PHILADELPHIA BAR ASSOCIATION

Probate and Trust Law Section Newsletter

No. 112 Published by the Section on Probate and Trust Law of The Philadelphia Bar Association August 2005

Report of the Chair

By JULIA B. FISHER

The Probate Section – as usual through our hard-working and amazingly productive committees – has had a number of opportunities so far this year to respond to "late breaking" developments that impact all of its members.

In late December of 2004, the Treasury published sweeping revisions to the Circular 230 regulations that establish standards of practice for tax professionals. The changes, for the most part, became effective on June 20, 2005. The Education Committee worked with the Tax Section on very short notice to prepare an outstanding April 19 presentation on "Giving Tax Advice after June 20: Can You Comply with Circular 230?"

On April 18, 2005 the IRS released Revenue Procedure 2005-24 which imposes new rules and requirements for charitable remainder trusts created after June 28, 2005. The Legislative Committee leaped into action and prepared a comment letter to the Service – you can find a copy of their work in this issue of the newsletter. In addition, the Committee will consider a legislative solution to the issues the Revenue Procedure creates for Pennsylvania practitioners.

Another project in which members of the Section are participating is the recently launched Philadelphia Register of Wills' website and computerization project. The project is intended to provide, among numerous other things, for electronic filing, the prospect of using .pdf fill-in forms, and the possibility of short certificates issued upon probate. All of these are very exciting and much desired applications of technology to our area of practice.

Save the date! The Probate Section's Annual Meeting will be held on December 13, 2005. The program for this year's annual meeting promises to be an interesting and topical subject – "What is Family? New Issues Confronting the Estate Planner in the 21st Century". The panel will address the many ways parent/child and spousal relationships are formed today and what this means to the estate planner. Our speakers include Susan N. Gary, Associate Professor, University of Oregon Law School; Nancy J. Knauer, Peter J. Liacouras Professor of Law, James E. Beasley School of Law of Temple University and Marilyn C. Sanborne, Ballard Spahr Andrews & Ingersoll LLP.

Have a restful and reinvigorating summer – we'll see you in the fall!

Inside this Issue........

Comment Letter to the IRS

July 13, 2005

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Courier's Desk
1111 Constitution Avenue, NW
Washington, DC 20044

Re: Rev. Proc. 2005-24 Regarding Guidance on Spousal Election Rights and Charitable Remainder Unitrusts under IRC Section 664

Dear Commissioner Everson:

I am writing on behalf of the Legislative Committee of the Probate Section of the Philadelphia Bar Association to comment on Rev. Proc. 2005-24. This revenue procedure concerns the tax consequences to the grantor of a charitable remainder annuity trust or a charitable remainder unitrust where the surviving spouse of the grantor has the right under applicable state law to receive a share of the assets of the trust by electing to receive a share of the grantor's estate in the event of the grantor's death.

If the charitable remainder trust is to receive its anticipated tax treatment, the revenue procedure provides a special waiver provision requiring the non-grantor spouse to waive his or her elective right to share in the income or principal of the charitable remainder trust upon the death of the grantor. Failure to waive such right would cause the charitable remainder trust not to qualify as a charitable remainder trust under §664 of the Internal Revenue Code.

I understand you have received extensive comments from the American Institute of Certified Public Accounts (AICPA) and by the American Counsel on Gift Annuities (ACGA) concerning this revenue procedure. We agree with both organizations that the issues they raise are of very real concern to attorneys whose practice includes the creation of charitable remainder trusts. In addition to agreeing with the concerns of these organizations, we would like to comment more specifically on the impact of Rev. Proc. 2005-24 on Pennsylvania residents.

Pennsylvania is one of the states whose legislature has chosen to permit a surviving spouse to elect against the will of a deceased spouse and receive a share of the decedent's estate regardless of the terms of the will. The elective right extends to a conveyance by the deceased spouse during his or her lifetime (whether before or after the marriage) in which principal could have been used for the benefit of the deceased spouse. Since an inter vivos charitable remainder trust created by the deceased spouse would be such a conveyance, we believe that Rev. Proc. 2005-24 would require a waiver by the spouse of a Pennsylvania grantor of the spouse's right to elect against the grantor's charitable remainder trust in order to have the charitable remainder trust qualify as such for tax purposes.

Although obtaining such a waiver may not be difficult in many cases, it is evident that there may be very common situations in which it will be difficult to do so or, worse, where the waiver will not be obtained for readily anticipated reasons of inadvertence. As an example, a waiver would be required at the time a married grantor changes his or her residence to Pennsylvania in the case of a grantor who established a charitable trust in a different jurisdiction which did not provide for a spousal election or which provided for a waiver in a form insufficient to satisfy Pennsylvania law.

Although one of the alternatives suggested by the revenue procedure is to have Pennsylvania law changed to exclude charitable remainder trusts from the assets subject to election by the surviving spouse, this would be directly contrary to the public policy of Pennsylvania as reflected in its current elective share statute. For example, if the statute were to be so changed, a Pennsylvania resident could disinherit his or her spouse by transferring his or her entire estate to an inter vivos charitable remainder trust, retain the annuity or unitrust payment for life, and have the property pass to charity on his or her death. The public policy of Pennsylvania has consistently prohibited a spouse from disinheriting his or her spouse in a situation where the deceased spouse has retained such an interest in an inter vivos trust created during the lifetime of the deceased spouse.

