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Report of the Chair

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It has been a very productive year. I wish I could take credit for the Section's many accomplishments, but I cannot. Instead, I write to highlight some of the most significant.

E-Filing. On October 18, 2004, the Supreme Court of Pennsylvania adopted Pa. O. C. R. 3.7, which authorizes electronic filing of legal papers in Orphans' Court matters. Due to the hard work of Administrative Judge O'Keefe, assisted by others, e-filing in the Philadelphia Orphans' Court Division will become a reality on January 1, 2005. Orphans' Court Division General Court Regulation 2004-01 sets forth the applicable procedures. (A Local Rule is expected to be promulgated early next year.) Judge O'Keefe made the implementation of e-filing his priority, and we extend our thanks to him for doing so. Thanks also to Dominic Rossi (Deputy Court Administrator, Legal Services) and to the Rules and Practice Committee (including Margie Thompson, Chair, Mary Jane Barrett, Joe Campbell, Gene Gillin and Nina Stryker) for working through the myriad issues associated with e-filing – both technical (e.g., how to handle original documents) and legal (what about privacy?). The Philadelphia Orphans' Court Division will be the first Orphans' Court Division in Pennsylvania to institute e-filing. It is hoped that the system will serve as a model in the Commonwealth.

Red Book. A new Red Book, the updated Practice and Procedure Before the Orphans' Court Division of the Court of Common Pleas of Philadelphia County, is now "good to go". This companion to the previously updated Blue Book (Register of Wills Manual) and Green Book (Forms for Use Before the Register of Wills and Orphans' Court Division in Philadelphia) joins those two volumes as part of the Philadelphia Estate Practitioner Handbook. The Red Book was given in hard copy to all Section members who attended the Annual Meeting at the Kimmel Center on November 30, and will be distributed later to other Section members. The website version will be up and running shortly. Many thanks to all members of the Rules and Practice Committee (again!) who revised, updated and expanded the Red Book, and

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Inside this Issue....

Rev. Rul. 2004-64: A Pennsylvania Tax Trap?

By CHRISTOPHER H. GADSDEN
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Grantor trusts have become increasingly popular in wealth transfer planning. A trust is deemed a grantor trust if the grantor has reserved certain economic interests or administrative controls that are specified in sections 671-677 of the Internal Revenue Code. In general, grantor trust status means that all items of income, deduction and credit of the trust are reported on the grantor's individual income tax return rather than the separate tax return of the trust. Wealth transfer planning frequently involves irrevocable trusts that are excluded from the grantor's gross estate for federal estate tax purposes but are classified as grantor trusts for federal income tax purposes (sometimes referred to as "defective grantor trusts").[1] One estate planning advantage of such a grantor trust is that sales and exchanges between the grantor and the grantor trust do not cause the recognition of income or capital gain. A second advantage is that the grantor's payment of income tax resulting from the trust income and gain augments the effectiveness of the wealth transfer by relieving the trust and its beneficiaries of a tax liability.

The transfer tax status of these trusts has been shrouded in uncertainty. Some practitioners have worried, based on several private letter rulings in the 1990's, that the grantor's payment of income taxes might be deemed an additional gift to the trust for gift tax purposes. On the other hand, practitioners have also worried that a retained right to be reimbursed for such taxes, which some nervous grantors have wanted, might cause estate tax inclusion under section 2036.

The Internal Revenue Service provided useful guidance on these gift and estate tax issues when it released Rev Rul. 2004-64 on July 6, 2004. The ruling addressed three scenarios involving an irrevocable grantor trust with an independent trustee: (i) the payment of income taxes by the grantor when neither the governing trust instrument nor applicable state law required or permitted reimbursement, (ii) mandatory reimbursement of the grantor's income tax liability under the terms of the governing instrument or applicable state law; and (iii) reimbursement of the grantor's income tax liability pursuant to trustee discretion that has been granted by the governing instrument or applicable state law.

Because the IRS's analysis of all three scenarios relies significantly on applicable state law, an estate planning attorney should know and take into account the law in the grantor's domicile. What then is Pennsylvania law on this subject? The issue for purposes of the first two scenarios is whether Pennsylvania law <u>requires</u> a grantor trust to reimburse the grantor for his or her income tax liabilities attributable to the trust's income. The Pennsylvania Probate Estates and Fiduciaries Code does not specifically address this issue[2] and, to the author's knowledge, no appellate court in Pennsylvania has ruled upon it. However, there are several old lower court decisions concluding that reimbursement of the grantor was <u>required</u>.

In *French Trust*, 23 Fiduc. Rep. 296 (O.C. Phila. 1963), the trustee under a 1910 deed of trust raised the question whether the settlor, who had reserved the net income of the trust for life and a limited testamentary power of appointment over the principal, should be reimbursed for taxes on capital gains that were retained in the trust. The question arose because the 1954 Internal Revenue Code and the regulations thereunder had changed the applicable federal law by introducing the concept of a grantor trust and making the grantor personally liable for capital gains tax. Judge Shoyer of the Orphans' Court of Philadelphia County noted that the Pennsylvania Principal and Income Act of 1947 directed that a tax on any gain that was allocated to principal "shall be paid out of principal notwithstanding said tax may be denominated a tax upon income by the taxing authority." With this rule in mind Judge Shoyer concluded:

> "Equity similarly <u>requires</u> that although the Internal Revenue Code and Regulations impose upon the settlor-beneficiary the income tax on capital gains realized and retained by the trustee, the principal of the trust should be applied in relief of such tax. It is so ordered."

23 Fiduc.Rep. at 300 [emphasis added].

In the second case, *Mathey Trust*, 11 Fiduc.Rep. 2d 1996 (O.C. Montg. 1981), the settlor-beneficiary of an irrevocable trust petitioned the court to reform a trust. Even though the trust had been established a year after enactment of the 1954 Internal Revenue Code, its governing instrument contained no provision to relieve the grantor of the income tax

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burden. The opinion noted that the Treasury Regulations had not been issued until 1958. Writing for the court en banc, Judge Tredinnick cited *French Trust* and concluded:

> "As between the trust and the settlor, however, equity requires that the fund bear the ultimate responsibility for the tax."

11 Fiduc.Rep.2d at 101[emphasis added].

It is possible to distinguish these cases from current trusts on at least two grounds. First, both of these cases involved equitable considerations that might have swayed the court: a change in circumstances (i.e., introduction of the grantor trust rules) and a resulting surprise for the grantor. The grantor's income tax obligation is now understood by most estate planners and the element of surprise should not be present. Secondly, the 1947 Principal and Income Act referenced by Judge Shoyer has been replaced by the 2002 Principal and Income Act, which only purports to apportion taxes "required to be paid by a trustee." PEF Code §8166.[3] However, the cases have not been explicitly overruled and there may be some lingering question as to whether – to quote Judge Tredinnick-- "equity requires that the fund bear the ultimate responsibility for the tax."

If, under applicable Pennsylania law, the grantor does have the right to be reimbursed, the grantor who pays the income tax may not be protected from gift tax by Rev. Rul. 2004-64. On the estate tax side, the IRS may argue for inclusion of the grantor trust assets in the grantor's gross estate if Pennsylvania state law still requires reimbursement of income taxes.

What steps should the estate planning attorney consider? The revenue ruling provides that mandatory tax reimbursement under state law or the governing instrument will not cause estate tax inclusion for a grantor of a pre-October 4, 2004 irrevocable trust. If the grantor of such a trust wants to avoid any taxable gift, he or she could demand income tax reimbursement.[4] The grantor could waive the right to be reimbursed for future income taxes, but this release of a right that is separate from and subsequent to the funding of the trust might be deemed a separate gift, albeit one that would be extremely difficult to value.

In new trust situations the estate planning attorney should consider a provision in the governing instrument that waives any right of the grantor to be reimbursed for income taxes notwithstanding state law to the contrary. A second alternative would be to locate the trust in a jurisdiction where the applicable law clearly does not mandate tax reimbursement.

Suppose that the governing instrument of a Pennsylvania trust negates any right of the grantor to demand reimbursement for taxes but gives the trustee discretion to pay tax reimbursements. Rev. Rul. 2004-64 is quite specific that this discretionary power "would not alone cause the inclusion of the trust in A's gross estate for federal estate tax purposes" [emphasis added]. However, the ruling leaves the door open for estate tax inclusion if the discretion is combined with other facts "including but not limited to…applicable local law subjecting the trust assets to the claims of A's creditors." What then is Pennsylvania law on the reach of the grantor's creditors?

A number of Pennsylvania decisions have concluded that, with or without a spendthrift clause in the governing instrument, the grantor's creditors may reach the income or principal of a trust to the extent of the grantor's interest therein. See, for example, *Murphey v. C.I.T. Corporation*, 347 Pa. 591 (1943), in which the Supreme Court of Pennsylvania ruled that the grantor's retained income interest was subject to execution by his creditors but the remainder interest was not. The opinion relied upon §156 of the Restatement, Trusts, which is now embodied in §58(2) of the Restatement Third, Trusts. Paragraph (2) of that section provides: "a restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid."

