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Report of the Chair

By JULIA B. FISHER
J.P. MORGAN & CO.

As 2005 draws to a close, what we might have thought at the beginning of the year would be a time of tax reform – dramatic or otherwise – is instead a time of recovery from the devastating and costly effects of a series of hurricanes in the U.S. The effects extend from the human tragedy that all of us witnessed to the economic impact of reduced oil refinery capacity, and the ripple effect that fuel shortages have and likely will continue to have across the country in the form of higher gasoline and home heating costs over the winter.

As a result of these events there has been a shift in focus in Washington away from the possibility of tax repeal or reform. A collateral effect is the difficulties that those of us who advise clients continue to face along with our clients – complexity and uncertainty for the foreseeable future.

The Probate Section – in 2006 to be led by Chair Extraordinaire - Mary Jane Barrett, Chair Elect - Kathleen Stephenson, Vice Chair - Kevin Gilboy and Secretary - Margie Thompson – stands ready to do whatever we can in the face of these circumstances to help our members advise our clients as effectively as possible. The current issue of the newsletter is yet another example of the valuable and practical sharing of advice and guidance that we can provide to one another.

Our committees are here for the benefit of every member of the Section, and your participation in the Section provides "fuel" for those committees that work so hard to deliver value to the Section.

And the presentation at our annual meeting on December 13th – "What Is Family" has done much to help us navigate the new issues confronting the estate planner in the 21st century. So make it a resolution for 2006 to participate at some level in the Probate Section.

In the meantime, Happy Holidays to all of you and your families – however your family may be defined!

Inside this Issue...

Charitable Giving Opportunities Created by KETRA

By ROBERT H. LOUIS
SAUL EWING LLP

The Katrina Emergency Tax Relief Act of 2005 ("KETRA") was enacted to provide assistance, in the form of tax planning benefits, to those affected by the recent hurricanes. However, the new law offers planning opportunities that may be used by many taxpayers. These opportunities relate to the ability to make increased charitable contributions, in an effort to encourage taxpayers to increase giving in general and not just for hurricane relief.

Suspension of Percentage Limits on Charitable Giving Deduction

The ability of individual taxpayers to deduct charitable contributions is limited to a percentage of the taxpayer's income. For most taxpayers and most large charities, the limit is 50% of adjusted gross income. There are other limits, depending on the type of property donated and the type of charity. Amounts contributed in excess of the percentage limit may be carried over to succeeding years. Under the new law, but for a limited time only, "qualified" charitable contributions may be deducted up to the full amount of the taxpayer's adjusted gross income, less the amount deducted for other charitable contributions. Any excess contribution amount would still be carried over to later years, subject to other limitations.

What Are Qualified Charitable Contributions?

Qualified charitable contributions are (1) cash contributions made (2) from August 28, 2005 to December 31, 2005 to (3) a charitable organization that is described in Section 170(b)(1)(A) of the Internal Revenue Code – generally churches, schools, hospitals and other public charities. Donor-advised funds do not qualify, nor do supporting organizations under Code Section 509(a)(3).

Limits on Itemized Deductions

Federal income tax law provides for a reduction of itemized deductions, including charitable contributions, depending on the level of the taxpayer's income. Under the terms of KETRA, the deduction for qualified charitable contributions is not treated as an itemized deduction for purposes of the reduction of itemized deductions. Consequently, the entire amount of such contributions can be deducted on the individual taxpayer's 2005 tax return, up to the limits described above.

(It is important to note that different rules apply to corporate contributions, and that those contributions must be made for relief efforts related to Hurricane Katrina.)

Use of Retirement Accounts

One planning technique that may be considered in view of this change in the law relates to the donation of funds from a retirement plan account or individual retirement account. Many taxpayers have expressed an interest in making contributions of account balances, in whole or in part, to charities. Legislation has been introduced repeatedly in Congress to permit this type of contribution, but it has never been enacted. The new law permits taxpayers to withdraw funds from a retirement account, pay them to a charity, and take a full charitable contribution deduction, up to the limits described above.

There are some possible offsets that apply to the tax benefits of making a gift of retirement accounts assets. First, it is important to keep in mind the state income tax consequences of a gift of an income-producing asset to a charity. In those states, such as Pennsylvania, that do not have a charitable contribution deduction, it is important to determine whether the withdrawal from the retirement account is otherwise free of tax.

In addition, the withdrawal from the individual retirement account increases the taxpayer's adjusted gross income. This could affect the calculation of alternative minimum tax and could also result in the reduction of other itemized deductions, as well as the taxation of a larger amount of Social Security benefits. Distributions from a retirement account before age 59½ could result in payment of a 10% penalty.

This planning opportunity can be of great value for those with charitable intentions, but it is important to know all of the tax consequences that flow from it.

The American Jobs Creation Act of 2004: Deferred Compensation Strictly Regulated

By TIMOTHY F. KENNEDY
MONTGOMERY, MCCRACKEN, WALKER & RHOADS

Introduction

The American Jobs Creation Act ("AJCA") was signed into law on October 22, 2004 and will have a significant impact on most deferred compensation programs. Among other things (e.g., tax relief to manufacturers), AJCA adds Section 409A to the Internal Revenue Code ("Code") which places new requirements and tighter restrictions on almost all deferred compensation.

Generally speaking, "deferred compensation" refers to compensation that a person has a "legally binding right to" in one year but which is not actually or constructively received (or included in gross income) until a later year. Deferred compensation is often used by employers to attract key management employees and/or executives. The clear benefit of deferring such compensation is that the employee can also defer the taxation on these amounts. Employers typically provide for deferred compensation through a non-qualified deferred compensation plan. However, given the broad definition of "deferred compensation," Code Section 409A also applies to a wide variety of other arrangements.

Before AJCA, employers had enormous flexibility in designing an almost limitless variety of deferred compensation arrangements to suit an equally wide variety of business purposes. While such business purposes may still be achieved, AJCA's new Code Section 409A imposes significant and new requirements on almost all compensation deferred through arrangements after December 31, 2004. As a result, this employer flexibility has been greatly limited.

Code Section 409A covers four primary components of deferred compensation arrangements as follows: (1) Distributions, (2) Acceleration of Benefits, (3) Deferral Elections, and (4), Funding. The purpose of this article is to summarize each of these major provisions and then discuss certain reporting requirements, the strict penalties for failure to timely comply, and the effective date (including new transitional rules).

Deferred Compensation Plans

Before addressing the provisions of Code Section 409A, it is important to know what plans or arrangements are subject to AJCA. Code Section 409A applies to all deferred compensation. This is defined broadly to include any plan, agreement or arrangement that provides for the deferral of compensation. For example, supplemental executive retirement plans, "top-hat" plans, stock appreciation rights plans, phantom stock plans, excess benefit plans and/or other deferred compensation plans for executives and directors are all, generally speaking, subject to Code Section 409A. Significantly, the IRS also makes it clear that deferral plans that cover just one individual (e.g., separate special executive arrangements) are also subject to Code Section 409A.

While this is an extensive definition, the following types of plans are specifically excluded from the definition of deferred compensation: (1) qualified retirement plans under Code Section 401(a); (2) 403(b) tax-deferred annuities; (3) individual retirement annuities ("IRAs"); (4) 457(b) plans for tax exempt and governmental entities; (5) 415(m) qualified excess benefit plans; (6) simplified employee pensions; (7) SIMPLE plans; and (8) arrangements for vacation, sick leave, compensatory time, disability pay or death benefits.

Distributions

The first area covered by Code Section 409A is distributions. Code Section 409A limits the types of events that can trigger a distribution of benefits from a deferred compensation plan to the following six events: (1) separation from service; (2) disability; (3) a time (or fixed schedule) specified under the plan; (4) a change in ownership or control of the corporation; (5) an unforeseeable emergency; or (6) death. No other distribution events are permitted. However, plans can further limit distribution events to some or one of the above distribution events.