Recommendation:

Rev. Proc. 2005-24 provides a safe harbor for charitable remainder trusts in existence before June 28, 2005, which would cause them to be disqualified for tax purposes only if the surviving spouse actually elects against the trust and the election requires some or all of the trust assets to be paid to the surviving spouse rather than charity.

We recommend that this approach should be adopted for all

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Comment Letter to the IRS, continued

charitable remainder trusts, regardless of when they are created. The possible right of election against such assets should not disqualify the trust for favorable tax treatment. However, if the surviving spouse actually elects against the estate of a deceased spouse and the assets of the deceased spouse's charitable remainder trust are responsible for the payment of any part or all of such elective share, then the charitable remainder trust would be disqualified for an income tax deduction so as to include in the final income tax return of the deceased spouse any income tax charitable deduction allowed to the decedent when the trust was created.

Discussions among experienced practitioners across the country strongly suggest that instances of spousal elections against charitable trusts are very few and far between, while the potential negative impact of the revenue procedure on otherwise properly drawn and administered charitable trusts, which are in fact providing the charitable benefits intended, will be disproportionately severe. Our recommendation is intended to preserve the integrity of the charitable deduction where charitable trusts operate as intended and to preserve the integrity of the tax law where charitable benefits are actually compromised by a claim against the charitable trust.

We further recommend that any additional guidance in this area address the estate tax consequences in the estate of the deceased grantor where his or her spouse exercises a right of election which is satisfied from the charitable trust. With respect to the estate tax charitable deduction, property passing to the charity rather than the surviving spouse should still qualify for the estate tax charitable deduction so that the charitable deduction would be reduced by the value of the assets passing to the surviving spouse. If the charitable remainder trust continues for the life of a successor beneficiary, the estate tax charitable deduction for the continuing charitable remainder trust should be reduced to take into account the amount that passed to the surviving spouse from the charitable remainder trust at the grantor's death.

We welcome the opportunity to discuss our comments with you or others at the IRS and the Treasury Department.

Sincerely yours,

Robert I. Friedman
Chair, Legislative Committee
The Philadelphia Bar Association

Section Events CALENDAR

Probate Section Annual Meeting – December 13, 2005

"What is Family" — New Issues Confronting The Estate Planner in the 21st Century"

Faculty: Susan N. Gary
Nancy J. Knauer
Marilyn C. Sanborne

JOIN A COMMITTEE

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

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The Family Office Phenomenon

By JOSEPH ROSKOS
PRESIDENT, FBO SERVICES, INC.
KING OF PRUSSIA

What do some of your clients in your estate planning practice have in common with the King of England and robber barons? Wealth, and the need for family office services.

The family office can be traced back to the King of England, who had his exchequer. The exchequer basically managed and accounted for the King's personal wealth, collected the income and made disbursements. For the robber barons in the 19th Century, their great concentrations of wealth required the services of the family office. During that time, the family office was an integral, yet not highly visible, part of the ecosystem of the rich. As one tours the summer home mansions in Newport, Rhode Island, it is noted that the wealth of commoners in the US far exceeded the wealth of royalty in Europe, much to the astonishment of the royalty. None the less, these fabulously wealthy commoners needed someone to account for their assets, collect their income, and make the disbursements for their personal living activities. The lifestyle of the robber barons included multiple households, distinct household staffs, expensive art collections, extensive travel and elaborate hobbies. Such a lifestyle required an entity –the office-- which served primarily personal financial management and accounting, separate and distinct from the accounting function of the business or businesses that gave rise to the wealth of the family. This separate "family office" provided an essential, personal privacy to the wealthy by a group dedicated solely to the family's service.

During the period from the 1920's through the 1980's, the personal family office was still maintained through significant historical events such as the Great Depression and World War II. But these events, and particularly the increase in income and estate tax rates, caused the family offices to reduce in both number and visibility. The family office became limited pretty much to the heirs of the super rich – the "old money."

During the last two decades, the concept of the family office has begun to re-emerge with a higher profile, but with a bit of a new twist on a very old concept. Clearly, one of the watershed events for the recognition, visibility, and proliferation of family offices was Sara Hamilton's forming of Family Office Exchange in Chicago around 1990. Hamilton's Exchange provided a forum for information about this old service to a new group of wealthy families. During this time, the growing economy, reduction of tax rates, and generational transfer of wealth resulted in a proliferation of wealth and with this wealth came the need for a family office, separate from the commercial enterprises, to manage the accounts associated with personal life activities.

But this most recent class of the wealthy differs in an important way from the "old money" out of which arose family offices in the country. The twist that I referred to above is that many of the new family offices have an additional purpose that the traditional offices did not have: the latest version of the family office tends not just to account for and manage the personal assets (meaning houses, farms, art objects, etc.) but also to manage the investments of the wealthy individual – at this point it is the source of the wealth. This is a subtle but important distinction in the evolution and characteristics of the modern family office. The shift from operating businesses to investments is often occasioned by a liquidity event in the economic life of the family, in which the family business or source of wealth is turned into cash or diversified investments. With this fundamental development, the nature and purpose of the family office shifted from that of the traditional family office. We now see the emergence of large banks and investment firms offering family office services, having special groups that cater to family offices, or even calling themselves family offices. While banks and investment firms naturally focus on capital transactions, the primary and nonetheless very necessary management and accounting of a family's personal wealth and lifestyle is still best served by a traditional family office model.