Comment f to §60 of the Restatement Third, Trusts states that where the trustee of an irrevocable trust has discretionary authority to pay income or principal to the settlor (or apply it for the settlor's benefit) "creditors of the settlor can reach the maximum amount the trustee, in the proper exercise of fiduciary discretion, could pay to or apply for the benefit of the settlor."

If Pennsylvania still follows the Restatement on this issue, it would appear that a discretionary power to reimburse the settlor for income taxes would allow creditors of the settlor to reach the maximum amount that the trustee could properly distribute to the settlor and, therefore, this "maximum amount" might be includible in the grantor's gross estate. Is the maximum amount capped by actual tax liabilities that have been incurred prior to the grantor's death, or the greatest amount of tax liability that could be

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Disclaimers of Spousal Joint Property: an Update

By KENNETH J. LEVIN
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I. INTRODUCTION

The question of whether a surviving spouse can make a "qualified disclaimer" for Federal Estate Tax purposes of the survivorship interest in property held jointly with a deceased spouse has become a crucial issue for post-mortem tax planning. The scheduled increases in the estate tax "exclusion amount" and the uncertainty as to whether those increases and the proposed repeal of the Estate Tax will actually go into effect have dramatically increased the need for the flexibility that can be provided by disclaimer planning in general and especially with spousal joint property. Moreover, lifetime planning to facilitate the use of certain post-mortem disclaimers of spousal joint property has likewise become a critical component of appropriate estate planning.

Pennsylvania residents have a particular challenge in this area. At the federal level, changes to the applicable Treasury regulations in recent years have substantially liberalized this type of post-mortem disclaimer planning. Nevertheless, at the state level, Pennsylvania has not amended its 1976 disclaimer statute to coordinate clearly with the newer federal regulations. As a result, Pennsylvania residents who wish to disclaim survivorship interests in spousal joint property cannot feel entirely secure that their disclaimers will be given effect for federal estate tax purposes.

II. FEDERAL TAX LAW CHANGES

Until the early 1990's, the Treasury Regulations governing the use of disclaimers for spousal joint property were extremely restrictive and permitted such disclaimers only in a very narrow set of circumstances. After a series of decisions holding these Regulations invalid, however, the IRS took a new look and adopted what it hoped would be more reasonable and more nationally uniform standards. After announcing its acquiescence

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generated from the assets of the trust or simply the entire trust estate on the theory that it was all available for discretionary distribution if the need for tax reimbursement arose? Does it depend upon whether the discretionary power to reimburse the grantor applies only to taxes incurred in the current year or cumulatively to taxes in the current year and previous years?

Given the state of Pennsylvania law on the reach of the grantor's creditors, the estate planning attorney who prepares a Pennsylvania trust authorizing discretionary reimbursement of the grantor's taxes should have some concern. The trust assets, or some portion thereof, may be includible in the grantor's gross estate for federal estate tax purposes. Therefore, if the Pennsylvania grantor is uncomfortable about his or her exposure to grantor income tax liability and wants some protection, the estate planning attorney should consider either a non-grantor trust or a grantor trust in a jurisdiction such as Delaware that provides greater protection from the grantor's creditors.

ENDNOTES

[1] An irrevocable trust can be classified as a grantor trust for federal income tax purposes. It should be noted, however, that different rules apply for Pennsylvania income tax purposes. An irrevocable trust is a separate income taxpayer.

[2] See, however, the discussion of the 2002 Principal and Income Act, infra.

[3] The Comment to §506 of the Uniform Principal and Income Act (PEF Code §8167) does discuss irrevocable grantor trusts and states that the Act "does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases….If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust."

[4] If the grantor makes such a demand and the independent trustee rejects the demand on the basis that Pennsylvania state law does not require reimbursement, the grantor may take the position that there has been no taxable gift.

Disclaimers of Spousal Joint Property, continued

in a number of the cases, it issued a proposed amendment (the "Proposed Amendment") to the Regulations providing much broader opportunities for using disclaimers of survivorship interests in spousal joint property. The Proposed Amendment, however, would have provided many fewer opportunities to Pennsylvania residents than to those residing elsewhere, because the availability of the new opportunities was dependent, in substantial part, on the "severability" of spousal joint property. Since Pennsylvania tops the fifty states in restrictions on severability of such property, the Proposed Amendment would have presented many fewer opportunities here than elsewhere. After reviewing the suggestions of a number of commentators from Pennsylvania and elsewhere criticizing the discriminatory and non-uniform character of the Proposed Amendment, the IRS agreed in Final Regulations, which became effective December 31, 1997, to eliminate "severability" of spousal joint property as a prerequisite to the validity of post-mortem disclaimers of the survivorship interest in such property.

The impact of the Final Regulations may be summarized as follows:

1. The Final Regulations substitute the statutory language "transfer creating the interest" for the term "taxable transfer" throughout the disclaimer Regulations "as the reference point for determining when the 9-month period for making the disclaimer commences." While the IRS takes the position that this change does not have the effect of "prescribing any new rules for applying section 2518," this position is extremely questionable. <u>This change is effective, however, only for "transfers creating the interest or power to be disclaimed made after December 30, 1997," rather than to disclaimers made after that date</u>. Accordingly, in the case of joint tenancies created before 1998, the prior rules permitting disclaimers within 9 months from the "taxable transfer" remain in effect regardless of the date of the disclaimer. Although the IRS takes a contrary position, the retention of this old definition for spousal joint tenancies created before 1998 should, in light of the applicable statutory provisions and more general disclaimer Regulations, properly be interpreted to permit the disclaimer of at least one-half (1/2) of all bank accounts, brokerage accounts and mutual funds titled in the joint names of the spouses before 1998, and any Treasury Regulation to the contrary should be held invalid. This result follows because there is clearly a taxable transfer under Section 2040 to the surviving spouse upon the death of the first spouse and no taxable transfer for gift taxes purposes to the surviving spouse during the deceased spouse's lifetime. Under the general principles of the disclaimer Regulations, when these two requirements are met, the disclaimer is valid. To preclude disclaimers for spousal joint property to the extent described while permitting disclaimers of other property under corresponding circumstances would create precisely the sort of inconsistent treatment which caused the courts to hold the prior Regulations invalid in the early 1990's. While an analogous argument can be made under the Final Regulations for spousal joint tenancies created after 1997, it is somewhat more complicated and harder to present in as compelling a fashion.

2. Under prior law and under the Proposed Amendment, the IRS took the position after 1995 that for joint bank accounts and joint brokerage accounts of spouses ("the special category" of property held jointly by spouses), a qualified disclaimer may be made within nine months of the death of the first spouse. This special category had been extremely important for disclaimer planning because the IRS viewed such accounts in states with the Uniform Multiple-Party Account Act (which is in force in Pennsylvania) as subject to disclaimer even if such states (like Pennsylvania) had strict nonseverability restrictions on spousal joint property. Thus the IRS permitted disclaimers of the survivorship interest in such accounts, while denying the validity of disclaimers of the survivorship interest in all other spousal joint property in such states.

<u>The Final Regulations made a major departure from the Proposed Amendment and all prior law</u> by permitting disclaimers within 9 months of the death of the first spouse to die of the survivorship interest, <u>regardless of whether the tenancy is severable</u>. This change applies to <u>disclaimers made after December 30, 1997</u>. Thus the distinction between the special category of joint bank accounts and joint brokerage accounts, on the one hand, and all other spousal joint property, on the other, no longer has any bearing on the validity or timeliness of disclaimers made after the death of the first spouse.

3. The Final Regulations attribute an entirely different and important significance, however, to accounts falling within this special category. In the case of assets in this special category (i.e. bank accounts, brokerage accounts and,

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under the Final Regulations, also mutual funds), the amount which may be disclaimed at the death of the first spouse is the portion of the joint tenancy attributable to the contribution of the deceased spouse. In the case of virtually all other assets held jointly by spouses, the amount which may be disclaimed is one-half (1/2), regardless of the amounts contributed by the spouses. This distinction makes the decision of spouses to place assets in a joint brokerage account rather than to retain their own certificates a highly significant one for tax planning purposes and a trap for the unwary.

The position of the IRS to correlate the portion of the assets in such accounts subject to disclaimer with the amount attributable to the contribution of the deceased spouse purports to rest on the ability of the deceased spouse to withdraw such amount without the consent of the surviving spouse. It arises from a change of position by the IRS in the mid-1990's. Prior to that date, relying on cases such as *Carney v. Carney*, 673 A.2d 367 (Pa. Super 1996), the IRS took the position that in Pennsylvania one spouse could <u>not</u> withdraw such amounts without the consent of the other. During that period, however, the IRS shifted its position and concluded that in states like Pennsylvania, which have enacted the Multiple-Party Accounts Act, the contributing spouse <u>does</u> have that right. Whether the IRS's change of position on this subject is really based on its interpretation of state law or rather on a desire to achieve national uniformity is unclear. In any event, it is clear that the IRS will not challenge a disclaimer of the portion attributable to the contribution of the deceased spouse. Whether the taxpayer should take a contrary position in appropriate cases now that only the amount subject to disclaimer and not the validity (i.e., timeliness) of a disclaimer is at issue, however, is an important question. As indicated hereafter, it will often be advantageous for the taxpayer to take the contrary position.