Acceleration of Benefits

Under Code Section 409A, once an election to defer (as to amounts, form and timing of payment) has been made, a payment of deferred compensation may not be accelerated, or paid out more quickly

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AJCA, continued

than as elected and/or as set forth in the plan. Thus, the common practice of allowing early distributions with a small "haircut," is now prohibited.

Deferral Elections

Participants in deferred compensation plans must make salary deferral elections no later than the last day of the preceding taxable year in which the service giving rise to the deferral amounts is provided. For example, a participant wishing to defer compensation earned in 2007 would need to make a salary deferral election no later than December 31, 2006. However, newly eligible participants are able to submit their initial election within 30 days of first becoming eligible to participate.

For performance-based compensation (e.g., most bonuses), elections must be made no later than six months prior to the completion of the performance period. For example, an election to defer 2007 performance-based compensation must be made no later than June 30, 2007.

Code Section 409A does permit deferred compensation plans to allow subsequent changes to the time and form of payment elected, but also imposes tight restrictions on such changes. For example, the plan must require that such election not take effect until at least 12 months after the date on which the election is made. In addition, in the case of distributions for events other than disability, death or unforeseeable emergency, the first payment cannot take effect until at least 5 years from the date the payment would otherwise have been made.

Funding

In most cases, offshore funding arrangements (including springing "rabbi trusts" protecting deferrals in the event of company financial downturn) typically used to protect deferred compensation amounts from creditors, will now be taxed as Code Section 83 "property" as soon as the amounts are set aside.

New Reporting Requirements

Employers are required to report to the IRS amounts deferred and earned under deferred compensation plans on Form W-2 or 1099, even if such amounts are not included as taxable income.

Penalties

The penalty for failure to comply with AJCA is significant. If a plan does not meet (even if operationally) the requirements of Code Section 409A, then all amounts deferred under the plan for the taxable year and all preceding taxable years must be included in a participant's income and taxed for the current year. In addition, such amounts are subject to interest and an additional income tax equal to 20% of the compensation that is required to be included in taxable income as a result of the plan failure. Consequently, employers should review and update their deferred compensation plans to comply with AJCA in order to protect the deferred tax arrangements of their current plans.

Effective Date/Transitional Relief

Any amount deferred on or after January 1, 2005 is subject to Code Section 409A. Amounts deferred before this date are generally grandfathered unless the deferred compensation plan providing for the deferrals has been materially modified after October 3, 2004.

Providing some transitional relief, the deadline for plan document compliance with Code Section 409A has recently been extended to December 31, 2006 by the IRS. In the meantime, affected plans must operate in good faith compliance with AJCA.

This one-year extension of transitional relief, however, does not apply to all provisions of Code Section 409A. For example, deferral elections must generally be made by the end of 2005.

Conclusion

Code Section 409A impacts a tremendous number of plans and arrangements. Virtually every big company will be affected by its restrictions. There is a lot of work ahead for many employers. First and foremost, employers need to become familiar with these very complex rules so that they can operate in good faith compliance. Employers should also begin, as soon as possible, to identify all of their deferred compensation plans, including those contained in individual employment agreements. Getting each plan subject to 409A into document and operational compliance will take time and, as mentioned above, the penalties for failure to do so are significant.

Notice of New Committee

An Orphans' Court Litigation and Dispute Resolution Committee was formed earlier this year. Probate Section members with an interest in Orphans' Court litigation and dispute resolution (including mediation) are welcome to join. Contact Lawrence C. Norford, Esquire at Saul Ewing LLP for further information. He can be reached at: (215) 972-8417 or lnorford@saul.com.

ETHICS COLUMN

By PAUL C. HEINTZ
OBERMAYER, REBMANN, MAXWELL & HIPPELL

Question: How long should a lawyer retain a client's estate planning, estate administration and trust files?

Questions about the retention of files are among those most frequently posed to Ethics Committees and experts and understandably so. We lawyers are keenly aware that file retention is important, yet we also are increasingly burdened by the photocopying, file and storage costs.

The easy and simple answer to the question is: "It depends." While there is no clear general answer, the answer applicable to each case and file will emerge so long as the lawyer remembers two important principles: First, the file, or certainly most of it, actually belongs to the client. Second, the client has a reasonable expectation that we lawyers will not carelessly and prematurely destroy a portion of the file that is useful or valuable to the client and that we will be able to make such portions of it available to the client when he or she needs information.

Estate planning files should generally be retained for the lifetime of the client plus the estate administration period plus the statute of limitations period pertaining to legal malpractice actions. (In Pennsylvania, because of the probability an action against a scrivener will be based on an alleged breach of contract, that period would be four rather than two years.) Incidentally, superseded Wills should usually be retained in the file, too.

Estate administration files can be culled significantly once the administration has been completed and the statute of limitations pertaining to legal malpractice has expired. However, certain documents, such as the letters testamentary, death tax returns, closing letters, accounts, adjudications, Receipts and Releases, and proof of payment of debts, taxes and distributions should be retained as long as it is practical to do so. Long term retention assures that the lawyer can easily answer questions about income tax cost basis and handle later-discovered assets. Long-term retention is particularly important if testamentary trusts were created.

Trust administration files should be retained until the trust has been terminated, the trust assets distributed and the trustees have received complete Receipts and Releases and, when appropriate, a court's adjudication of the account. Thereafter, and once the applicable statute of limitations with respect to legal malpractice has expired, the files may be culled significantly. However, certain documents such as the trust document, the account, adjudication, schedule of distribution, income tax cost basis information, receipts and releases and proof of final disbursements and distributions should be retained as long as it is practical to do so.

If the long term retention of even a small portion of an estate or trust file is burdensome, the lawyer should consider scanning the documents and retaining electronic copies. While not ideal, if a bank or trust company served as the fiduciary or co-fiduciary, the lawyer may have reason to rely on that entity to retain estate and trust administration documents.

Another solution is to give the file to the client. After all, the file does belong to the client. For a number of good reasons, however, experienced practitioners are quite reluctant to relinquish files. The client may lose the file or the file may be inadvertently or prematurely destroyed by the client or others to the detriment of the lawyer or third parties. Ease of access to information in the file is lost. The information in the file may be needed to defend against a legal malpractice claim. At least in the estate planning area, it is probable the file will be needed for subsequent client services. Finally, the time it takes to put a file in shape to give it to the client and the costs of photocopying portions to retain can be rather daunting.

When long term retention is neither desired nor a viable option, as may be the case for a solo practitioner or a lawyer with a small firm, shipping the file to the client with appropriate retention instructions may be the best solution. Certainly, that action would be understandable upon the retirement of the lawyer if other arrangements cannot be made.

There are other important points to remember when considering the retention of files. All lawyers, law firms or trust and estate groups

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JOIN A COMMITTEE

The Section's Committees depend on the steady flow of people, energy and ideas. Join one! Fill in the form below and send it to the Section Chair:

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Name:
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E-Mail:

Committee Preferences
First:
Second:
Third:

Ethics Column, continued

should have a file retention and disposition policy. Lawyers, not staff members, should decide when and how to dispose of files. Client confidentiality should be observed during file culling and destruction. Proof of relinquishment to the client of original and intrinsically valuable documents and property should be retained indefinitely. Finally, an index of destroyed files should also be retained indefinitely.

For further guidance on the issue of file retention, lawyers should consult the American Bar Association Formal Opinions 1376 and 1384 (1977), Pennsylvania Bar Association Formal Opinion 99-120, Philadelphia Bar Association Professional Guidance Committee Opinions 87-1 and 88-17 and §46 of the Restatement 3d of the Law Governing Lawyers (2000). Lawyers should also, of course, refer to the Rules of Professional Conduct, and specifically Rules 1.15 and 1.16, although these two Rules are not particularly comprehensive.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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Shall We Mediate?