As estate planners, you may recognize your client's need for the kind of personal accounting

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Pennsylvania Impressionists Surge on the Art Market

By MATTHEW S. WILCOX
VICE PRESIDENT OF TRUSTS & ESTATES
FREEMAN'S AUCTIONEERS
PHILADELPHIA

In the last ten years, a group of early 20th century painters from New Hope, Pennsylvania has begun to receive serious recognition by both the art market and academia. Referred to as "Pennsylvania Impressionists", the spiritual founder of the movement was New Hope painter William Langson Lathrop (1859-1938), who became an inspirational mentor for many generations of painters. His studio, once the heart of the New Hope art colony, later evolved into a vital community art center, which continues today.

The Pennsylvania Impressionists chose to paint outside, en plein air, not in the studio, and typically focused their subject matter on nature's beauty: Pennsylvania landscapes, snowy winter scenes, the great outdoors. Their art is not defined by any one common style, but by an array of distinct individual styles rooted loosely in late 19th-century tonalism and impressionism. What binds the group generally is the immediate sensation of colorful, natural scenes executed with energetic, bravura brushwork.

Pennsylvania Impressionism has emerged as one of the most quickly appreciating sectors of the art market. Paintings by such artists as Fern Isabel Coppedge, Walter Baum, Kenneth Nunamaker, Walter Schofield, and John Fulton Folinsbee have all increased in value quite significantly in recent years. Among the most notable artists of the Pennsylvania Impressionists are Daniel Garber, Edward Redfield and Roy Nuse. Last year a Nuse painting estimated from $70,000 - $100,000 sold for a world record $311,750. That record, and most other world records for the Pennsylvania Impressionists, were realized locally, in Philadelphia, where collector interest in the genre is strongest.

According to Alasdair Nichol, painting specialist at Freeman's, "the market for Pennsylvania Impressionists has accelerated so quickly over the last few years it is difficult to predict how long it can be sustained at these high levels," but he adds that "with each subsequent auction, new collectors emerge, so the prognosis is good."

For those intending to dabble in art investment, a cautionary note should be added. While a Redfield painting sold last December for $300,750, another Redfield in the same sale reached only $8,225. Issues of quality, size, condition, subject matter, color, and provenance all impact the value the art market will bear. All paintings not being equal, a good rule of thumb for the amateur collector is: never invest in a painting you wouldn't mind seeing on your wall for a long, long time. Of course, as in all matters of business, seeking the counsel of experts is always sage advice.

Matthew S. Wilcox is a graduate of Bowdoin College and holds a Master's Degree in Art History from UNC-Chapel Hill.

The Family Office Phenomenon, continued

and managerial services associated with the traditional family office as well as the investment management associated with the latest spin on the family office. In a future article, I will cover the emergence of the multi-family office (MFO) and how to analyze whether a family office or multifamily office is the best for your client.

THANK YOU!

Susan Collings, of Drinker, Biddle & Reath, has retired after several years of service as editor of this newsletter and chair of the Section's Publications Committee. It is a difficult task to persuade people to take the time to write articles for the newsletter and Susan deserves the thanks of all Section members for her hard work and dedication to the task.

TAX UPDATE

By JOAN AGRAN
MCCAUSLAND, KEEN & BUCKMAN

I. TREASURY REGULATIONS

Final Regulations Issued on Ordering Rules for Charitable Remainder Trusts

In *T. D. 9190, 70 Fed. Reg. 12793 (3/16/05)*, the Treasury issued final regulations amending the proposed ordering rules for characterizing distributions from charitable remainder trusts to provide guidance on the treatment, under Code Sec. 664(b), of qualified dividend income and different classes of capital gains and losses.

The final regulations retain the position of the proposed regulations that charitable remainder trusts must maintain separate classes within a category of income when two classes are only temporarily subject to the same tax rate. The final regulations also continue to require that dividends must not only satisfy the Code Sec. 1(h)(11) definition but must also be received by the charitable remainder trust after 2002 to be eligible for inclusion in the qualified dividend income class. Treasury rejected a suggestion that the final regulations should include a provision similar to that in Regs. § 1.664-1(d)(4)(ii) to allow a trustee to correct an incorrect distribution resulting from a fiduciary accounting mistake so that the charitable remainder trust could receive the benefit of the correction in the year when the correction is made, stating that the proper remedy in such a case is the filing of an amended return rather than a current-year adjustment.

For consistency with the netting rules generally applicable to other noncorporate taxpayers, in netting capital gains and losses, the gains and losses of the long-term capital gain classes should be netted before netting a short-term capital loss against any class of long-term capital gain.

The final regulations clarify that the character of all amounts a charitable remainder trust distributes or is deemed to distribute at any time during a taxable year must be determined at the end of the charitable remainder trust's taxable year and that the tax rates on a distribution or deemed distribution are the tax rates applicable to the classes of income from which the distribution is derived in the year of distribution rather than the rates applicable to those classes in the year when the charitable remainder trust receives the income.

Treasury added examples to the final regulations illustrating: (i) the end result of a short-term capital loss and a combination of long-term capital gains and losses that net to a long-term capital loss; (ii) the end result when an income class has a net-loss amount that is carried forward without affecting the tax character of distributions; and (iii) the treatment of the distribution of qualified five-year gain between January 1, 2004 and December 31, 2008.