4. The significance of unilateral severability is therefore dramatically different under the Final Regulations from its significance under prior law. Under prior law, nonseverability precluded a disclaimer after the death of the first spouse. Under the Final Regulations, nonseverability will no longer preclude disclaimer, but will determine the amount subject to disclaimer. If the decedent's contribution exceeds 50%, nonseverability will reduce the amount subject to disclaimer; <u>but if the decedent's contribution is less than 50%, nonseverability will increase the amount subject to disclaimer</u>. <u>Thus, for the first time, it may be advantageous in some circumstances for the taxpayer to argue (as the IRS did prior to 1995) that bank accounts, brokerage accounts and mutual funds are nonseverable</u> in states like Pennsylvania, by relying on the same cases that the IRS relied on in the early 1990's and on any subsequent similar cases.

5. The Final Regulations establish a rule as to the amount includable in the gross estate of a disclaimant of a joint bank account, joint brokerage account, or mutual fund. Under this rule, the portion disclaimed is treated as probate property fully includable in the gross estate and the portion which is not disclaimed retains its character as joint property, one-half (1/2) of which is includable in the gross estate. Where the first spouse to die has contributed all the funds to the account, therefore, the entire joint property will be included in such spouse's estate for Federal Estate Tax purposes.

6. The Final Regulations do not explicitly specify the amount includable in the gross estate of the decedent of spousal joint assets other than those in the special category described above (i.e. other than bank accounts, brokerage accounts, and mutual funds). The IRS has regularly taken the position, however, that it will follow an approach analogous to that for the special category; i.e. when the one-half (1/2) subject to disclaimer is disclaimed, it becomes probate property, and the remaining one-half (1/2) will retain its character as joint property. <u>Therefore in the case of nonseverable joint property, for which the survivorship interest is disclaimed by the surviving spouse, three-quarters (3/4) of the spousal joint property will be included in the first spouse's estate</u>.

III. NEW PLANNING OPPORTUNITIES UNDER THE FINAL REGULATIONS

A disclaimer by the surviving spouse of the survivorship interest in property held jointly with a deceased spouse after the latter's death, when recognized as valid for Federal Estate and Gift Tax purposes, presents major opportunities for substantial tax savings. The most common objective of such a disclaimer is to permit the shift of sufficient assets into the probate estate of the deceased spouse to permit full use of the deceased spouse's "exclusion amount." In some cases the lack of sufficient assets to fund a trust of that size in the absence of a disclaimer is simply the result of poor lifetime planning; e.g., clients might have extremely well-drawn wills or trust agreements providing

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for marital and non-marital shares, but have failed to structure their assets to permit implementation of those documents. On the other hand, there are numerous situations when client concerns or personal non-tax objectives preclude the appropriate asset structure during lifetime. Disclaimer planning frequently permits those concerns and non-tax objectives to be met while providing the same or greater tax savings than traditional planning, which commonly requires a lifetime division of the spousal joint property.

One such non-tax objective may be the retention of entireties ownership for purposes of creditor protection. Second, the spouses' assets may consist substantially of residences which they are reluctant, for emotional or other reasons, to title separately. Third, the spouse with the more substantial assets may simply be unwilling to give up full ownership or control of those assets in order to achieve transfer tax savings, but may be willing to put them into entireties ownership. Fourth, the rapidly changing size of the "exclusion amount" and uncertainty as to future legislative changes make it increasingly difficult to modify estate plans with sufficient speed to create a credit shelter trust of the appropriate size. In all of these circumstances, if the funding of the credit shelter trust of the deceased spouse can be accomplished through a qualified disclaimer, it will be possible to accomplish the same estate tax saving which might have been achieved through a lifetime division of assets without interfering with the objectives that dictated the retention of joint ownership during lifetime. Finally, it will frequently be possible to obtain income tax savings by maintaining joint ownership while both spouses are living and using a qualified disclaimer at the first death.

The Final Regulations make it clear that a disclaimer by the surviving spouse of a survivorship interest in jointly held property can produce not only estate tax saving but also substantial income tax savings. They treat the portion of spousal joint property that is disclaimed as a probate asset and the balance, or undisclaimed portion of the spousal joint property, as retaining its character as spousal joint property governed by section 2040 of the Internal Revenue Code. The result is that when a qualified disclaimer can be made for Federal Estate Tax purposes, more than one-half (1/2) of the value of the spousal joint property will be included in the deceased spouse's gross estate. Accordingly, the disclaimer will result in a basis step-up for more than one-half (1/2) of the value of the property and create the potential for capital gains tax saving on sale of the property or ordinary income tax savings through its depreciation. If the dispositive instruments have been appropriately drafted to deal with the consequences of the disclaimer, these income tax savings can be achieved without any significant effect on the clients' dispositive plan.

The Final Regulations therefore create opportunities for major income tax savings. The amount of the income tax savings available under the Final Regulations will depend upon the type of property subject to disclaimer. In most instances, the portion of the property for which a qualified disclaimer can be made will be one-half (1/2), and the result will be a step-up in basis for three-quarters (3/4) of the jointly held interest. In the case of spousal joint interests in bank accounts and brokerage accounts, however, if the deceased spouse has furnished all of the consideration, a basis step-up for the entire value of the spousal joint property will be available. Thus the potential for a full basis step-up, which the Internal Revenue Service challenged so vigorously in the past in cases like *Gallenstein v. U.S.*, 91-2 USTC ¶60,086 (D.C. Ky. 1991), aff'd, 975 F.2d 286 (6th Cir. 1992), and similar cases as to property placed in joint names of spouses prior to 1977, will now be available through the disclaimer route for such property regardless of the date of the establishment of the joint ownership.

IV. PENNSYLVANIA OBSTACLES

The principal disclaimer provisions in effect in Pennsylvania are set forth in Chapter 62 of the Probate, Estates and Fiduciaries Code, 20 Pa. C.S. § 6201, et. seq. At the time of their adoption in 1976, they put Pennsylvania in the forefront of modern disclaimer approaches by the various states. That was true both from the point of view of promoting sensible property law results and of conferring upon Pennsylvania residents the full benefits provided by federal tax law. On the latter subject the Official Comment to Chapter 62, when it was first enacted, stated in part:

> "A disclaimer under new Chapter 62 will not necessarily be effective for federal estate tax purposes and it is specifically provided in Section 6207 that it does not affect additional requirements under the Inheritance and Estate Tax Act of 1961, June 15, P.L. 373; 72 P.S. 2485-101 et

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hand, a disclaimer can never be effective for tax purposes if it is ineffective under State property law. One purpose of Chapter 62 is to liberalize the property law requirements for disclaimer so that legitimate attempts to avoid taxes on unwanted gifts will not be frustrated by property law provisions that are stricter than those required for tax purposes." [emphasis added]

The provisions adopted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in the version of the Uniform Disclaimer of Property Interests Act promulgated in 1999 very effectively carry out the purposes set forth in the above Official Comment to Pennsylvania's Chapter 62. That Act defines "jointly held property" to include property held as tenants by the entireties and explicitly authorizes the disclaimer of the survivorship interest in all such "jointly held property." Section 4(a) of that Act specifies the amount of jointly held property which may be disclaimed as follows:

(a) Upon the death of a holder of jointly held property, a surviving holder may disclaim in whole or in part the greater of:

(1) a fractional share of the property determined by dividing the number one by the number of joint holders alive immediately before the death of the holder to whose death the disclaimer relates; or

(2) all of the property except that part of the value of the entire interest attributable to the contribution furnished by the disclaimant.

In contrast, section 6201 of the Probate, Estates and Fiduciaries Code, 20 Pa. C.S. § 6201, provides as follows:

> "A person to whom an interest in property would have devolved by whatever means, including a beneficiary under a will, an appointee under the exercise of a power of appointment, a person entitled to take by intestacy, a joint tenant with right of survivorship, a donee of an inter vivos transfer, a donee under a third-party beneficiary contract (including beneficiaries of life insurance and annuity policies and pension, profit-sharing and other employee benefit plans), and a person entitled to a disclaimed interest, may disclaim it in whole or in part by a written disclaimer which shall:
>
> (1) describe the interest disclaimed;
>
> (2) declare the disclaimer and extent thereof; and
>
> (3) be signed by the disclaimant.
>
> The right to disclaim shall exist notwithstanding any limitation on the interest in the nature of a spendthrift provision or similar restriction." [emphasis added]

This language is much less clear than that of the Uniform Act in ensuring that the benefits conferred by the liberalization of Treasury Regulations will be fully available here. While the inclusion of the words "by whatever means," particularly in conjunction with the terms of the Official Comment, should be sufficient to ensure that the surviving spouse may properly disclaim entireties property in Pennsylvania, the statute should be amended to include tenancies by the entireties in the enumerated list of specific types of property that may be disclaimed to dispel any lingering question on the subject. Even more important, the statute should be amended in a manner similar to that of the above provision of the Uniform Act and specify that the portion of the entireties properties subject to disclaimer is the greater of (1) one half (1/2) or (2) the portion attributable to the consideration furnished by the deceased spouse. If those changes were enacted, a taxpayer domiciled in Pennsylvania could be confident that state law provisions would not preclude disclaimer of the full portion of spousal joint property which can validly be disclaimed for federal tax purposes as promised by the Official Comment when the statutory provisions were originally enacted.