By LAWRENCE C. NORFORD AND RYAN R. GAGER
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In many areas of the law and in many parts of the country, some form of alternative dispute resolution ("ADR") has already arrived. For a number of years ADR (including, among other things, arbitration, mediation, and mini-trials) has been recognized as a creative, less expensive alternative to litigation that parties can use to resolve their disputes and that can lighten overloaded court dockets. Often, court rules require the parties to try some form of ADR. ADR, and specifically mediation, has begun to be used in other jurisdictions to settle the various kinds of disputes arising in probate court. Now the idea appears to be gaining traction in Pennsylvania. With mediation making inroads in many areas of the law, the time has come for all of us to answer the question: Shall we mediate?

Many of us have read the article the Honorable Richard B. Klein of the Pennsylvania Superior Court published in the Pennsylvania Bar Association's Real Property, Probate and Trust Law Newsletter advocating the use of mediation in probate disputes.[1] Judge Klein argues that, as lawyers, we do a disservice to both the court and our clients if we do not advise our clients on the use of ADR. Lawyers taking this viewpoint to heart might ponder some initial questions about mediation: How can mediation be used in the probate context? What types of probate disputes are best suited for mediation? What is the role of the lawyer in mediation?

Already a number of states, including Arizona, California, Connecticut, Florida, Georgia, Hawaii, Michigan, New Hampshire, Texas, Utah and Washington have addressed these questions and instituted court sponsored mediation programs for probate disputes. These jurisdictions have developed programs that tackle issues such as whether mediation should be voluntary or mandatory, how many hours should be devoted to mediation, how much mediators should be paid and who is chosen to be a mediator.[2] Across the river, in New Jersey, court rules provide that courts have the power to refer any probate matter to mediation for a three hour period.[3] After the initial three hours, parties are to choose whether to continue to mediate.[4]

Under the right circumstances, most types of probate disputes could be mediated. Mediation could help resolve issues of estate and trust administration, particularly where beneficiaries and fiduciaries have an ongoing relationship. The mediation of contested guardianship proceedings could minimize the corrosive effects of a disagreement over the care of a loved one. The emotional and psychological aspects frequently involved in a will contest could often be handled more effectively by a skilled mediator than by lawyers and judges trained to try or settle cases but not to actively listen to the non-legal concerns of the parties.

Mediation could also be used to narrow the issues before the court. For instance, in a case involving disputes over both a legal issue, for example an ambiguity in a tax clause, and the often vexing issue of the disposition of tangible personal property, the parties might choose to mediate the tangible personal property issues and try or settle the legal issue. Imagine not having to ask the Court to resolve the disposition of the photo albums or bric-a-brac!

Counsel can take advantage of the flexible nature of mediation to encourage the client to pursue unique solutions to the dispute that would not be available through litigation. If mediation fails, the parties are free to return to their litigation positions.

Mediation can be of great benefit to clients and the court system at large. There appears to be little, if any, downside to pursuing the development of an Orphans' Court mediation protocol that would formalize in some way the encouragement of mediation in appropriate cases. For mediation to succeed as an additional option to resolve probate disputes, bench and bar must learn about and support the process and participate in its use and development. The Probate Section's Orphans' Court Litigation and Dispute Resolution Committee has begun to examine the use of mediation to resolve probate disputes. It is perhaps not unrealistic to foresee a future in which mediation will be a commonly accepted part of what we do to help resolve Orphans' Court disputes.

ENDNOTES

[1] *The Use of Mediation in Probate Litigation*, Real Property, Probate, and Trust Law Newsletter, Winter 2005 (Issue No. 58), at 18-19. Judge Klein's article identifies

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Mediation, continued

seven key elements that are useful to characterizing mediation. In general, when the authors of the present article talk about mediation, we mean a non-binding effort by disputing parties to fashion their own solution to a conflict with the help of a trained facilitator. Mediation allows parties to write their own rules to govern the resolution process and outcome.

[2] For a detailed discussion of some of these court sponsored programs see Ray D. Madoff, *Mediating Probate Disputes: A Study of Court Sponsored Programs*, 38 Real Prop. Prob. & Tr. J., 697 (Winter 2004).

[3] R. 1:40-6(a).

[4] R. 1:40-4(b). There is no charge to the parties for the initial three hours of service. Compensation for subsequent time spent mediating is determined by the mediator and the parties involved.

TAX UPDATE

By JOAN AGRAN
MCCAUSLAND, KEEN & BUCKMAN

I. TREASURY REGULATIONS

New Six-Month Automatic Extension For Gift and GST Returns

In *TD 9229, 70 Fed. Reg. 214 (11/4/2005)*, the Service has issued new temporary regulations under Code Sec. 6081 addressing the procedures for individuals to obtain a six-month automatic extension of time to file federal gift and GST tax returns. The temporary regulations are effective for applications of automatic extension of time to file a gift or a GST return filed after December 31, 2005.

Currently, under Code Sec. 6075(b)(2), an individual who makes a gift and who requests an automatic extension of time to file his income tax return is deemed to have an extension of time to file the federal gift tax return. Temporary Reg. §25.6081-1T allows donors who do not request an extension of time to file an income tax return to request an automatic six-month extension of time to file a gift tax return by filing a new version of Form 8892, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709. The new version of Form 8892 will no longer require a signature or an explanation of the need for the extension of time to file.

In addition, a skip person distributee required to file a GST Transfer Tax Return for Distributions or a trustee required to file a GST Transfer Tax Return for Terminations can file for an automatic extension of time to file the return after the prescribed due date by completing Form 7004.

II. COURT DECISIONS

Homes Sold By Estate Beneficiary Remain Subject To Federal Estate Tax Liens

In *First American Title Insurance Co., et al. v. U.S., 95 AFTR 2d 2005-2460 (DC WA)*, decedent's estate consisted primarily of three houses and stock in a restaurant. After filing the federal estate tax return and paying the estate tax but before receiving a closing letter, daughter sold the three houses after she had titled them in her and her husband's name pursuant to a power given her by a state court in her capacity as personal representative.

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The Selden Society

Is your idea of a lazy Saturday afternoon curling up with "Perpetuities in a Nutshell" by W. Barton Leach? We hope not, but if you have an interest in the common law and how it developed over the last 600 years or so, you might be interested in joining the Selden Society. The Selden Society was formed in England in 1887 for the purpose of encouraging scholarship regarding the ancient common law. There are about 1,000 members, primarily in the U.K. and U.S., but in many other countries, especially those whose judicial systems are based on English law. The leadership is the expected collection of Rt. Hons. and Q.C.s. The royal patron is Prince Phillip, although he did not show up at the one meeting the editor attended in Lincoln's Inn in London.

The Society publishes a scholarly volume about once a year, which is distributed to members. The most recent volume was Reports from the Time of Henry VIII, Part II. Cases are reported in law French on one page and translated with English on the other. If you are interested in learning more about the Selden Society, please check the web site at www.law.harvard.edu/programs/selden_society.

Tax Update, continued

On audit, the Service increased the value of the stock by almost $150,000 more than was reported on the estate tax return. When the estate failed to pay the tax, the Service sent letters to the purchasers of the three houses threatening to seize and sell the houses unless they paid the remaining estate tax owed. The title companies representing the purchasers paid the estate taxes under protest and then filed refund claims. When the Service denied the claims, the title companies sued in district court.