The final regulations are generally effective for taxable years ending after November 20, 2003. However, the rules providing for the netting of capital gains and losses and requiring long-term capital gains to be distributed in a specified order, as well as certain transitional rules, are effective for taxable years ending on or after December 31, 1998.

Final Regulations Issued on Election out of GST Deemed Allocations

In *T.D. 9208, 70 Fed. Reg. 37258 (6/29/05)*, the Service issued final regulations addressing: (i) the Code Sec. 2632(c)(5)(A)(i) election to not have the Code Sec. 2632(c)(1) deemed allocation of unused GST tax exemption apply to certain transfers to a Code Sec. 2632(c)(3)(B) GST trust; and (ii) the election under Code Sec. 2632(c)(5)(A)(ii) to treat a trust as a GST trust.

The proposed regulations permitted transferors to elect out of (i) a current transfer only or (ii) a current-year transfer and all future transfers to the same trust. The final regulations give transferors the additional option of electing out of: (i) only certain designated future transfers to a trust; or (ii) all future transfers made by the transferor to any trust (regardless of whether the trust exists at the time of the election out). The transferor may elect out of future transfers even if the transferor has not made a current-year transfer and is not otherwise required to file a federal gift tax return. The Service added examples illustrating language that may be used in the election out statement to satisfy the requirements for the various election out options.

The final regulations specifically confirm that an election out of the automatic allocation rules for future years is limited to automatic allocations to indirect skips made

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during the transferor's lifetime under Code Sec. 2632(c) and has no effect on the automatic allocation rules that apply after the transferor's death under Code Sec. 2632(e).

For indirect skips made after December 31, 2000, to which Code Sec. 2642(f) (the estate tax inclusion period or ETIP rules) does not apply, a transferor's unused GST exemption is automatically allocated to the property transferred. The final regulations clarify that in the case of an automatic allocation to an indirect skip under Code Sec. 2632(c), the automatic allocation is effective as of the date of the transfer, and becomes irrevocable on the due date for filing the federal gift tax return, for the calendar year in which the transfer is made, whether or not a gift tax return is filed reporting the transfer.

If a transferor makes an indirect skip and affirmatively allocates GST exemption in an amount that is less than the value of the property transferred, the transaction is, in effect, an allocation of the amount that was affirmatively allocated and an election out of the automatic allocation rules for the value of the property not covered by the exemption amount affirmatively allocated. Therefore, an affirmative partial allocation of GST exemption is treated as an election out of the automatic allocation rules with regard to the balance of that transfer.

The rules regarding the automatic allocation to an indirect skip subject to an ETIP are revised to conform to Code Sec. 2632(c)(4) and provide that the automatic allocation to a direct skip or an indirect skip is deemed to be made at the close of the ETIP. Therefore, a transferor may elect out of the automatic allocation rules for transfers subject to an ETIP that are either direct skips or indirect skips at any time prior to the due date of the federal gift tax return for the calendar year during which the ETIP closes. Transferors may elect out of the automatic allocation rules on the gift tax return reporting the transfer to the trust, or on a gift tax return filed for any calendar year subsequent to the year of the transfer up to and including the calendar year in which the ETIP closes. To apply the election out to prior-year transfers that are subject to an ETIP, the election-out statement must specifically (i) describe the prior-year transfers to be covered by the election out; (ii) state that those transfers are subject to an ETIP; and (iii) state that the transferor wishes to elect out of the automatic allocation to those prior-year transfers. Except in that limited circumstance, the final regulations provide that an election out does not apply to any prior-year transfer to a trust, including a transfer subject to an ETIP, even if the ETIP closes after the election has been made. Once an affirmative allocation of GST exemption is made (including to a transfer subject to an ETIP), the allocation may not be revoked.

IRS Finalizes Regs on the GST Tax `Predeceased Parent Rule'

In *T.D. 9214 (07/15/2005)*, the Service has finalized proposed regulations (issued in 2004) on the GST tax predeceased parent rule with several changes. The final regulations apply for terminations, distributions, and transfers occurring after July 17, 2005. However, for transfers after Dec. 31, 1997 and before July 18, 2005, taxpayers may rely on any reasonable interpretation of Code Sec. 2651(e).

The final regulations provide that for purposes of Code Sec. 2651(e), an individual's interest in property or a trust is established or derived when 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 is considered established or derived on the earliest of those occasions. The interest of a remainder beneficiary of a trust for which a QTIP election under Code Sec. 2523(f) or Code Sec. 2056(b)(7) has been made is deemed to have been established or derived, to the extent of the QTIP election, on the date as of which the value of the trust corpus is first subject to tax under Code Sec. 2519 or Code Sec. 2044. However, under the final regs, this rule does not apply to a trust to the extent that a reverse QTIP election under Code Sec. 2652(a)(3) has been made for the trust because, to the extent of a reverse QTIP election, the spouse who established the trust will remain the transferor of the trust for GST purposes.