To date, however, such changes have not been enacted. The reasons put forth by those opposing such changes range from antiquated metaphysics to unfounded concerns. It has been suggested that the various "unities" which characterize entireties property would be destroyed if disclaimers of the survivorship interest in such property were explicitly permitted. This argument makes no sense. It is hard to imagine anything which could destroy such "unities" more conclusively than the death of one of the spouses. Authorization for any action after that date cannot destroy that which no longer exists.

Similarly, it has been argued that the possible disclaimer of the survivorship interest in spousal

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joint property somehow could destroy the creditor protection available to the spouses during their joint lifetimes. Even if it were not clear before 1998 (and in reality it was), the Treasury's explicit recognition in 1998 as to the validity of a disclaimer of the survivorship interest in entireties property that was totally nonseverable during the joint lifetimes of the spouses establishes beyond question that such an argument is completely fallacious. Indeed, as discussed above, the state law changes proposed above will permit planning through the use of disclaimers, which will increase creditor protection significantly by reducing the need to split such assets for estate planning purposes while both spouses are living.

The failure to make such changes, while harmful, may not be critical where post-mortem planning is remedial in nature and there may be nothing to lose by attempting a disclaimer. As to the lifetime planning required to permit optimal use of post-mortem disclaimers, however, the failure to make the necessary state law changes will drastically reduce the benefit of the Treasury's changes for Pennsylvania residents. Uncertainty as to the state law effectiveness of disclaimers could cause Pennsylvania taxpayers to revert to the traditional splitting of spousal joint property even where such an approach may be the less advantageous and less flexible course. It is also unfortunate that Pennsylvania, which originally had one of the most forward-looking disclaimer statutes, has been left to languish in a state of uncertainty, making it one of the least helpful state statutes in this important planning area.

V. CONCLUSION

Major opportunities for estate planning have become available by the liberalization reflected in the Treasury's Final Regulations. At the same time, the current rapid changes in the estate tax arena have dramatically increased the need for planning with disclaimers. With a little help from the state Legislature, Pennsylvanians, like taxpayers in many other states, would be able to take advantage of these increasingly important planning strategies.

Estate Liability for Mortgages on Jointly Owned Property

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The liability of an estate for a mortgage on property held jointly by the decedent and a surviving spouse has been an issue brought before the Pennsylvania courts on several occasions. Although the law on the issue has been well settled, the outcome usually turns on the specific facts of the case. The general rule guiding these cases is that a decedent's estate is liable for the surviving spouse's proportionate share of a debt on jointly owned property where the decedent and the surviving spouse were jointly liable under the mortgage and accompanying note. *Dowler Est.*, 368 Pa. 519, 84 A.2nd 209 (1951). Accordingly, only one half of the outstanding principal on a mortgage, jointly executed by a decedent and spouse on property held by them as tenants by the entireties, is a deductible debt of the decedent's estate for Pennsylvania Inheritance Tax purposes. *Kershaw Estate*, 352 Pa. 205, 42 A.2d 538 (1945). The law is based upon the presumption that the liability of the mortgagors is equal, and the decedent would be entitled to contribution or indemnification from the spouse to the extent of one half of the mortgage

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Deferred Compensation Arrangements After the American Jobs Creation Act of 2004

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On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004. Along with a wide variety of tax changes, the new law imposes a system of statutory requirements on deferred compensation arrangements. Every such arrangement must now be reviewed and many will have to be modified.

Overview

The new law provides a definition of deferred compensation that will be explained in more detail through guidance to be issued by the Treasury Department. For those arrangements covered by the new law, distribution is limited to six specified events or circumstances. The new rules also deal with the method of electing to defer compensation, and prohibit the use of certain types of deferral funding mechanisms. The failure to comply with these rules will result in the loss of income tax deferral and the imposition of interest and penalties. Deferrals, whether or not taxable, must now be reported each year on Form W-2 or 1099. The new rules take effect January 1, 2005, and can, under some circumstances, affect amounts deferred before that date.

Arrangements Covered by the New Law

First, it is important to understand what is covered by the new law. New Section 409A of the Internal Revenue Code of 1986 ("Code") applies to any plan, agreement or arrangement (including those that apply to only one person) that provides for the deferral of compensation, other than a qualified employer retirement plan or a bona fide vacation or sick leave, compensatory time, disability pay or death benefit plan. The new law applies to deferral arrangements for employees, independent contractors and directors. The new law should not apply to incentive stock options (Code Section 422) or employee stock purchase plans (Code Section 423) and probably not to any other stock option with (1) an exercise price at least equal to the fair market value on the date of grant and (2) no deferral other than the right to exercise the option. Many

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Estate Liability on Mortgages, continued

debt. It makes no difference that the property subject to the loan is not a probate asset of the decedent's estate. The controlling factor is whether the decedent and the surviving spouse were jointly liable for the debt at the time of the decedent's death - a liability that continues after decedent's death, and, therefore, constitutes a debt of the estate. *Kershaw*, 368 Pa. at 206, 84 A.2nd at 538.

The outcome changes, however, where it is determined that the decedent is the sole obligor on a mortgage note and the surviving spouse has merely signed the mortgage as an accommodation. Upon the presentation of evidence showing that the surviving spouse merely signed a mortgage as an accommodation and as surety for the decedent, the decedent's estate is liable for the total outstanding mortgage principal and cannot seek contribution against the co-signor surviving spouse. In this situation, the estate is entitled to deduct the entire mortgage indebtedness on the inheritance tax return. *Gingrich Est*. 11 Fiduc. Rep. 2d 111 (O.C. Leb. 1990)(the mortgage, bond and warrant signed by the surviving spouse clearly made her jointly liable for mortgage on properties, thereby undermining the estate's claim that she was merely an accommodation party); *Roach Est*., 17 Fiduc. Rep. 2d 305 (O.C. Bucks 1992)(estate allowed deduction for entire outstanding mortgage indebtedness where surviving spouse received none of the joint loan proceeds and signed note and mortgage only to comply with the lender's requirements); *Yaller Est*., 22 Fiduc. Rep. 2d 431 (O.C. Del. 2002)(decedent's estate solely liable for mortgage on entireties property where decedent was the sole obligor on mortgage and note; surviving spouse's name was merely appended to the mortgage instrument which clearly stated that she was not obligated to make payment of the debt under the note). In addition, if the decedent and the surviving spouse execute either an oral or written agreement to hold the surviving spouse harmless for all claims and liabilities arising from the mortgage debt, the decedent's estate will be solely liable for the mortgage and entitled to a full deduction for the outstanding mortgage. *Hack Est*., 10 Fiduc. Rep.2d 68 (O.C. Montg. 1990).

Deferred Compensation Arrangements, continued

deferral arrangements will clearly fall within the statutory definition. For others, the question of coverage is not as clear. The new law requires that guidance be issued by the Treasury Department by December 21, 2004, and an important part of that guidance will be to assist in determining the range of compensation techniques covered by the new law.

Effective Date of the New Law

New Code Section 409A applies to amounts deferred after December 31, 2004. An amount will probably be considered deferred before that date if it is earned and the right to the deferred amount is vested by December 31, 2004. Amounts that have been deferred, but in which an employee or independent contractor is not yet vested by December 31, 2004 will be subject to the new law.

However, the new law will apply to amounts deferred before December 31, 2004 if the deferred compensation plan is materially modified after October 3, 2004. The definition of a material modification is not set forth in the statute, but the legislative history of the new law defines it as the addition of any benefit, right or feature. By contrast, the elimination of a benefit, right or feature is not a material modification. Until more definitive guidance is issued, care must be taken in making any changes in existing deferred compensation arrangements.

Restriction on Distribution Events

Under the new law, there are only six events that can give rise to distribution:

- separation from service
- disability
- death
- a specific time or a specific schedule
- an unforeseeable emergency
- a change in control.

One limitation on the separation from service rule is that key employees of a publicly traded corporation may not receive distributions from deferred compensation plans until six months after separation from service. Key employees are officers earning more than $135,000 for 2005 (but not more than 50 individuals); employees who are 5% owners; and employees who are 1% owners and earn more than $150,000.

The legislative history indicates that payment at a "specific time" does not include payment when a particular event occurs. For example, payment when an employee's child enters college would not satisfy the law.

The term "change in control" is not defined in the statute, but the legislative history suggests that a definition similar to, but more restrictive than, the golden parachute rules of Code Section 280G will be applied.

The term "unforeseeable emergency" is defined as a severe financial hardship to the individual arising from an illness or accident in the family, a casualty loss, or other extraordinary circumstances beyond the participant's control.

Prohibition on Acceleration of Payments

New Code Section 409A(a)(3) prohibits any deferred compensation plan from accelerating the time or schedule of payments under the plan. Treasury regulations might permit some exceptions to the prohibition on acceleration, such as for de minimis benefit amounts or to comply with a divorce decree.

Restrictions on Deferral Elections

Under the new rules, an election to defer income must be made before the taxable year in which the services giving rise to the deferred compensation are performed. There is an exception for the initial deferral by new plan participants: they must make the election not later than 30 days after becoming eligible to participate, with respect to income earned after the election is made.

A separate rule applies to performance-based compensation. For performance-based compensation that is based on services provided over a period of 12 months or more, the election to defer the compensation may be made up to six months before the end of the election period.