The title companies agreed that under Code Sec. 6324(a)(1) at decedent's death a special estate tax lien attached to her gross estate and that the estate's personal representative didn't obtain a discharge of liability under Code Sec. 2204 before selling the properties in question. However, they argued that the proceeds from the sale of the homes were used to pay charges against the estate and administration expenses, thereby divesting the lien under Code Sec. 6324(a)(1). To prove that divestment occurred, the title companies had to show that (i) the sale proceeds satisfied charges against the estate or expenses of its administration, and (ii) a court with proper jurisdiction allowed the satisfaction. The title companies contended that the proceeds from the house sales were used to pay encumbrances, taxes, title insurance premiums, and real estate commissions and that these payments qualify as 'charges against the estate or expenses of its administration.' They also contended that a court with proper jurisdiction allowed the payments, citing the non-intervention probate order granted to the personal representative at the time of her appointment.

The district court disagreed. The court noted that the daughter could have but did not petition the probate court to allow any of the sale proceeds from the three properties to satisfy 'charges against the estate and expenses against its administration' and therefore held that the special estate tax liens did not divest from the homes.

Highest and Best Use of Land For Valuation is Mixed Use of Recreation and Timber Farming

In *Kolczynski Est. v. Comr., T.C. Memo 2005-217 (9/20/05)*, decedent died holding a 100% ownership interest in a tract of land in the South Carolina lowlands with neither zoning nor use restrictions, comprised of 2,095 acres with timberlands, open fields, access to a shallow branch of a river, and 226 acres of what were historically rice fields which no longer function as such and no longer have dikes to regulate water flow from tidal changes. The land, which provides a notable ecosystem, is inhabited by an array of wildlife including deer and migratory water fowl. A commission was founded to preserve the basin in its natural and pristine condition. Decedent's estate tax return included the land with a date of death value of $4,378,013. The Service issued a notice of deficiency that included a $1,112,979 increase to the fair market value of the land.

In the Tax Court, the estate argued that a comparative sales approach was the proper method to value the land, while the Service contended that the proper method was a summation method aggregating the merchantable timber value, the value of the land without timber and improvements (the bare land value), and the value of any improvements. The Tax Court held that the highest and best use for the land was a mixed use of recreation purposes and timber management, concluding that the fair market value on the valuation date was $4,829,252.

Citing *Olson v. U.S., 292 U.S. 246 (1934)*, the Tax Court focused on the highest and most profitable use for which the property was adaptable and likely to be needed in the reasonably near future. The court noted that the decedent had used the land for hunting and horseback riding and that the standing timber was cut only to assist in covering the expenses of maintaining the property. These facts supported a finding that the highest and best use for the land was a mixed use of recreation and timberland, with selective timber farming supporting the recreational value.

Assets Qualifying for Marital Deduction Reduced

In *Lurie Est. v. Comr., No. 04-3800 (CA 7 9/30/05),* decedent, an Illinois resident, was survived by his wife and six minor children. Decedent's mother had created 10 trusts over which decedent had a limited power of appointment. He exercised the power in 1990 to create six new trusts, one for each minor child.

Prior to his death, decedent had executed a revocable trust and a Will. The revocable trust provided that (i) upon decedent's death the assets of the revocable trust would be allocated between a marital trust and nonmarital residuary trust and (ii) if the residue of the probate estate was insufficient to pay estate expenses, those expenses were to be paid from the revocable trust. The Will provided that any residuary amount, after payment of debts, funeral expenses, costs of administration,

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Tax Update, continued

taxes, and legal expenses, was be distributed to the revocable trust.

On the federal estate tax return, the estate claimed that after taking the marital and other deductions there was a taxable estate of zero. The Service, on audit, determined that the trusts over which decedent held a power of appointment should have been included in his gross estate and calculated an estate tax deficiency, which the residual probate estate was insufficient to cover.

In the Tax Court, the parties stipulated that the trusts would be included in the decedent's gross estate but disagreed as to whether the estate taxes were payable from the trusts or the revocable trust assets that otherwise would have gone to the marital trust. The Tax Court held that because the revocable trust provided for the payment of estate taxes and legal costs if the residuary probate estate was insufficient, the estate taxes and legal costs should be paid out of revocable trust assets that otherwise would go to the marital trust.

The Seventh Circuit affirmed the Tax Court's ruling, finding that decedent gave specific instructions in his Will and revocable trust as to how the residual estate was to be administered, how the expenses of his estate were to be handled in the event the residuary estate was insufficient, and sufficiently communicated that he intended to negate the Illinois default rule of apportionment.

Although the estate argued that the revocable trust agreement disclosed the decedent's unmistakable intent to maximize the marital deduction, an intent inherently at odds with the waiver of equitable apportionment, the court determined that the trust instrument contained no express language of decedent's intent not to reduce the marital trust by the payment of estate taxes and contained no language barring the executor from using trust estate funds otherwise eligible for the marital trust for the payment of estate taxes.

Tax Court Values FLP Applying 12% Minority Discount and 23% Marketability Discount

In *Kelley Est. v. Comr., T.C. Memo 2005-235 (10/11/05)*, decedent, his daughter and daughter's husband organized a limited partnership and an LLC which held the 1% general partnership interest. Decedent contributed $1,101,475 in cash and certificates of deposit to the partnership and daughter and husband contributed $50,000 cash to the partnership. Decedent died three months later, owning a 33.33% interest in the LLC and a 94.83% interest in the partnership. Daughter and her husband owned the remaining two-thirds interest in the LLC and 4.17% interest in the partnership. An appraisal firm hired by the estate prepared a valuation of decedent's interests in partnership and LLC, concluding that a 53.5% valuation discount was applicable. The Service issued a notice of deficiency determining that the discounts claimed by the estate were too high and applying a 25.2% discount.

The Tax Court held on the basis of these facts that a 12% minority discount and a 23% marketability discount were appropriate in valuing the interests in the partnership and the LLC. The Tax Court stated that the net asset value approach is often given the greatest weight in valuing interests in an investment company and that after determining the net asset value of the partnership and the LLC, it is appropriate to discount decedent's interest in each entity to reflect lack of control and/or lack of marketability. In determining the minority discount, the Tax Court explained that it would take the arithmetic mean of certain closed-end funds, as shareholders in all closed-end funds lack control and determined that a 12% minority discount was appropriate on the grounds that the Service had conceded that a discount factor of up to 12% would be appropriate and the estate failed to prove that a figure greater than 12% would be appropriate. Although the estate's valuation used the net asset value methodology, the court rejected the estate's figures because the estate's sample study was too small and the studies incorporated a lack of marketability discount, resulting in an overstatement of the minority interest discount.

Entire Value of Apartment Building Included in Decedent's Estate

In *Maniglia Est. v. Comr., T.C. Memo 2005-247 (10/26/05)*, decedent, a widow, died in 1999, survived by one son who was appointed executor of her estate. Decedent had previously transferred real estate comprised of a multi-unit, residential rental apartment building to a Massachusetts nominee trust, naming herself as the settlor and sole beneficiary. The indenture of trust was recorded in 1977, and was never amended. Son managed the property, except for a period in the early 1980s when he was unable to perform his management responsibilities. The bank account into which rents were deposited and from which expenses were paid was at all times in the name of the trust. In 1978, son signed a building permit which named the trust as the owner of the property

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and all documentation relating to the building permit indicated that trust, or the son as trustee of the trust, was the owner of the property.

From 1978 through 1999, federal partnership returns were filed in the name of the trust. From 1996 through 1999, state partnership returns were filed in the name of the trust. For taxable years 1996 through 1999, the partnership filed Schedules K-1 indicating that decedent and her son each owned a 50% interest in the partnership and reporting 50% of the partnership's income to each partner; decedent and son each reported the income reported on the Schedules K-1 on their individual federal income tax returns. No written partnership agreement exists, and no formal records of the partners' capital accounts or formal financial statements exist.

The federal estate tax return filed for decedent's estate in 2000 reported on Schedule F that decedent owned only a 50% interest in the trust, a partnership owned equally by decedent and her son, and reported only 50% of the property's date of death value (as determined by the estate). The Service determined a deficiency of $764,472.