Under the proposed regulations the predeceased parent rule wouldn't apply to transfers to collateral heirs if, at the time of the transfer, the transferor (or the transferor's spouse or former spouse) has any living lineal descendants. In response to comments that this inappropriately narrowed the application of the predeceased parent rule, the Service removed the parenthetical language. Reg. § 26.2651-1(b) now requires that, for the predeceased parent rule to apply to transfers to collateral heirs, only the transferor must have no living lineal descendants at the time of the transfer.

Under proposed Reg. § 26.2651-2(b), if an adoptive parent legally adopts an individual who is: (i) a descendant of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse); and (ii) 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

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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. The final regulations retain this rule, but add an additional requirement that the individual not be adopted primarily for GST tax-avoidance purposes. This determination is to be based on facts and circumstances, with the most significant factor being whether there is a bona fide parent/child relationship between the adoptive parent and adoptive individual.

The preamble to the final regulations states that although an adopted individual is treated as related by blood to the adoptive parent under Code Sec. 2651(b)(3) and generally is treated as his child under state law, the adopted individual also continues to be the blood relative of his birth parents. Thus, the generation assignment of the adopted individual with regard to a transfer from an ancestor of the birth parent is measured under Code Sec. 2651(b), but, subject to the exception in Reg. §26.2651-2(b), the relationship between them may be subject to Code Sec. 2651(f)(1), which provides that an individual who would be assigned to more than one generation is assigned to the youngest of those generations. In addition, if an individual's generation assignment is adjusted with regard to a transfer either under Code Sec. 2651(e) or as a result of an adoption described above, a corresponding adjustment with respect to that transfer is 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

Life Insurance Trust Held Not to Have an Insurable Interest

In *Chawla, Trustee for Harald Giesinger Special Trust, v. Transamerica Occidental Life Insurance Company*, 200 SWL 405405, Civil Action No. 03-CV-1215 (ED VA, Feb. 3, 2005), decedent, in 2000, tried to obtain a life-insurance policy on his life, naming his physician's wife as the owner and beneficiary. When the insurer refused to issue the policy because the proposed owner and beneficiary wasn't a relative and didn't have an insurable interest in decedent, the decedent made the proposed owner and beneficiary a trust in which both he and the physician's wife were co-trustees. The insurer issued the policy to the trust.

Following the decedent's death, the insurer denied the claim, alleging decedent failed to disclose key medical information. The trustee sued for breach of contract in the U.S. District Court for the Eastern District of Virginia. The court (applying Maryland law because the policy was delivered to the trustee in Maryland, where she lives) ruled in favor of the insurer, finding that decedent misrepresented his medical history on his applications for the policy, omitting some serious health issues. The court further stated that the policy would also be void because the trust had no insurable interest in decedent's life. The court stated that the trust gained more financially upon decedent's death than when he was alive, and the trust `suffered no detriment, pecuniary or otherwise' when decedent died.

Estate Could Exclude Stock Transferred to LLC But Not LLC Units Transferred to FLP

In *Estate Of Wayne C. Bongard*, 124 TC No. 8 (2005), decedent created an irrevocable stock trust and funded it with stock of his wholly owned corporation. Some years later, following advice that pooling all of the corporation's stock in a holding company would better position the corporation for a corporate liquidity event, considered necessary to raise capital and remain competitive, decedent and the trust transferred their respective shares of the corporation's stock to an LLC, in exchange for which they received LLC class A and class B membership units.

At about the same time, decedent and the trust formed a family limited partnership to which decedent transferred all of his LLC class B membership units in exchange for a 99% limited partnership interest, and to which the trust transferred a portion of its LLC class B membership units in exchange for a 1% general partnership interest. About one year later, decedent gifted a 7.72% partnership interest to his wife. He made no other gifts of his partnership interest before his sudden death the following year.

The Service determined that the corporation's stock transferred to the LLC was includible in decedent's gross estate under Code Secs. 2035(a) and 2036(a) and issued a notice of deficiency, stating that over $50 million in additional estate tax was owed.

The Tax Court agreed with the estate that the stock transfer was a bona fide sale for adequate and full consideration in money or money's worth and that there was a significant and legitimate nontax reason for the transfer. Decedent and the trust each received an interest in the LLC that represented adequate and full consideration reducible to money value and therefore Code Sec. 2036(a) did

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not apply. This holding precluded the application of Code Sec. 2035(a) to some gifts decedent made of his LLC units within three years of his death.

With regard to the transfer of LLC units to the partnership, the Tax Court noted that (i) estate tax savings played a significant role in motivating the transfer to the partnership, (ii) the record did not support that nontax reasons for the partnership's existence were significant motivating factors, and (iii) the partnership did not perform a management function for the assets it received and never engaged in any businesslike transactions, either before or after decedent's contribution of membership units to the partnership. In reality, decedent did not receive any benefit beyond transfer tax savings from placing his membership units in the partnership and, therefore, the bona fide sale exception did not apply.

The court then determined that decedent retained possession and enjoyment of the transferred property under an implied agreement. Decedent controlled whether the partnership could transform its sole asset, the class B membership units, into a liquid asset. As CEO and sole member of the corporation's board of directors, he determined when the corporation redeemed its stock in each of the seven instances of redemptions before his death. By choosing not to redeem the membership units held by the partnership, he exercised practical control over the partnership and limited its function to simply holding title to the class B membership units. On this basis, the decedent's gross estate had to include the value of the class B membership units held by the partnership on his death that was proportionate to his 91.28% limited partnership interest. In addition, Code Sec. 2035(a) required his estate to include the 7.72% limited partnership interest transferred by decedent to his wife within 3 years of his death (although this interest should qualify for the marital deduction).