Changing the Time and Form of Distributions

Many existing deferred compensation arrangements permitted participants to change the time when payments were made. The new rules limit the ability to make such changes. There are three such limitations:

- An election to defer to a later date the receipt of deferred compensation may not take effect within 12 months from the date it is made.
- For a distribution to be made on separation from service, at a specified date or on a fixed schedule, or

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as a result of a change in control, the extension of the deferral period must be at least five years from the date the payment would otherwise have been made.

• For a payment to be made at a specified date on a fixed schedule, the further deferral election cannot be made within 12 months of the first scheduled payment.

Limitations on Funding Mechanisms

The new law also deals with funding arrangements for deferred compensation. Two types of funding arrangements will result in immediate taxation of the amounts deferred. First, assets that are used to fund deferred compensation and that are held in trusts based outside the US will result in the loss of deferral. If assets are held within the US and are subsequently transferred outside the country, taxation will occur when the transfer is made. Second, if assets are generally available for any expense but, on the happneing of some event (e.g., change in the company's financial health) become restricted to providing benefits, then the deferral will be taxed to the participant immediately.

Reporting and Withholding of Tax

Another new provision of the Internal Revenue Code, Section 6051(a)(13), requires that the amount of all deferrals be reported on Form W-2 (for employees) or Form 1099 (for non-employees). Reporting is required even if the deferral amount is not currently taxable. In addition, amounts that become taxable to employees under Section 409A are subject to income tax withholding.

Penalties

The new deferred compensation rules contain significant penalty provisions. If a deferral does not satisfy the rules of Section 409A, the deferral of income will not be effective and the amount deferred will be included in taxable income for federal income tax purposes. In addition to the income tax liability, new Section 409A requires the payment of interest from the time the tax would have been due if there had been no deferral of income. The interest rate is the IRS underpayment rate plus one percent. Further, a penalty tax of 20% of the amount includible in income must be paid if the deferral does not meet the statutory requirements.

These rules as to income inclusion and penalty and interest payments apply only to those participants in the deferred compensation arrangement as to whom the statutory requirements are not met. If the deferral is lost because of action taken with respect to only one participant, only that participant will suffer the consequences. If the entire plan or arrangement fails to satisfy the law, then every participant will be penalized.

What To Do Now

The Treasury Department representatives who have discussed the new law have emphasized that its aim is not to trap employers. We expect that the guidance to be issued will give some transitional relief. It's important, though, to start planning for the changes now. We suggest the following steps:

• Identify all nonqualified deferred compensation arrangements, including plans, employment agreements and other individual compensation arrangements, whether with employees, directors or independent contractors.

• For each such plan or arrangement, determine whether there are provisions that do not comply with the new rules under Section 409A.

• Consider grandfathering existing plans to ensure that they do not become subject to the new rules.

• Notify participants that changes might have to be made in their deferrals.

• Continue to monitor developments with respect to the new law.

• Prepare to amend or terminate plans and arrangements after the Treasury Department guidance is issued in December.

NEWSLETTER ARTICLES

What would you like to see in future issues of the Probate and Trust Law Section Newsletter? The Communications Committee is looking for articles and ideas of interest to the probate bar. Please send any articles or ideas to:

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ETHICS COLUMN

By PAUL C. HEINTZ
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Does an attorney have an obligation to notify a client that the attorney has committed legal malpractice that has caused, or will cause financial harm to the client?

Although there have been no ethical opinions issued in Pennsylvania with respect to an attorney's obligation to notify the client or other party harmed by the attorney's malpractice, it would seem that Rule 1.4 of the Rules of Professional Conduct in Pennsylvania would require notification.

In an attorney disciplinary proceeding, the Supreme Court, Appellate Division, of New York held that an attorney's failure to advise a client of the nature and extent of malpractice claims committed by the attorney violated his professional duty to promptly notify the client of his failure to act and of the possible claim the client may have against him. *Tallon v. Committee on Professional Standards*, Third Judicial Department, 86 A.D.2d 897, 447 N.Y.S.2d 50 (1982). In another attorney-disciplinary proceeding, the Supreme Court of Indiana held that the attorney's commission of malpractice and failure to respond to the client's repeated requests for information violated Rule 1.4 (a), the rule requiring an attorney to keep the client reasonably informed about the status of a matter and promptly comply with reasonable requests for information. *In re Higginson*, 664 N.E.2d 732 (Ind. 1996). In a malpractice case in California, the court held that among the fiduciary duties owed the clients by an attorney is the obligation to render a full and fair disclosure to the client of all facts that materially affect his rights and interests. The court further stated that any material concealment or misrepresentation will amount to fraud. *Neel v. Magana*, *Olney*, *Levy*, *Cathcart & Gelfand*, 6 Cal.3d 176, 491 P.2d 421, 98 Cal. Rptr. 837 (1971).

Furthermore, if the attorney's interests diverge or become adverse to the client, the attorney must fulfill his fiduciary duty to the client by notifying the client of that fact and how it may have affected the client. *Golden Nugget, Inc. v. Ham*, 646 P. 2d 1221 (Nev. 1982) and *Miller v. Sears*, 636 P. 2d 1183 (Ak. 1981).

Other than the fact that it seems to be the right thing to do, is appropriate under Rule 1.4 and is consistent with the fiduciary nature of the attorney-client relationship, there is also a practical reason to notify the client. Notifying the client of the error, when the client is unaware of it and has no reasonable means of discovering it, will start the malpractice statute of limitations running. In Pennsylvania and most other states, the statute of limitations for legal malpractice does not begin until the client discovers, or should discover, the cause of action.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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Report of the Chair, continued from Page 1

particular thanks to Gene Gillin (who also has acted as Editor–in-Chief of the entire Philadelphia Estate Practitioner Handbook) and Margie Thompson, both of whom edited the Red Book. A very special thank you also to Wachovia Wealth Management for sponsoring both the hard copy of the Red Book and the costs attributable to adding it to the PEPH website.

Outreach. When I began my term as Chair, two concerns of mine were that the Probate Bar (including the Chair!) is getting older, and we are starting to see fewer active members. In the spring of 2004, the Section co-sponsored a Round Table (organized by Kathy Mandelbaum) on estate and trust practice for JD and LLM students at Temple's James E. Beasley School of Law, with speakers chosen to reflect the variety of practices available to students interested in our area. The Executive Committee also created an ad hoc Outreach Committee (with Kathy Mandelbaum as Chair) to explore additional opportunities to connect with practitioners who are new to probate and trust law practice. The Outreach Committee co-sponsored a second Round Table in October for students at Villanova Law School, and plans to sponsor future Round Tables at other local law schools. Next year, the Committee will continue to explore other outreach ideas including: a special CLE program focusing on the fundamentals of estate practice; creating a mentoring program for new practitioners; and giving students and younger practitioners the opportunity to write articles for the Probate and Trust Law Section Newsletter and other publications, which has already begun.

Public Service. Working with Karen Buck at the SeniorLAW Center, the Committee on Public Service (Howard Vigderman, Chair) organized volunteers to meet with, and prepare Wills and Powers of Attorney for low income senior citizens. Together with the Young Lawyers Division, Philadelphia VIP and the SeniorLAW Center, Section members volunteered again to participate in the "Wills for Heroes" project – a program to provide Wills and other estate planning documents for low income individuals who are caring for children other than their own. (Our Young Lawyers Representative, Matt Rosin, was instrumental in facilitating the Section's participation in "Wills for Heroes.") Individual Section members also have responded to the request of Judge Lazarus to assist Philadelphia VIP by providing additional volunteers to take on Tangled Title cases.

Getting the Message Out. The Section's Education Committee (Judy Stein, Chair) sponsored or co-sponsored four CLE seminars this year, all very well received. The Communications Committee (Susan Collings, Chair) produced two issues of the Probate and Trust Law Section Newsletter – both also well received.

* * *

You've heard it before, and it's still true: almost all of the Section's work (and there is a lot of it) is done by its Committees. We think so highly of Committees that in November the Executive Committee created a new Closely Held Business Committee whose mission is to: (1) stay abreast of current developments; (2) create a resource to encourage a multi-disciplinary approach to counseling the small business owner; and (3) create a Practice Guide for the Pennsylvania estate planning practitioner representing the owner of closely held business interests. This was Karin Kinney's idea, and so (of course) she was named the first Chair of the Committee.

I played a very small part in most of the above activity. I am, however, very proud to have had the opportunity to preside over such an active and productive Section. Finally, thank you to my fellow officers, Julia Fisher, Mary Jane Barrett and Kathleen Stephenson. I could not have done it, or enjoyed it as much, without you.

Pro Bono Opportunity

As part of National Health Care Decisions Week, the Young Lawyers Division, in cooperation with the Probate & Trust Law Section, sponsored an educational program for laypersons on the topics of health care advance directives, health care powers of attorney and organ and tissue donation. The program, which took place in late-October at the Interac Center for Older Adults, 6012 Ridge Avenue in Philadelphia, was free and open to the public.