On the basis of these facts, the Tax Court held that the entire value of the property was included in decedent's gross estate, determining that the property was not owned by a partnership between decedent and her son, and that the trust of which decedent was sole beneficiary owned the property at her death. The estate failed to produce sufficient credible evidence to show that the ownership of the property was other than as set forth in the documents. Neither the filing of partnership returns in the name of the trust nor the fact that son performed managerial tasks with respect to the property were sufficient to prove that a partnership owned an interest in the property. In addition, there was no written partnership agreement, no balance sheets showing the partnership assets or formal financial statements indicating the property was owned by a partnership. In fact, the trust document, deeds, and other documents admitted into evidence indicated that the trust owned the property, that decedent was the sole beneficiary and that her son was the trustee.

Restrictive Partnership Provision Disregarded in Valuing Gifts of Limited Partnership Interests

In *Smith v. U.S., No. 02-264 (W.D. PA 9/19/05)*, in 1997, taxpayer, his son and daughter formed a family limited partnership under Pennsylvania law. Taxpayer contributed 100% of the common stock of an operating business to the partnership, retaining a 2% general partnership interest and a 95.15% limited partnership interest, giving son a 1% general partnership interest and a 0.90% limited partnership interest, and daughter a 0.95% limited partnership interest. Taxpayer made gifts of limited partnership interests to son and daughter in 1998, retaining his 2% general partnership interest and a 53.960% limited partnership interest. The partnership agreement provided that (i) the general partners were to act and make decisions based on a majority vote of the total general partnership interests, and (ii) at least one-half of the limited partnership interests needed to consent to an amendment of the agreement.

Taxpayer reported the total value of his 1998 gifts of limited partnerships as $1,025,392 and paid gift tax. The appraisal attached to the return applied a marketability discount in valuing the gifts based on a provision in the partnership agreement limiting the price and terms upon which the partnership would be required to pay a limited partner for his or her interest if the partnership exercised its right of first refusal if an interest was sold. The Service, applying Code Sec. 2703, disregarding this provision and issued an assessment increasing the total value of the 1998 gifts to $1,828,598 and increasing his gift taxes. Taxpayer paid the additional tax and filed a refund claim to which the Service failed to respond. Taxpayer filed suit in district court and died shortly thereafter.

Although the Service and the estate both raised arguments under Code Sec. 2703, the court found that a threshold issue of the application of Code Sec. 2301 was dispositive of the ultimate issue of whether the restrictive partnership provision controls the value of taxpayer's gifts of limited partnership interests. The court explained that, based on the legislative history, Code Sec. 2703 was intended to supplement the existing Code Sec. 2031 requirements rather than to supplant them and that the requirement that an agreement be binding during life and after death under Code Sec. 2031 continues to apply. Because the taxpayer held two-thirds of the general partnership interests and more than one-half of the limited partnership interests, the court concluded that the restrictive provision in the partnership agreement was not binding on taxpayer during his lifetime and should be disregarded in valuing his gifts because taxpayer retained for life the unilateral ability to amend the partnership agreement, including the terms of the restrictive provision.

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Insurance Proceeds Under Buy-Sell Agreement Not Included in Valuation of Corporation

In *Blount Est. v. Comr., No. 04-15013 (CA 7 10/31/05)*, the decedent and his brother-in-law, shareholders in a corporation, entered into a stock purchase agreement with the corporation that required shareholder consent to transfer stock and established that the corporation would purchase the stock on the death of the holder at a price agreed upon by the parties or a purchase price based on the book value of the corporation. The corporation bought insurance policies on each of the shareholder's lives.

In January 1996, decedent's brother-in-law died, owning 46% of the corporation's outstanding shares which was then valued at $7.9 million. The corporation received $3 million from the insurance proceeds and paid a little less than the $3 million to brother-in-law's estate. In October 1996, decedent was diagnosed with cancer and in November 1996, decedent amended the stock purchase agreement. The new agreement did not provide for future price adjustments in accordance with book value, which effectively locked the price at the January 1996 value. Decedent died in September 1997, owning approximately 83% of the corporation. The corporation paid $4 million to decedent's estate. The estate filed a return declaring $4 million as the value of the shares and the Service filed a notice of deficiency claiming that the stock was worth $7.9 million.

On the basis of these facts, the Tax Court held that the original agreement, modified by the 1996 agreement, was to be disregarded for the purpose of determining the value of the shares. The Tax Court also held that the amount of tax should have been calculated by adding the insurance proceeds to the other assets of the corporation in order to arrive at the fair market value of the corporation.

The Seventh Circuit affirmed the Tax Court's finding that the stock-purchase agreement did not fall within the statutory exception under Code Sec. 2703(b)), that would allow the parties to conclusively establish the value of the corporation for taxation purposes at an agreed upon purchase price. However, the Seventh Circuit reversed the Tax Court's computation of the corporation's fair market value, holding that the insurance proceeds should not have been added to the value of the corporation.

Citing Regs. §20.2031-2(h), the Seventh Circuit noted that in order to qualify for the exception to the general rule that stock be valued at its fair market value, the restrictive agreement must be binding during the life of the decedent. The original agreement provided that it could only be modified by the parties thereto; at the time of the 1996 agreement the only remaining parties were the decedent and the corporation. Because decedent effectively controlled the corporation, the original agreement did not meet the exception to the general rule, and the value of the shares in decedent's estate must be determined using a fair-market valuation per Code Sec. 2703. The Seventh Circuit agreed with the Tax Court that the stock-purchase agreement was also to be disregarded under Code Sec. 2703(a), because it was not comparable to an arm's-length transaction as required by Code Sec. 2703(b)(3).

Citing Regs. §20.2031-2(f)(2), the Seventh Circuit noted that in valuing the corporate stock, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." The court found that the limiting phrase, "to the extent that such nonoperating assets have not been taken into account," precluded the inclusion of the insurance proceeds. The corporation acquired the insurance policy for the sole purpose of funding its obligation to purchase decedent's shares in accordance with the stock-purchase agreement. Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation (which was the case here).

III. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

Service Releases 8 New Sample Charitable Remainder Unitrusts

The Service has issued eight new sample charitable remainder unitrusts (CRUTs), complete with annotations and alternate provisions, in separate revenue procedures. Each sample trust meets the requirements under Code Sec. 664 and Reg. §1.664-3 for treatment as a CRUT. Six of the eight new revenue procedures supersede and update one or more earlier sample CRUTs. There is also a new inter vivos CRUT and a testamentary CRUT with a term of years unitrust period.

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Section 4 of each new revenue procedure includes a sample CRUT created by a U.S. citizen or resident. The Service will recognize a trust as a qualified CRUT meeting all of the requirements of Code Sec. 664(d)(2) and, if applicable, Code Sec. 664(d)(3), if (i) the trust operates in a manner consistent with the terms of the trust instrument, (ii) the trust is a valid trust under applicable local law, and (iii) the trust instrument is substantially similar to the sample in the particular revenue procedure or properly integrates one or more alternate provisions of the particular revenue procedure into a document substantially similar to the sample. The eight sample CRUTs are:

• Inter vivos CRUT for one measuring life in Rev Proc 2005-52, superseding Rev. Proc. 89-20, and Rev. Proc. 90-31, Sec. 4.

• Inter vivos CRUT with a term of years unitrust period in Rev. Proc. 2005-53.

• Inter vivos CRUT with consecutive interests for two measuring lives in Rev. Proc. 2005-54, superseding Rev. Proc. 90-30, Sec. 4 and Rev. Proc. 90-31, Sec. 5.

• Inter vivos CRUT with concurrent and consecutive interests for two measuring lives in Rev. Proc. 2005-55, superseding Rev. Proc. 90-30, Sec. 5 and Rev. Proc. 90-31, Sec. 6.

