. However, a conservative estimate of the cost of constructing the exhibit according to Donald's plans is in excess of $1 million and it appears unlikely that it can ever be constructed for anything approaching $500,000.00. Will this cause the charitable gift to fail, either in its entirety or at least to the extent of the $500,000.00 earmarked for construction of the exhibit? If so, what will become of the failed portion of the gift?

SOLUTION:

Under Kentucky's version of what has historically been referred to as the "cy pres" doctrine, the trustee of Donald's trust may institute an action seeking a declaration of rights and construction of the trust agreement, including the powers and duties of the trustee to accomplish Donald's intentions as nearly as possible under the circumstances, either by authorizing the expenditure of more than $500,000.00 for construction of the exhibit or deferring construction of the exhibit indefinitely, in order to be able to carry out the other purposes for which the trust was established. See Citizens Fidelity Bank & Trust Co. v. Isaac W. Bernheim Foundation, 305 Ky. 802, 205 S.W.2d 1003 (1947).

In applying this doctrine (which literally means "as nearly as may be"), the Kentucky courts have limited it to situations where the donor's specific charitable object or ascertainable charitable objective has been identified, but the mode or method prescribed for accomplishing the objective is inadequate, impossible or inappropriate. In such a case, the court has concluded that it may substitute a more suitable mode or method that will effectuate the donor's intent. However, the court may not supply a charitable beneficiary or purpose where the donor has not done so, but only manifested a general charitable interest.

See Defenders of Furbearers v. First National Bank and Trust Company of Lexington, Ky., 306 S.W.2d 100 (1957), where under a will written in December, 1953, a trust was established for the benefit of the Lexington/Fayette County Humane Society for ten years for the purpose of hiring an agent to work the streets of Lexington to try to relieve the condition of overworked and mistreated horses - a situation that everyone seems to have agreed did not exist. The will went on to say that if the Humane Society declined this "request" under the stated conditions, the trust funds were to be divided equally between the National S.P.C.A. and the Defenders of Furbearers.

The Court of Appeals found two reasons for not applying the Kentucky cy pres doctrine:

(1) The doctrine applies only where the failure or impossibility relates to the method or mode of carrying out the charitable purpose and not where the purpose itself fails or is incapable of accomplishment; and
(2) The doctrine will not be applied where there is an express provision in the
governing instrument for an alternative disposition of the gift if the designated charity or
charitable purpose proves impossible, inexpedient or impractical.

See also Orphan Society of Lexington v. Board of Education of Lexington, Ky., 437
S.W.2d 194 (1969), where the Court of Appeals adopted the opinion of Circuit Judge Scott Reed
(who by the time the appeal was heard had become a member of the Court) in which he held that
where a trust had been established for the benefit of a school that was designed to meet the needs
of the children of a particular area, the subsequent closing of that school and the transfer of its
facilities to another school did not render the trust's specific restricted purpose impossible of
performance, so as to necessitate resort to the cy pres doctrine "as such." Instead, Judge Reed
concluded that the donor's "primary specific purpose" could be performed by applying the trust
income to the needs of the children from the particular area who were attending the successor
school.

PROBLEM: FAILURE OF EITHER LIFETIME OR TESTAMENTARY TRUST FOR
SURVIVING SPOUSE TO QUALIFY FOR MARITAL DEDUCTION.

Mary executed a revocable trust agreement that contained a QTIP trust for her husband,
John. She then executed an amendment to that trust in which she revoked the QTIP trust
conditioned upon the "execution, completion and funding" of an irrevocable lifetime QTIP trust
for John's benefit. The amendment further provided that if for some reason the lifetime QTIP
trust was not "executed, completed or funded" prior to Mary's death, the revocable trust QTIP
trust would be "revived."

Mary then executed and funded the irrevocable lifetime QTIP trust, which recited that it
was her intent that property transferred to this trust be construed as qualified terminable interest
property and that any provision to the contrary would be null and void. She then filed a
Form 709 in which she claimed a gift tax marital deduction for the irrevocable lifetime QTIP
trust. However, for some reason that gift tax return was not timely filed (perhaps due to the fact
that Mary died of a brain tumor some three months after its due date). The IRS took the position
that the lifetime QTIP trust did not qualify for the gift tax marital deduction and asserted a gift
tax deficiency. (First Security Bank of Southern New Mexico, N.A., Personal Representative of
the Estate of Mary Kate Nielson, v. United States, 2001-1 USTC ¶ 60, 406 (D.N.M., 2001)).

SOLUTION:

Mary's estate filed a Form 706 on which it made a protective QTIP election and claimed
a marital deduction for the revocable trust QTIP trust. It then paid the gift tax deficiency and
filed for a refund. Next it instituted a state court action in which it successfully obtained a
determination that because creation of the irrevocable lifetime QTIP trust was expressly
conditioned on treatment of the assets transferred to it as qualified terminable interest property,
completion of the transfer to the lifetime QTIP trust had not occurred and could not occur to
fulfill Mary's intent and that the transfer was incomplete, invalid and void under state law.
In the ensuing federal district court refund action, the court found that the state court's ruling was not binding on it, but it nevertheless reached the same conclusion. It then ruled:

(1) The revocable trust QTIP trust was revived by the express provisions of the trust amendment that revoked it.

(2) The assets that had been transferred to the irrevocable lifetime trust returned to Mary's estate, from which they passed under the residuary provision of her will to the revocable trust QTIP trust.

(3) The protective QTIP election for the revocable trust QTIP trust was proper and should have been allowed.

(4) The estate was entitled to a refund of the taxes paid.

References