Attorneys are now being sought to draft health care advance directives and health care powers of attorney on a pro bono basis. You may volunteer to take on a matter at any time by contacting Matthew Rosin by e-mail at matthew.rosin@dbr.com

TAX UPDATE

By JOAN AGRAN
MCCAUSLAND, KEEN & BUCKMAN

I. TREASURY REGULATIONS

Treasury Issues Proposed Regulations Revising and Clarifying §2702 Regulations

The Treasury has issued proposed regulations to amend the Code Sec. 2702 regulations (REG-163679-02, 69 Fed. Reg. 44476) to conform and clarify them based on the holdings in *Walton v. Comr.*, 115 T.C. 589 (2000) and *Schott v. Comr.*, T.C. Memo 2001-110, rev'd and rem'd, 319 F.3d 1203 (9th Cir. 2003).

Reg. §25.2702-3(d)(3), which provides that the qualified unitrust or annuity interest must be payable "for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of these periods," was litigated in *Walton*. Reg. §25.2702-2(a)(5), which treats the retention of a power to revoke a qualified unitrust or annuity interest of the grantor's spouse as the retention of a qualified unitrust or annuity interest, was litigated in *Schott*.

The grantor in *Walton* created a two-year GRAT with any scheduled annuity payments to be made to the grantor's estate if the grantor died before the term expired, and the balance of the trust corpus to be paid to the remainder beneficiary at the end of the term. The Tax Court concluded that such a retained annuity is a qualified interest under Code Sec. 2702 for the specified term and that Reg. §25.2702-3(e), Ex. 5, which reaches the opposite conclusion on similar facts, is invalid. Prop. Reg. §25.2702-3(e), Exs. 5 and 6 reflect that change.

The GRAT in *Schott* provided for fixed annuity payments to the grantor for a 15-year term or until the grantor's prior death and, if the grantor died before the term expired, to the grantor's spouse, if living, for the remainder of the term unless the grantor revoked the spouse's interest. Although the Tax Court held that the spousal interest was not qualified, the Ninth Circuit concluded on appeal that the spousal interest was qualified. The proposed regulations clarify treating a grantor's spousal interest as a qualified interest only if the spouse's interest, by itself, would constitute a qualified interest under Reg. §25.2702-3(d)(3), but for the grantor's revocation power.

The proposed regulations will generally apply to trusts created on or after July 26, 2004. However, the Treasury stated that the Service would not challenge any prior application of the changes to Prop. Reg. §25.2702-3(e), Exs. 5 and 6.

Proposed Regulations Explain GST Trust Qualified Severance Rules

The Treasury has issued proposed regulations under Code Sec. 2642(a)(3) (REG-14598703) on the qualified severance of a trust for purposes of the GST tax. The regulations explain the proper procedure, timing, and required reporting of a qualified severance, and the permitted methods of funding the resulting trusts.

Prop. Reg. §26.2642-6(b)(3) clarifies the Code Sec. 2642(a)(3) requirement that a trust be divided on a fractional basis for it to constitute a qualified severance. Each new trust must receive assets with a value equal to a fraction or percentage of the total value of the trust assets. The severance of a trust based on a pecuniary amount will not satisfy this requirement. Each separate trust isn't required to be funded with a pro rata portion of each asset held by the original trust; the separate trusts could be funded on a non pro rata basis if funding is based on the total fair market value of the assets on the date of funding.

For purposes of the Code Sec. 2642(a)(3)(B) rule that a resulting trust provide in the aggregate for the same succession of interests of beneficiaries as in the original trust, Prop. Reg. §26.2642-6(b)(4) clarifies that (i) the beneficiaries of each separate trust resulting from the severance need not be identical to those of the original trust, and (ii) for trusts that grant the trustee the discretionary power to make non pro rata distributions to beneficiaries, the separate trusts are considered to have the same succession of interests of beneficiaries if (a) the terms of the separate trusts are the same as the terms of the original trust, (b) the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation than the person or persons who held the beneficial interest in the original trust, and (c) the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period

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provided for in the original trust.

Prop. Reg. §26.2642-6(c) provides that a qualified severance must be reported by:

1. Filing Form 706-GST, writing ‘Qualified Severance’ in red at the top.

2. Attaching a ‘Notice of Qualified Severance’ that clearly identifies the trust that is being severed and the new trusts created, with the inclusion ratio of the trust that was severed and the inclusion ratios of the new trusts.

3. Filing the return and attached notice even if the severance doesn’t result in a taxable termination.

Prop. Reg. §1.1001-1(h)(1) provides that a qualified severance isn’t an exchange of property for other property differing materially either in kind or in extent under Code Sec. 1001 if: (i) an applicable state statute or the governing instrument authorizes the trustee to sever the trust; and (ii) if the separate trusts created by the severance are funded on a non pro rata basis, an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non pro rata basis. If these conditions are satisfied, the basis of the trust assets is the same after the severance as the basis of those assets before the severance, and the holding periods of the assets distributed to the new trusts include the holding period of the assets in the original trust.

Treasury Issues Proposed Regulations On The GST Tax Predeceased Parent Rule

The Treasury has issued proposed regulations (REG-145988-03) providing rules and examples on the GST tax predeceased parent rule. The proposed regulations generally would apply for terminations, distributions, and transfers occurring on or after the date they are finalized. For transfers occurring after Dec. 31, 1997, and before the date that the regulations are finalized, taxpayers may rely on the proposed regulations or any other reasonable interpretation of Code Sec. 2651(e).

Proposed Reg. § 26.2651-1(a)(3) provides that, for purposes of Code Sec. 2651(e), an individual’s interest in property or a trust is established or derived at the time the transferor is subject to estate or gift tax. If a transferor is subject to transfer tax on the property on more than one occasion, then the individual’s interest would be considered established or derived on the earliest of those occasions. However, an exception to this general rule would apply for remainder interests in trusts for which a QTIP election has been made for all or part of the trust. To the extent of the QTIP election, the remainder beneficiary’s interest would be deemed to have been established or derived on the death of the surviving spouse, rather than on the transferor’s earlier death.

Under Proposed Reg. §26.2651-2(b), if an adoptive parent legally adopts an individual who is: (1) a descendant of a parent of the adoptive parent (or the adoptive parent’s spouse or former spouse); and (2) under the age of 18 at the time of the adoption, then the adopted individual would be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether a transfer from the adoptive parent (or the spouse or former spouse of the adoptive parent, or a lineal descendant of a grandparent of the adoptive parent) to the adopted individual is subject to GST tax.

In addition, Proposed Regs. §26.2651-1(a)(2) and §26.2651-2(c) provide that if an individual’s generation assignment is adjusted with regard to a transfer under either Code Sec. 2651(e) or as a result of an adoption described above, a corresponding adjustment with respect to that transfer would be made to the generation assignment of that individual’s spouse or former spouse, that individual’s descendants, and the spouse or former spouse of each of that individual’s descendants.

II. COURT DECISIONS

Property Not Included In Estate Even Though Prior Marital Deduction Allowed

In *Estate of Rose Posner,* TC Memo 2004-112, husband’s Will devised half of his estate to a marital trust for his wife’s benefit. The estate claimed a marital deduction under Code Sec. 2056(b)(5) on the Federal estate tax return which was filed with a copy of husband’s Will attached. Code Sec. 2056(b)(5) allows a deduction for property in which the spouse has a qualifying life estate, coupled with a general power of appointment. The Service allowed the deduction after audit.

After wife’s death, her disinherited daughters challenged her Will, claiming that wife did not possess a power of appointment over the marital trust property and therefore the property should revert

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Tax Update, continued

to husband's estate to be distributed pursuant to the residuary clause in his will. The matter wound up in Maryland state court where the Baltimore County circuit court ruled that the marital trust property was not part of wife's estate but instead reverted to husband's estate because wife did not possess a testamentary general power of appointment.

While the state litigation was pending, the estate filed the Federal estate tax return including the marital trust property in the gross estate. Subsequently the estate filed a claim for an estate tax refund on grounds that the litigation in Maryland state courts found the inclusion of the marital trust property in wife's estate to have been in error. The Service disallowed the refund claim. Although the Service did not dispute that wife did not have a testamentary power, it took the position that she had an inter vivos general power of appointment which caused the property to be included in her gross estate under Code Sec. 2041. The Tax Court found that wife did not have a general power, either inter vivos or testamentary, because husband's will contained no substantive provisions regarding powers of appointment of any sort.

The Service then claimed that the property nonetheless was includible in wife's estate under the duty of consistency. In order for the duty to apply in a particular case, there must be (i) a representation by the taxpayer, (ii) reliance on it by the Service, and (iii) an attempt by the taxpayer, after the statute of limitations on assessment has expired, to change the representation. The Tax Court held that the duty was not applicable in this case because, under established precedent, the duty does not apply to mutual mistake on the part of a taxpayer and the Service concerning a pure question of law. In this case the inconsistency arose because of a mutual mistake in the construction of husband's Will under Maryland law, a purely legal issue. Therefore, the property didn't have to be included in wife's gross estate.

Estate Tax Value Must Be Used To Calculate Inherited Art's Cost Of Goods Sold

In *Conrad Janis, et ux., et al. v. Commissioner, TC Memo 2004-117*, decedent owned and operated an art gallery for about 40 years until his death. His children were the co-executors and sole beneficiaries of his estate. In determining the value of the gallery, the Service allowed various discounts totaling over 60%.