• Testamentary CRUT for one measuring life in Rev. Proc. 2005-56, superseding Rev. Proc. 90-30, Sec. 6 and Rev. Proc. 90-31, Sec. 7.

• Testamentary CRUT with a term of years unitrust in Rev. Proc. 2005-57.

• Testamentary CRUT with consecutive interests for two measuring lives in Rev. Proc. 2005-58, superseding Rev. Proc. 90-30, Sec. 7 and Rev. Proc. 90-31, Sec. 8.

• Testamentary CRUT with concurrent and consecutive interests for two measuring lives in Rev. Proc. 2005-59, superseding Rev. Proc. 90-30, Sec. 8 and Rev. Proc. 90-31, Sec. 9.

Section 5 of each revenue procedure contains annotations providing guidance on numerous aspects of CRUTs, including information on trust qualification, valuation of unmarketable assets, income tax deduction limitations, trustee provisions, donor identity, permissible recipients, percentage requirements, valuation rules, early distributions to charity, prorating unitrust amount, determining unitrust amount payable in year of recipient's death, distribution to and designation of remaindermen, multiple and alternative remaindermen, continuing trust for charity, proration and severance of additional contributions, valuation date in year of additional contributions, testamentary additions, multiple trustees, and prohibited transactions.

Section 6 of each revenue procedure contains alternative provisions, including provisions relating to the payment of part of the unitrust amount to a charity, a qualified contingency, the restriction of the charitable remainderman to a public charity, a retained right to substitute the charitable remainderman, a power of appointment to designate the charitable remainderman, the net income method of calculating the unitrust amount, the net income with make-up method of calculating the unitrust amount, and a combination of methods for calculating the unitrust amount.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Renunciation Results in Taxable Gift

In *PLR 200530002*, prior to January 1, 1977, grandfather funded a trust which provided income to his son for his life. Upon the son's death, the trust is to be divided into equal shares for each of his grandchildren, and the income from a respective grandchild's share is distributed to the grandchild for life. On the death of a grandchild, subject to grandchild's testamentary limited power of appointment, the principal is distributed to the grandchild's issue. The trust also provides that, in all events, the trust will terminate 21 years after the last to die of several measuring lives, two of whom are still living.

Taxpayer, a grandson who was not alive at the creation of the trust (and whose father is now deceased), learned of his interest in the trust and reached the age of majority prior to January 1, 1977. If taxpayer survives the expiration of the perpetuities period, the trust corpus will pass to him outright. Taxpayer proposes to renounce 1/5 of this remainder interest which will then pass to his issue, per stirpes.

On the basis of these facts, the Service ruled that: (i) the renunciation of 1/5 of the remainder interest constitutes a taxable gift; (ii) taxpayer will be treated as making a gift of 1/5 of the entire value of the corpus of the trust, and no actuarial factor will be necessary; and (iii) the gift will cause 1/5 of the entire value of the trust to become subject to GST tax.

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The Service noted that under Regs. §25.2511-1(c)(2), the renunciation of a portion of the remainder interest will constitute a taxable gift unless it is made within a reasonable time after knowledge of the existence of the transfer. The renunciation was not timely because it was not made within a reasonable time after taxpayer learned of the existence of the transfer that created the remainder. Moreover, by accepting the entire trust income, taxpayer has accepted the entire trust corpus. Because taxpayer proposes to renounce 1/5 of the remainder interest while retaining the income interest in the trust, this constitutes a transfer in trust for purposes of Code Sec. 2702(a)(1). Under Code Secs. 2702(b)(1), (b)(2), and (a)(2)(A), the income interest is not a qualified interest and will be valued at zero. Because the transferees are taxpayer's issue, the renunciation results in a taxable gift of 1/5 of the entire value of the corpus.

Lastly, although the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985. The renunciation of 1/5 of the remainder interest will constitute a completed gift by taxpayer who will be treated as the transferor of 1/5 of the entire value of the corpus of the trust and the gift will cause 1/5 of the entire trust to become subject to Chapter 13 of the Code.

Renunciation of Qualifying Income Interest in Severed QTIP results in Gift

In *PLR 200530014*, decedent's residuary trust estate became payable to a marital trust for the benefit of his surviving spouse. The marital trust provided that the net income be paid to the spouse during her lifetime in quarterly or more frequent intervals and in addition, the trustees could distribute principal to her for her maintenance, health, and welfare. Upon spouse's death the trustees are to distribute (i) a sum certain to spouse's son, if he survives spouse; and (ii) the balance in equal shares the decedent's two daughters. The estate filed a Form 706, making an election to treat the marital trust as qualified terminable interest property pursuant to Code Sec. 2056(b)(7)(B)(v).

Following the filing of the estate tax return, spouse petitioned the court for an order to sever the marital trust into two separate and distinct marital trusts, Marital Trust A and Marital Trust B. Marital Trust A and Marital Trust B will have terms identical to the Marital Trust, except that Marital Trust B will not contain the provision that provides for a distribution to spouse's son upon her death. Marital Trust A will continue to include this provision so that son's aggregate interest after the severance will remain the same as his interest in the marital trust before the severance, as required by state law.

Pursuant to court order, (i) Marital Trust B will be funded with a set amount and the balance will fund Marital Trust A, (ii) once the marital trust is severed into two separate trusts, spouse will renounce her entire interest in Marital Trust B and will waive her right of recovery under Code Sec. 2207(A)(b) for any gift taxes paid as a result of the renunciation. Under state law, upon spouse's renunciation, Marital Trust B will terminate and the principal of Marital Trust B shall be divided into shares for decedent's daughters.

On the basis of these facts, the Service ruled that:

(i) the proposed severance of the marital trust into Marital Trusts A and B as permitted by state law, the proposed funding of the trusts, and the proposed renunciation of her entire interest in Marital Trust B will not affect the status of Marital Trusts A and B as QTIP trusts.

(ii) when spouse renounces her qualified income interest in Marital Trust B, pursuant to Code Sec. 2519, she will be deemed to have made a transfer of all of Marital Trust B's property, other than her qualifying income interest therein; she is treated as making a gift under Code Sec. 2519 of the fair market value of Marital Trust B determined on the date of disposition (including any accumulated income and not reduced by any amount excluded from total gifts under Code Sec. 2503(b) with respect to the transfer creating the interest) reduced by the value of her qualified income interest, and further reduced by the amount she is entitled to recover under Code Sec. 2207A(b).

(iii) when spouse renounces her qualified income interest in Marital Trust B, the transfer of her income interest is a transfer by her under Code Sec. 2511; the amount of the gift will be the value of her qualified income interest on the date of disposition.

(iv) when spouse waives her right of recovery provided by Code Sec. 2207A(b), she is treated as transferring the unrecovered gift tax amount to the daughters, from whom the recovery could have been obtained; the amount of the gift will be the amount of reimbursement to which she was entitled.

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(v) no part of the property of Marital Trust B deemed transferred under Code Sec. 2519 will be included in spouse's gross estate pursuant to Code Sec. 2044(b)(2).

(vi) spouse's renunciation of her entire interest in Marital Trust B will not result in a transfer under Code Sec. 2519 of any of the assets of Marital Trust A; and (vii) spouse's renunciation of her entire interest in Marital Trust B will not result in her interest in Marital Trust A being valued at zero under Code Sec. 2702.

Transfer of Home With Retained Life Estate Includible in Estate

In *TAM 200532049,* decedent and his spouse executed a deed conveying title to their residence which they owned jointly with rights of survivorship to their daughter in fee simple, but reserving to themselves a life estate in the property, and also reserving the power during their lifetime to sell, convey, and dispose of the property (but not to devise the property) in fee simple, and to retain as their own all of the proceeds thereof. After the first spouse died, decedent continued to reside in the residence until his subsequent death three months later.