Real Estate Transferred From Rev Trust To FLP Included In Transferor's Estate

In *Estate of Virginia A. Bigelow*, TC Memo 2005-65 (3/30/05), decedent in 1991 gave a 1/175 undivided interest in her home which was worth $1.75 million to each of her three children (one of whom later died before she did) and transferred her remaining interest to her revocable trust, of which she and her son were the trustees. Her son was also her agent under a durable power of attorney from 1986 until her death in 1997 and executor of her estate. In 1992 decedent, after suffering a stroke, moved into an assisted-living facility, at which time she gave each of her daughters an additional .75% interest in the property.

In January 1993, the trustees and the children exchanged the home for another residential property and $125,000 in cash. In 1994, the trust and decedent's children formed a limited partnership to engage in the business of owning and operating residential real property, with the trust as both the sole general partner and a limited partner, and the three children as limited partners. The trust transferred the property (but not a debt secured by it) to the partnership. Decedent, in her capacity as grantor and beneficiary of the trust, agreed to hold the partnership harmless for a bank loan and line of credit secured by the property.

The partnership agreement allocated 1% of the net operating profits and losses of the partnership to the general partner and 99% to the limited partners. From the beginning of 1995 to decedent's death, son transferred funds between the partnership and the trust 40 times. Until decedent's death, the partnership paid those expenses which exceeded her monthly income. The partnership did not make any distributions to any other partners before decedent died. Soon after her death the property was sold and final partnership distributions were made to the partners.

The estate did not include the value of the property on the estate tax return but included the value of the decedent's limited partnership interest discounted for lack of marketability and her general partnership interest, applying a 35% control premium. The Service determined an estate tax deficiency, after concluding that the real property transferred to the partnership was includible in decedent's gross estate under Code Sec. 2036(a)(1).

The Tax Court found that decedent's use of partnership income to replace the income lost because of the transfer of the property to the partnership showed that there was an implied agreement between decedent and her children that she would retain the right to the income from the property. After the transfer of the property to the partnership, the property continued to secure decedent's legal obligation to pay the bank loan and the bank line of credit, evidencing her retention of the economic benefit of ownership of the property after it was transferred to the partnership. The court further concluded that there was no bona fide sale because the transfer was not made in good faith in that the transfer impoverished decedent, partnership formalities were not respected, and the transfer did not provide any nontax benefit to decedent.

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Decedent's Unassignable Lottery Winnings Constitutes Annuity Valued by Use of Tables

In *Donovan Est. v. U.S.*, 95 AFTR 2d 2005-885 (D. Mass. 4/26/05), decedent won the lottery on January 4, 1999, on which date Massachusetts issued him the first of 20 annual $100,000 checks, the only check he received prior to his death in July 1999. Under Massachusetts law, he was not permitted to assign the winnings. Decedent's estate tax return showed no estate tax due, listing the remaining 19 payments as an asset appraised at $367,482. The Service calculated the asset as being worth $1,091,553 by reference to statutory annuity tables, resulting in an additional tax liability of $173,610 plus interest. The estate paid tax and filed a claim for refund, which the Service rejected. The estate then sued in District Court.

The only issue for the district court was the value to be included in the estate, based on whether the lottery prize won by decedent constituted an annuity. Rejecting the estate's contention that lottery winnings were a "restricted beneficial interest" excepted from the Code Sec. 7520 tables by Regs. §20.7520-3(b)(1)(ii), the court found that the lottery prize was an ordinary annuity to be valued using the valuation tables. The court found that the nonmarketability of lottery winnings did not warrant valuation outside the annuity tables. Noting that at the time of decedent's death, he held an enforceable right to receive set annual payments from a most reliable source, the court concluded that the unassignable nature of the decedent's right did not lessen its worth to decedent's estate in any way significant for tax purposes or in a way not already contemplated by the annuity tables.

Family Limited Partnership Assets Included in Decedent's Estate Under §2036(a)(1)

In *Korby Est. v. Comr.*, T.C. Memo 2005-102 (5/10/05), in 1993, decedent and her husband were diagnosed with serious medical conditions and moved to a nursing home where they resided until their deaths in 1998 within five months of each other. They were survived by four sons.

Decedent and her husband had created a revocable trust in 1993, funding it with assets they owned jointly and individually. The following year, decedent, her husband and their sons executed a family limited partnership agreement governed by Minnesota law, to which the revocable trust transferred a money market account in exchange for a 2% general partnership interest. Decedent and her husband then contributed assets to the partnership, with husband receiving a 58.46% limited partnership interest and decedent receiving a 38.26% limited partnership interest. The sons contributed 1.28%. The couple gave a 24.5% limited partnership interest to each of four irrevocable trusts created for the sons, which gifts they elected to split and were reported on 1995 gift tax returns. The returns applied a 43.61% discount in valuing the partnership interests. The partnership agreement provided for management fees to be paid to the revocable trust as general partner, in an amount determined by the general partner, and for the reimbursement of partnership expenses incurred by the general partner. From 1995 to 1998, the partnership and the trust paid many of decedent's and her husband's household living expenses. In addition to their social security benefits, the trust used cash from the partnership to pay for nursing home expenses, other expenses and made cash payments to husband.