The children continued to operate the gallery for a number of years, first through a trust and then through a partnership. On the advice of the children's attorney, the accountant filed amended trust returns to reflect a beginning value for the collection's undiscounted value. By using this undiscounted value for the collection as its inventory, the gallery increased the reported amount of its cost of goods sold for a number of years, generating a large net loss for each year in question.

On the basis of these facts, the Tax Court concluded that, under Code Sec. 1014 and Reg. §1.1014-3(a) , the children's basis in each work of art in the collection was equal to the work's proportionately discounted value as determined for estate tax purposes. The Tax Court determined that the duty of consistency required them to use the collection's discounted value as their basis for purposes of calculating the gallery's cost of goods sold for the years in question.

Transfers To Partnership Were Bona Fide

In *David A. Kimbell Sr., et al. v. United States,* 93 AFTR 2d 2004-985 *(CA 5)*, decedent transferred a large portion of her assets to three entities, a revocable living trust, an LLC, and a family limited partnership (the LLC and the partnership being created just months prior to decedent's death). Decedent and her son were co-trustees of the trust and son was paid a monthly fee to manage the trust. The LLC, managed by the son, was owned 50% by the trust and 50% by decedent's son and his wife. The LLC was the general partner of the partnership, contributing 1% of the capital, while the trust was the sole limited partner, contributing 99% of the capital, or $2.5 million. Through her 50% interest in the LLC and her 100% interest in the trust, decedent's real interest in the partnership was 99.5%. The Service, in an audit of the Federal estate tax return filed after decedent's death, determined that the value of decedent's 99.5% interest in the partnership was almost twice that stated in the return. The estate paid the additional taxes and sought a refund.

The U.S. District Court, noting that there are two exceptions that prevent the operation of Code Sec. 2036(a) -- transfers that are bona fide sales for full and adequate consideration and transfers in which the transferor doesn't retain a property interest -- concluded that the transfer of assets to the partnership did not satisfy either exception. The court granted the government's motion for partial summary judgment and denied the estate's cross motion. *David A. Kimbell Sr., et al. v. United States,* No. 7:01-CV-0218-R (N.D. TX 2003).

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The Fifth Circuit reversed the District Court, holding that the FLP assets were not includible in decedent's gross estate under Code Sec. 2036. The court found that the transfer was a bona fide sale because (i) decedent retained sufficient assets outside the partnership for her own support and there was no commingling of the partnership's assets and her personal assets; (ii) partnership formalities were satisfied and the assets contributed to the partnership were actually assigned to it; (iii) the assets contributed to the partnership included working interests in oil and gas properties which require active management; and (iv) son advanced several credible and unchallenged non-tax business reasons for the formation of the partnership that could not be accomplished through decedent's trust.

The Fifth Circuit further concluded that decedent's transfer was for full and adequate consideration because (i) the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (ii) the assets contributed by each partner to the partnership were properly credited to their respective capital accounts, and (iii) on termination or dissolution of the partnership the partners were entitled to distributions from it in amounts proportionate to their respective capital accounts.

Finally, the court held that the assets contributed to the LLC were not includible in decedent's gross estate under Code Sec. 2036(a) because decedent did not retain the right to enjoy or designate who would enjoy the LLC property.

Amended Buy-Sell Agreement Disregarded Under Code Sec. 2703

In *Estate of George C. Blount, et al. v. Commissioner,* TC Memo 2004-116, in 1981 decedent and his brother-in-law and the company in which they each owned ½ of the stock, entered into a buy-sell agreement setting the price for the redemption of the stock at a shareholder's death. In 1992, the company formed an ESOP which later became a minority shareholder. After the redemption of brother-in-law's stock following his death in 1996, decedent (who now controlled the company) and the company executed an agreement requiring the company to buy decedent's stock at a set price at his death. The company also received proceeds from an insurance policy owned on decedent's life. Decedent's estate reported the value of the stock at the price set in the agreement (which was paid at his death in 1997). The Service claimed the value of the stock was almost double that reported. The Tax Court held that the 1996 agreement adopted a formula that significantly reduced the amount paid for the stock, causing the agreement to be subject to the strict rules of Code Sec. 2703. The court further held that the modified agreement would be disregarded under Code Sec. 2703(a), because it did not consist of terms comparable to similar arrangements entered into by persons in an arm's-length transaction.

Taxpayers' Transfers of Stock to FLPs Constitute Indirect Gifts of Stock to Children

In *Senda v. Comr.,* T.C. Memo 2004-160, husband and wife created two family limited partnerships, with the husband holding the general partnership interest in both partnerships. Each of husband, wife and their three children were designated as holding limited partnership interests. Although the children's partnership interests were purportedly held for them in trust, there was no written trust agreement at the time the first partnership was created and no tax returns were filed in the name of the trust. The trusts were eventually executed after the creation of the second partnership. The children, as limited partners, reported income/losses from the first partnership on their individual tax returns.

Husband and wife transferred stock from their joint brokerage account to each of the partnerships some time after each partnership's creation and on that same day, each gave to each child (or the trust for that child) a limited partnership interest in each partnership. The certificates of ownership reflecting the transfers were not prepared and signed, as to the first partnership, until several years thereafter, and as to the second partnership, until several weeks after the transfers. The children (or their trusts) purportedly contributed oral accounts receivable in exchange for their partnership interests. These transfers were never reduced to writing, had no terms for repayment, and had never been paid.

Husband and wife filed gift tax returns reflecting gifts of the partnership interests to the children with discounts for minority interest and lack of marketability. The Service issued a notice of deficiency, determining that the fair market value of the property transferred to the children was the value of the stock contributed to the partnerships without lack of marketability and minority interest discounts.

The Tax Court, citing *Shepherd v. Comr.,* 115 T.C. 376,

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389 (2000), aff'd, 283 F.3d 1258 (11th Cir. 2002) and *Jones Est. v. Comr*., 116 T.C. 121 (2001), found the formalities of the FLPs to be lacking. The court noted that neither partnership had ever prepared annual financial statements and that husband, as general partner, did not maintain any books or records for either partnership other than brokerage account statements and partnership tax returns. Tax returns were prepared months after the transfers of the partnership interests and the certificates of ownership reflecting the transfers were not prepared until at least several weeks after the transfers. Because husband and wife presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children, the court found that the transactions were integrated. On the basis of these facts the court concluded that the transfers of stock to the partnerships, coupled with transfers of limited partnership interests to their children, constituted indirect gifts of stock to the children; and that the gift tax should be determined on the fair market value of the stock.

FLP Provision May be Subject to Code Sec. 2703

In *Smith, Sidney E. v. U.S*., 94 AFTR 2d 2004-5283 (2004, DC PA), taxpayer and his two children formed a family limited partnership with taxpayer initially owning 95.15% of the limited partnership interests. The agreement contained a provision that limited the price and terms upon which the partnership would be required to pay a partner for his limited interest in the partnership, if the FLP exercised its right of first refusal. Taxpayer gifted each child a 20.235% limited partnership interest in 1998 for which he took a marketability discount. The Service disallowed the discount, applying Code Sec. 2703 to disregard the restrictive provision in valuing the gifted interests. In litigation, the Service filed a motion for summary judgment that Code Sec 2703(a) applied.

The district court, in a case of first impression, rejected the taxpayer's reliance on *Church v. U.S.,* 88 AFTR 2d 2001-5352 (CA 5, 2001), stating that under Reg. §25.2703-1(a)(3) the restrictive provision set forth in the partnership agreement is the type of restriction to which Code Sec. 2703(a) was intended to apply. The restrictions that were involved in *Church* merely limited the right of a buyer or assignee of a partnership interest to become a partner; *Church* did not involve a restrictive provision that fixed the price of a partnership interest at less than fair market value, as the provision in this case did. The court granted the motion for summary judgment but left open the possibility that the restrictive provision could qualify for the "safe harbor" exception of Code Sec. 2703(b) if the taxpayer could demonstrate at trial that all of the safe harbor requirements were met.

Estate Had To Include Assets Transferred To Family Limited Partnership

In *Estate of Thompson v. Commissioner,* No. 03-3173 (CA 3 9/1/2004), decedent formed two limited partnerships, one with his daughter and her husband and one with his son. Decedent contributed marketable securities and some notes to both partnerships while his son-in-law and his son contributed real property to each of their respective partnerships. The son also contributed some mutual funds to the second partnership. Each partnership had a corporate general partner of which decedent held 49% of the interest, his children held 49% of the interest in each of their respective partnerships and an unrelated party held the remaining 2% interest.

In total, decedent, then age 95, transferred $2.8 million in assets ($2.5 million in the form of marketable securities) to the partnerships, retaining only $153,000 in personal assets, and with an annual income of $14,000 from two annuities and Social Security. He had annual expenses of $57,202, and an actuarial life expectancy of 4.1 years. The partnerships continued to hold the marketable securities in decedent's brokerage account with minimal post-transfer trading. The partnership with his daughter also made loans to members of the daughter's family; although interest was charged on these loans, payments were often late or not paid at all.

The partnerships made cash distributions to decedent, some of which he used to provide holiday gifts to family members. During the same time period, he made gifts of interests in both partnerships to individual family members. After his death, two years later, the partnerships each sold about $350,000 in securities to partially fund bequests in his will and to pay his estate taxes.