Daughter, as the personal representative of decedent's estate, prior to filing decedent's federal estate tax return, retained an attorney to prepare a disclaimer pursuant to which she, as personal representative, would disclaim, on behalf of the decedent, one-half of the value of the residence that purportedly passed from the spouse to the decedent on the spouse's death. If this disclaimer had been properly and timely executed, no estate tax would have been imposed on decedent's estate. However, this disclaimer was never executed and the entire value of the residence was included in decedent's gross estate, resulting in decedent's estate being liable for estate tax. The estate sued the attorney for malpractice for failure to have the disclaimer executed, ultimately recovering an amount approximately equal to the additional federal and state estate tax, interest and penalties that were paid by the estate attributable to the attorney's alleged malpractice.

The estate subsequently filed a claim for refund of estate taxes, asserting that only one-half the value of the residence was properly includible in decedent's gross estate and also claiming a deduction under Code Sec. 2053(a)(2) for attorney's fees and litigation costs arising from the malpractice suit.

On the basis of these facts, the National Office ruled that: (i) the entire value of the residence is includible in decedent's gross estate—50% under Code Secs. 2036(a)(1) and (2), and 50% under Code Sec. 2041(a)(2); and (ii) the attorney's fees and expenses of litigation arising from the malpractice suit filed against Attorney are deductible administration expenses under Code Sec. 2053.

Because the decedent had transferred his one-half interest in the residence to his daughter while retaining with respect to his transferred one-half interest, a life estate in the property (including the power to dispose of the property and retain the proceeds), at his death the value of that undivided one-half interest is includible in decedent's gross estate under Code Sec. 2036(a)(1) and (2). In addition, because the decedent possessed, at the time of his death, the unrestricted power to appropriate the entire value of the residence for his own benefit, the value of the one-half interest in the residence that spouse conveyed pursuant to the deed is includible in decedent's gross estate under Code Sec. 2041(a)(2).

Regarding the fees, in general, in order for a claimed administration expense to be deductible under Code Sec. 2053, the expense must be allowable under applicable state law and must satisfy the regulatory requirements contained in section 20.2053-3. Here, the fees paid satisfied the criteria for allowance of attorney's fees under Maryland law, that is, the fees were incurred to recover estate assets, and avoided dissipation of estate assets. The fees were necessarily incurred in the administration of the estate for purposes of Regs. §20.2053-3(a) and (c) and were paid in order to recover a loss incurred by the estate during administration, and were not incurred for the individual benefit of the heirs and legatees.

Gift To Club Qualifies for Annual Exclusion as Gift to a Single Entity

In *PLR 200533001*, taxpayer is a member of a club that is organized as a nonstock corporation and which qualifies for tax exemption under Code Sec. 501(c)(7). Taxpayer intends to make cash contributions to the club, subject to the immediate control of the board of directors, which the club intends to use to upgrade the facilities. The taxpayer requested a ruling that the contribution will be treated as a gift to the club as a single entity that will qualify for the gift tax annual exclusion under Code Sec. 2503(b), to the extent that it does not exceed the annual exclusion.

On the basis of these facts the Service ruled that (i) taxpayer's

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transfer will be a gift of a present interest to the club as a single entity, and (ii) to the extent that taxpayer's gift does not exceed the annual exclusion amount, the gift will be excludible for gift tax purposes under Code Sec. 2503(b). Because the club is operated solely for nonprofit purposes (the recreation, enjoyment, education, and entertainment of its members) and not for the economic benefit of its members, the Service found that the club comes within the exception to the general rule of Regs. §25.2511-1(h)(1), "for charitable, public, political or similar organizations," and therefore taxpayer's transfer will be a gift to the club as a single entity.

In addition, because the club will receive the immediate and unrestricted use of taxpayer's gift, it will be a gift of a present interest and, therefore, to the extent the gift does not exceed the annual exclusion requirements in Code Sec. 2503(b), it will be excludible for gift tax purposes.

Transfer of Stock to Son Not a Gift

In *PLR 200534014*, although son was the driving force in organizing a corporation, because he had credit problems, son gave money to his father for the initial purchase of shares in the company on his behalf. Although father was the company's majority shareholder and signed personal guarantees to enable the company to obtain financing, he was not involved in the business of the company. As a result of funds loaned by the company to its shareholders for investments in a limited partnership as well as a limited liability company that was to serve as general partner of the partnership, father owned a pro rata portion of the partnership and the limited liability company. When the company no longer needed father's credit rating, father planned to have his ownership of the company, the partnership and limited liability company transferred to son's name to reflect son's beneficial ownership. Father represented that he never held any beneficial ownership of the shares issued in his name and that all the founding shareholders were aware that father was holding the shares in trust for son.

On the basis of these facts, the Service ruled that the initial transfer of funds from son to father was not a gift as father never had a beneficial interest in the in the corporation but rather held the shares in a resulting trust for son's benefit and, therefore, father's transfer of the company stock to son, including the change in ownership of the partnership and the limited liability company, was not a gift under Code Sec. 2511. Citing *Burnet v. Guggenheim, 288 U.S. 280 (1933),* the Service noted that the gift tax is not aimed at every transfer of legal title without consideration and that the rules of equity provide that a resulting trust arises when a grantor gratuitously conveys property to a grantee under circumstances that do not constitute a gift, in which case beneficial title remains in the grantor.

Assignment of Potential Proceeds of Wrongful Death Action To a Trust Completed Gift

In *PLR 200534015*, after filing wrongful death claims in federal court related to the death of the donor's husband, the donor created an irrevocable trust for her descendants. The trust agreement prohibited the donor from serving as trustee, and required that there be at least one independent trustee at all times. The donor executed an assignment agreement, irrevocably assigning the potential proceeds of the action, or the proceeds from the settlement of the action, to the trust. Under applicable state law, the potential proceeds of a judgment or settlement from a cause of action were recognized as a property interest that could be equitably assigned by one party to another.

After the assignment, the donor remained the named party in the wrongful death action, and continued to have direct responsibility for directing legal representation and making settlement decisions. Despite the donor's continued involvement in the administrative aspects of the claim, the donor had no means of reacquiring the economic benefit of the assigned proceeds, or of changing any of the interests created under the trust.

On the basis of these facts, the Service ruled that the donor's assignment of the potential proceeds from the cause of action to the trust was a completed gift at the time of the assignment. The Service, however, expressed no opinion on the value, for gift tax purposes, of the potential proceeds at the time of the assignment.

Transfer of Annuity to Decedent's Former Spouse is a Distribution under Code Sec. 72

In *PLR 200536014*, taxpayer's divorce settlement required her husband to pay to her a fixed amount per month until her death or remarriage, which obligation was to survive his death. Husband died, leaving a Will requiring the executor to reserve a portion of the estate to fund the payments to taxpayer. In order to avoid prolonging the administration

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of the estate for the duration of the payment obligation, the executor purchased a commercial annuity to fund the payments. The estate was the owner of the annuity and the annuitant was the taxpayer, but the executor intended to distribute the annuity contract to taxpayer in settlement of all her claims against the estate.

The annuity contract guarantees at least 191 monthly payments of a sum certain in order to assure the return of the amount of the entire single premium. There is no right to a lump sum or accelerated payment. Payments will continue until all the guaranteed payments are made or until taxpayer dies, whichever is later. If taxpayer dies before all the guaranteed payments are made, the remaining guaranteed payments will be made to the beneficiary designated by the owner of the annuity contract.

On the basis of these facts, the Service ruled that the distribution of the annuity contract was not a distribution to a beneficiary under Code Sec. 661 because taxpayer was not a beneficiary, but rather was a creditor of her husband's estate. The Service first noted that the transfer of the annuity to taxpayer did not constitute alimony and therefore was not includible in her gross income under Code Sec. 71. Rather, the transfer of the annuity contract was includible in taxpayer's gross income pursuant to Code Sec. 72(a), subject to the Code Sec. 72(b) exclusions. Noting that the taxpayer's investment in the contract is generally equal to the aggregate amount of premiums or other consideration paid for the contract, pursuant to Code Sec. 72(g), in this case taxpayer's investment in the contract is the value of the remaining guaranteed payments to be made under the contract that she agrees to receive in exchange for giving up her right to alimony.