The Service issued a deficiency notice to both estates, claiming that the full values of the partnership assets were includible in the gross estates under Code Secs. 2036(a)(1) and (2) and 2038(a)(1) and reducing the estate's adjusted taxable gifts to reflect the exclusion of the 1995 gifts of partnership interests.

The Tax Court held that the decedent and her husband had an implied agreement that they would receive income as needed from assets she transferred to family limited partnership, thus causing assets to be included in each estate under Code Sec. 2036(a)(1). The court found that husband had an implied agreement (on his own behalf and on his wife's behalf) with the sons that the assets transferred to the partnership would be available to the couple for as long as they needed income. Note that the formalities of the partnership agreement were not followed and the couple did not retain sufficient assets in their names or in the revocable trust to cover their expected expenses.

Stock Transfers to Trusts Bona Fide Sales for Full Consideration

In *Schutt Est. v. Comr.*, T.C. Memo 2005-126 (5/26/05), Decedent died in 1999. His wife's father had established a trust in 1940 for the benefit of his descendants, which was to terminate no later than 21 years after the death of the last survivor of his then-living issue, and his sons-in-law. Wife's father had established a second trust in 1936 for the benefit of wife's descendants which was to terminate on the date the youngest grandchild living at wife's death reached 40. Decedent and his wife, who had died in 1989, established various trusts for the benefit of their descendants. The same trust company served as trustee of all of these trusts.

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Decedent was concerned regarding sales by family members of core stockholdings and had a desire to extend and perpetuate his buy and hold investment philosophy over family assets in order to preserve the family wealth. To this end, in 1998, decedent negotiated with the trust company for the establishment of two Delaware business trusts to hold the stock of the family trusts and decedent's stock. The purpose of the Delaware business trusts was to consolidate all the trust assets of which decedent was either the director or investment advisor, including a substantial portion of decedent's own portfolio, thereby resulting in a consistent investment policy with respect to the assets in which the family had an equitable interest.

Following decedent's death, the Service sought to include in decedent's estate for federal estate tax purposes his personal assets transferred to the business trusts under either Code Secs. 2036(a) or 2038. The Tax Court disagreed with the Service, holding that the transfers were excepted from inclusion in decedent's gross estate under either Code Sec. 2036(a) or Code Sec. 2038, because the transfers constituted bona fide sales for adequate and full consideration.

The court based its holding on the fact that decedent's motives under his unique circumstances were more than merely testamentary. His desire to prevent the sale of core holdings in the family trusts in the event of a distribution to beneficiaries was real, was a significant factor in motivating the creation of the business trusts, was appreciably advanced by formation of the business trusts, and was unrelated to tax ramifications. The court noted that the contributed property was actually transferred to the business trusts in a timely manner, entity and personal assets were not commingled, the decedent was not financially dependent on distributions from the business trusts and retained sufficient assets outside of the business trusts to amply support his needs and lifestyle, and decedent was not effectively standing on both sides of the transactions. In addressing the issue of adequate and full consideration, the court noted that others contributed more than half of the property funding the entities. The court found that decedent employed his capital to achieve a legitimate nontax purpose and was not merely recycling his shareholdings.

Citing *Bongard Est. v. Comr.*, 124 T. C. No. 8 (2005), the court noted that (i) each participant in the business trusts received an interest proportionate in value to its respective contribution, (ii) the capital contributions made were properly credited to each transferor's capital account, (iii) distributions required a negative adjustment in the distributee's capital account, and (iv) liquidating distributions would also be made in accordance with capital account balances.

Property Transferred to FLPs Set up for Incapacitated Individual Included in Her Estate

In *Estate of Ida Abraham*, (2005, CA1) 95 AFTR 2d P2005-1018), decedent suffered from Alzheimer's disease and had to be placed under a guardianship. To ensure that her financial needs would be met and to prevent her estate from being drained by the contentious litigation among her children, in 1995 a state probate court entered a stipulated decree requiring the establishment of an estate plan for decedent. She died on June 9, 1997.

As part of the estate plan, in 1995 three pieces of commercial property owned by decedent and which generated steady rental income, were transferred to three family limited partnerships of which she and her children were partners. Between 1995 and 1997, when she died, decedent, through her guardian, transferred percentage interests of her share in the partnerships to her children and their families. The estate included the percentage interests in the partnerships still held by decedent at her death and valued these interests by applying minority and lack of marketability discounts. The Service issued a deficiency notice, including the property transferred to the partnerships in the estate under Code Sec. 2036.

The Tax Court ruled in favor of the Service, stating that it was clear, from the probate court's decree and from the testimony of the children and guardians about their understanding of the decree, that decedent's support needs were treated as an obligation of the partnerships, and that she was entitled to any and all funds generated from the partnerships. Only after her support needs were met could the children/limited partners receive their proportionate share of the partnership income. Therefore, decedent retained the enjoyment and use of the property transferred to the partnerships within the meaning of Code Sec. 2036(a)(1). The Tax Court also found that initial sales by decedent of partnership interests to her two daughters for $160,000 each were not bona fide sales for adequate consideration, because the estate did not produce sufficient evidence to demonstrate the fair market value for the partnership interests on the dates of the transfers.