Decedent's estate applied a 40% discount to the value of the partnerships and corporations for lack of control and marketability on the estate tax return for decedent's 87.65% interest in the first partnership and 54.12% interest in the second partnership. The Service disallowed the claimed discounts.

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The Tax Court in *Estate of Thompson v. Commissioner,* T.C. Memo 2002-246, found that the family partnerships were validly formed and properly recognized for federal estate tax purposes but agreed with the Service's position that the full fair market value of the assets transferred by decedent to the partnerships should be returned to his gross estate under Code Sec. 2036(a) because he retained control and enjoyment over the transferred assets during his lifetime.

The Third Circuit affirmed, finding no clear error in the Tax Court's finding of an implied agreement between decedent and his family that he would continue to be the principal economic beneficiary of the contributed property, which was sufficient to trigger Code Sec. 2036(a)(1). The fact that decedent did not retain sufficient assets to support himself for the remainder of his life, as calculated at the time of transfer, supported an implied understanding with the children that decedent would retain lifetime enjoyment and economic benefit of the transferred assets. Decedent's lack of control over the transferred property did not defeat this inference.

The Third Circuit agreed with the Tax Court that there was no transfer for consideration within the meaning of Code Sec. 2036(a). Neither partnership had engaged in any valid, functioning business enterprise. Other than favorable estate tax treatment resulting from the change in form, there was no real benefit from holding an untraded portfolio of securities in a family limited partnership with no ongoing business operations. Where the record demonstrates that the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of Code Sec. 2036(a). The Court also concluded that there was no bona fide sale within the meaning of Code Sec. 2036 because there was no discernible purpose for the transfer other than estate tax savings.

III. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

Alternate Method for Certain Taxpayers to Obtain Extension of Time to Allocate GST.

The Service has issued *Rev. Proc. 2004-46,* 2004-31 I.R.B. 142, effective August 2, 2004, providing a simplified method for certain taxpayers to obtain an extension of time under Reg. §301.9100-3 to make an allocation of GST exemption as an alternative to the usual letter ruling process. A user fee will not be charged for requests filed under this revenue procedure.

Since the addition of Code Sec. 2642(g) and the issuance of Notice 2001-50, 2001-2 C.B. 189, announcing that transferors may seek an extension of time to make an allocation of GST exemption, the Service has issued several letter rulings under Reg. §301.9100-3 granting an extension of time to make a timely allocation. In most cases, the transferor failed to allocate GST exemption to the trust on a timely filed gift tax return because the transferor was not aware of the need to affirmatively allocate the exemption to the transfers. As a result, the Service decided that, in these cases, it is appropriate to provide an alternate simplified method to obtain an extension of time to make an allocation of GST exemption, provided that the circumstantial and procedural requirements set forth in Rev. Proc. 2004-46 are met.

This revenue procedure applies only to a taxpayer who satisfies the following requirements: (i) on or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a GST may be made, (ii) at the time the taxpayer files the request for relief under this revenue procedure, no taxable distributions have been made and no taxable terminations have occurred, (iii) the transfer qualified for the annual exclusion under Code Sec. 2503(b), and the amount of the transfer, when added to the value of all other gifts by the transferor to that donee in the same year, was equal to or less than the amount of the applicable annual exclusion for the year of the transfer, (iv) no GST exemption was allocated to the transfer, whether or not a Form 709 was filed, (v) at the time the taxpayer files a request for relief under this revenue procedure, the taxpayer has unused GST exemption available to allocate to the transfer, and (vi) relief is requested in the manner outlined in the revenue procedure. If these requirements are satisfied, the transferor's GST exemption remaining at the time the gift tax return is filed under Rev. Proc. 2004-46 may be allocated to the transfer based on the value of the property as of the date of the transfer and will be effective retroactive to the date of the transfer.

Taxpayers who are denied relief under, or who are otherwise outside the scope of, this revenue procedure may request an extension of time to allocate GST exemption by requesting a letter ruling under the provisions of Reg. §301.9100-3. If a letter ruling is requested after relief was denied under Rev. Proc. 2004-46, the letter ruling

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request must indicate that relief was requested and denied under this revenue procedure.

Simplified Alternative To Request Relief To Make Late Reverse QTIP Election

The Service has issued *Rev. Proc. 2004-47,* 2004-32 I.R.B. 169, effective August 9, 2004, providing a simplified method for executors and trustees to request relief to make a late reverse QTIP election as an alternative to the usual letter ruling process. A user fee will not be charged for requests filed under this revenue procedure.

The Service has issued several private letter rulings granting relief to taxpayers who failed to make a reverse QTIP election on a timely filed estate tax return and who satisfied the Reg. §301.9100-3 requirements, which provides that requests will be granted if the taxpayer establishes that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the government's interests.

Relief is now available under the revenue procedure if, on the date the request is filed: (i) a valid Code Sec. 2056(b)(7) QTIP election was made for the assets or trust on the decedent's federal estate tax return; (ii) no reverse QTIP election was made because the taxpayer relied on a qualified tax professional who failed to advise the taxpayer of the need, advisability, or proper method to make a reverse QTIP election; (iii) the decedent has a sufficient amount of unused GST exemption under Code Sec. 2632(e) and Reg. §26.2632-1(d)(2) to result in a zero inclusion ratio for the reverse QTIP assets or trust; (iv) the estate is not eligible for a Reg. §301.9100-2(b) automatic six-month extension; (v) the surviving spouse has not made an inter vivos disposition of any part of the qualifying income interest for life in the QTIP assets or trust; (vi) the surviving spouse is alive or no more than six months have passed since his or her death; and (vii) the executor requested relief in the manner outlined in the revenue procedure.

An extension of time to make the reverse QTIP election does not extend the time for making an allocation of any remaining GST exemption. However, the decedent's unused GST exemption will be automatically allocated to the reverse QTIP assets or trust under Code Sec. 2632(e) and Reg. §26.2632-1(d)(2), based on the value of the assets or trust as finally determined for federal estate tax purposes, once the reverse QTIP election is made. The Service cautions that the relief provided in the revenue procedure does not include or grant permission to retroactively allocate the decedent's GST exemption or to make a late severance of a trust which must still be requested through the regular letter ruling process.

IV. IRS PRIVATE LETTER RULINGS

Service Approves Trust That Meets Both Prenuptial and Estate Planning Goals

In *PLR 200413011*, under the terms of a prenuptial agreement, husband intends to create and transfer some of his separately-owned property to a trust for the benefit of his wife. Husband will retain a limited power to appoint all the income and principal of the trust. The power will terminate on the first to occur of: (i) his death, (ii) his spouse's death, (iii) his written release of the power, or (iv) 20 years and 2 months after the creation of the trust.

During husband's lifetime and after his death, the trustee is to pay all of the net income, at least annually, to or for the benefit of wife. In addition, the trustee is to distribute to or for the benefit of wife, so much of trust principal as the trustee, in its sole discretion, may consider necessary or advisable for her health, support, maintenance and education. On written demand by wife, unproductive property is to be made reasonably productive. The trust is to terminate at such time as husband and wife agree, in which case, the principal is to be distributed to wife.

In the event of divorce, the property transferred to the trust will retain the characterization that it had before the transfer and is to be divided upon divorce as provided in the prenuptial agreement. The prenuptial agreement is to be null and void on the first to occur of (i) husband expressly and specifically nullifying it in writing, or (ii) the expiration of 20 years.

On the basis of these facts, the Service ruled that (i) husband's transfer of assets to the trust while he retains the power to appoint trust income and principal won't be a gift under Code Sec. 2501 and Reg. §25.2511-2(c), (ii) a completed gift to wife will occur each time a payment of income or principal is made to her, which gifts will qualify for the unlimited marital deduction under Code Sec. 2523, and (iii) because of husband's power and the provision concerning divorce, wife's interest is not a qualifying income interest for marital deduction purposes under Code Sec. 2523.

However, if and when the power of appointment is terminated and the agreement is nullified, wife's income interest will be a qualifying

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income interest for purposes of Code Sec. 2523. If husband makes a valid QTIP election under Code Sec. 2523(f), the trust assets will qualify for the gift tax marital deduction at that time and no part of the trust will be includible in husband's gross estate if wife survives him. If the QTIP election is made and wife does not dispose of any part of her income interest during life under Code Sec. 2519, the trust assets will be includible in her gross estate under Code Sec. 2044, whether or not she survives husband.

Partial Revocation of QTIP Election Not Permitted

In *PLR 200422050*, the Service refused to permit a personal representative, who had elected to deduct all of a marital trust as a QTIP, to convert the election into a partial election to deduct just enough to reduce the estate tax on the first spouse's estate to zero. The Service ruled that this was not a request for an extension of the time to make an election under Reg. §301.9100 and therefore that regulation was inapplicable in this case. Furthermore, the Service ruled that this situation did not fall within the scope of Rev Proc 2001-38 which operates only to treat an entire election as null and void where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. It cannot be used to substitute a partial election for an election as to an entire trust. As a result, the QTIP election was valid as to 100% of the marital trust and the entire value of the trust on the applicable date will be includible in the surviving spouse's estate under Code Sec. 2044.

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