QTIP Election Applied To After-Discovered Asset

In *PLR 200536015*, under the terms of decedent's Will, his residuary estate passed to two marital trusts, Marital Trust A, which was funded with the decedent's available GST exemption, and Marital Trust B which was funded with the balance. After the estate made a timely filed QTIP election for both trusts, the estate's personal representative discovered that a promissory note had inadvertently not been included on the return. If the existence of the promissory note had been known when the return was filed, the note would have funded Marital Trust B, and would have been listed on Schedule M of the return as qualified terminable interest property.

On the basis of these facts, the Service ruled that, upon the estate's filing a supplemental Form 706 to report the inclusion of the promissory note in the decedent's gross estate as an asset of Marital Trust B, the QTIP election would be treated as made for all of the property in Marital Trust B, including the promissory note.

IRD Included in Estate But Distribution Deduction Allowed

In *PLR 200537019*, at the time of decedent's death, he owned a nonqualified annuity contract purchased after October 21, 1979 and from which no payments had been received by decedent prior to his death. The named beneficiary of the death benefit under the contract is the estate. Pursuant to decedent's Will, the executor of his estate will give certain bequests of cash and personal property to individual named beneficiaries. The residue of his estate is to be divided equally and distributed to ten named charitable organizations.

Decedent's Will grants the executor of the estate the power to make distribution or division of the estate in cash or in kind, or both; to allot different kinds or disproportionate shares of property or undivided interests in property among the beneficiaries, and to determine the value of any such property; and to make such elections under the tax laws applicable to the estate as the executor determines should be made. The estate has made interim distributions satisfying all specific and pecuniary bequests. The amounts received upon surrender of the annuity contract will be distributed as part of the remaining residuary bequest to the charities, which have also received interim cash distributions.

On the basis of these facts, the Service ruled that under *Rev. Rul. 2005-30, 2005-20 I.R.B. 1015* (which applies to annuities purchased after October 21, 1979), (i) the excess received by the estate (as the named beneficiary of the contract) over the investment in the contract was IRD includible by the estate in its gross income for the year the contract was surrendered; and (ii) the estate is entitled to a deduction under Code Sec. 642(c)(1) for the amounts of IRD paid to the charities in the year of surrender, or under Code Sec. 642(c)(2) for the remaining amounts of IRD which were set aside for charitable purposes.

Single Beneficiary of each of Nine Trusts Measuring Life For RMD Purposes

In *PLR 200537044*, decedent executed an Inheritance Trust

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and a beneficiary designation form for his IRA in 2003, naming nine separate trusts established under the Inheritance Trust as the primary beneficiaries of his IRA. The designation also provided that the trusts were established as separate shares under the Inheritance Trust. The Inheritance Trust, which became irrevocable at decedent's death, was divided into nine separate shares under the terms of decedent's beneficiary designation prior to September 30th of the year after the year of decedent's death. The trusts were designated as a "conduit" trusts for purposes of the required minimum distribution rule, although the distributions were to he held until payment of trust expenses. Under the terms of the Inheritance Trust one of the trusts was converted by a Trust Protector to an accumulation trust which limited the potential remaindermen to persons not older than the primary beneficiary of that trust.

The Service first determined that the action of the Trust Protector converting one trust to an accumulation trust will not be treated as a post-death action taken by an individual or entity which negates, modifies, or changes the original beneficiary designation because the actions conformed to relevant provisions of the Inheritance Trust and those actions relate back to the date that decedent executed the Inheritance Trust.

Citing Regs. §1.401(a)(9)-5, Example 2 of Q&A-7, the Service ruled that (i) the provisions in the separate trusts (other than the converted trust) mandating that all withdrawals from retirement assets be distributed to the trust beneficiary as soon as possible after trust expenses are deducted will not cause any of the trusts to be treated as if there is an accumulation of distributions from retirement accounts, (ii) each of the separate trusts qualifies as a "see-through" trust (under Regs. §1.401(a)(9)-4, Q&A-5), (iii) for purposes of calculating required minimum distributions within the meaning of Code Sec. 401(a)(9), for each separate trust the appropriate measuring life will be the life of the primary beneficiary of the trust and the life expectancy of the beneficiary each trust may be considered without regard to the life expectancy of the beneficiaries of the other trusts.

Lapsing General Power Results in Inclusion in Child's Estate

In *PLR 200540004*, settlor created and funded an irrevocable trust for his child prior to September 25, 1985. The trustee has the discretion to pay income to the child with undistributed income added to principal. At age 30, child obtains the right to withdraw 1/6 of the trust principal. At age 35, child obtains the right to withdraw 1/5 of the remaining principal. The withdrawal rights are cumulative and do not lapse. Child has withdrawn a portion of the principal subject to child's withdrawal rights. When child reaches age 40, child will have the right to withdraw 1/4 of the remaining principal. After age 40, the maximum amount child can withdraw will be frozen at a specific sum. At child's death, the remaining trust principal is to be distributed among child's descendants pursuant to child's limited testamentary power of appointment.

On the basis of these facts, the Service ruled (i) that child's failure to exercise his withdrawal right from a pre-September 25, 1985 trust was not a constructive addition to the trust for GST tax purposes under Code Sec. 2601 and (ii) child's lifetime power to withdraw principal from the trust was a general power of appointment and that this lifetime power will lapse on child's death and any amount subject to the withdrawal power will be included in child's estate under Code Sec. 2041. As a result, under Reg. §26.2601-1(b)(1)(v)(D), child will become the transferor of that amount for GST tax purposes.

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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NUMBERS

	2006	2005
Gift and Estate Tax		
Annual gift tax exclusion	$12,000	$11,000
Estate tax exclusion	$2,000,000	$1,500,000
Non-citizen spouse annual gift exclusion	$120,000	$117,000
Special use valuation limit	$900,000	$870,000
Social Security		
OASDI tax rate	6.20%	6.20%
OASDI taxable wage base	$94,200	$90,000
Cost of living adjustment for benefits	4.10%	2.70%
Maximum annual benefit for person at full retirement age, assuming no earnings during the year	$24,636	$23,268
Retirement Earnings Test Exempt Amounts:		
Over full retirement age	No Limit	No Limit
Year full retirement age attained: Annual amount	$33,240	$31,800
Monthly amount	$2,770	$2,650
Below full retirement age: Annual amount	$12,480	$12,000
Monthly amount	$1,040	$1,000
Social Security Normal Retirement Age	65 years, 8 months (If born in 1941)	65 years, 6 months (If born in 1940)
Medicare		
Part A tax rate	1.45%	1.45%
Part A taxable wage base	Unlimited	Unlimited
Part A deductible	$952	$912
Part B deductible	$124	$110
Part B monthly premium	$88.50	$78.20
Deductible Long Term Care Insurance Premiums		
Age 40 or under	$280	$270
Age 41-50	$530	$510
Age 51-60	$1,060	$1,020
Age 61-70	$2,830	$2,720
Over 70	$3,530	$3,400
Contribution and Benefit Limits		
§401(k), §403(b), §457(b) elective deferral limit	$15,000	$14,000
§401(k), §403(b), §457(b) catch-up deferral limit	$5,000	$4,000
Defined benefit plan limit at age 62: Annual amount	$175,000	$170,000
Defined contribution plan limit: Annual amount	$44,000	$42,000
Percent of pay	100%	100%
Individual Retirement Account Contributions		
Traditional, spousal and Roth contribution limits	$4,000	$4,000
Catch-up contribution limit	$1,000	$500