On appeal, the First Circuit agreed with the Tax Court that the estate failed to show that the daughters paid adequate consideration for

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their interests. The court also noted that Service applied Code Sec. 2043 to reduce the amount includible in the estate by the $160,000 consideration paid by the daughters. The court noted, in addition, that all parties understood that the guardian had the discretion and the approval of the family to use all partnership income, if necessary, for decedent's support. The First Circuit stressed that Code Sec. 2036 does not require the decedent to have retained a legally enforceable interest as the estate was contending but that Code Sec. 2036 will apply if enjoyment of the transferred property is retained under an arrangement or understanding.

Gifts of Easements on Lake-Front Property are Qualified Conservation Contributions

In *Glass*, 124 TC No. 16 (2005), over a two-year period, taxpayers donated conservation easements on part of their property on the Lake Michigan shoreline, including much of a high, undeveloped bluff on that shoreline, to the Lake Traverse Conservancy Trust, an exempt organization that has operated for more than three decades to preserve land and wilderness in trust for conservation and for the recreation and education of the people of Michigan. Taxpayers deducted the value of donated easements, but the Service denied these deductions, claiming the easements weren't exclusively for conservation purposes.

The easements did not restrict taxpayers' use or enjoyment of their property (with three buildings on it including a log cabin, a guest house, and a garage) first as a vacation home, and later as their primary residence. They did, however, limit the development of the encumbered shoreline, preventing the taxpayers from building on the property's lake-front lots. Taxpayers could still develop the portion of their shoreline property unencumbered by the conservation easements in any way consistent with the zoning requirements.

Under Code Sec. 170(h)(1), a taxpayer can take a charitable deduction for a contribution of a partial interest in real property if it is a `qualified conservation contribution' (a contribution of a qualified real property interest that is made to a qualified organization exclusively for conservation purposes). Under Code Sec. 170(h)(4)(A)(ii) and Reg S 1.170A-14(d)(3), one of the ways a contribution qualifies as being for a conservation purpose is when the interest protects a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives. A contribution of a qualified real property interest that meets this significant habitat or ecosystem test is deductible even if the public's right to access that property is restricted.

On the basis of these facts, the Tax Court held that the easements satisfied the conservation purposes test because they protected a relatively natural plant or wildlife habitat. The encumbered shoreline, in its natural undeveloped state, was a relatively natural habitat for threatened plant species, bald eagles, and other wildlife. The conservation easements protect and preserve significant natural habitats by limiting the development or use of the encumbered shoreline. Similarly, the conservation easements operate to protect or enhance the viability of an area or environment in which a wildlife community and a plant community normally live or occur.

The Tax Court said the taxpayers also met the exclusive purposes requirement, which is intended to limit deductible contributions to those transfers which require that the donee hold the easement exclusively for conservation purposes (i.e., that they not be transferable by the donee in exchange for money, other property, or services). The Tax Court interpreted 'exclusively' to require the donee's holding of a qualified real property interest in perpetuity exclusively for one or more of the Code Sec. 170(h)(4) conservation purposes. The donee in this case is a legitimate, long standing nature conservancy, and the holding of the conservation easements is directly related to its tax-exempt purposes. The donee dealt at arm's length with the taxpayers and agreed (and has the commitment and financial resources) to enforce the preservation-related restrictions included in the easements in perpetuity, and any later holder of the conservation easements must be an entity fully committed to carrying out the contributions' charitable purposes. Further, these restrictions are legally enforceable to limit in perpetuity any inconsistent use of the encumbered shoreline.

Note that the Staff of the Joint Committee on Taxation has proposed changes which, if adopted, would (i) treat the protection of the natural habitats described in Code Sec. 170(h)(4)(A)(ii) as exclusively for conservation purposes only if it is pursuant to a clearly delineated governmental policy, i.e., it furthers a specific, identified conservation project, and (ii) not treat a qualified real property interest as contributed exclusively for a conservation purpose if the donor (or a family member of the donor) has a right to use all or a portion of the real property as a personal residence at any time after the contribution.

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Deduction for Advisory Fees Paid by Trust Subject to 2% Floor

In *Rudkin Testamentary Trust v. Comr.*, 124 T. C. No. 19 (6/27/05), the trustee of a trust engaged an outside firm to provide investment management advice for the trust and paid $22,241 for such services during the 2000 taxable year. The trust deducted these fees in full on its federal income tax return. The Tax Court held that the investment advisory fees paid by the trust are not fully deductible under the exception provided in Code Sec. 67(e)(1) with respect to costs that are paid or incurred in connection with administration of the trust that would not have been incurred if the property were not held in trust. Under Code Sec. 67(a), the investment advisory fees are deductible only to the extent that they exceed 2% of the trust's adjusted gross income, the court held.

The court noted that there is a split of authority on this issue, with the Sixth Circuit holding in *O'Neill v. Comr.*, 994 F.2d 302 (6th Cir. 1993), that the 2% limitation did not apply, and the Fourth Circuit holding in *Scott v. U.S.,* 328 F.3d 132 (4th Cir. 2003), and the Federal Circuit holding in *Mellon Bank N. A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001), that the fees are deductible subject to the 2% limitation. The Tax Court in this case agreed with the interpretation of the Fourth and Federal Circuits. Appeal in this case would be to the Second Circuit, which has not ruled on the issue.

Fifth Circuit Upholds Service's Position on Code Sec 2036 in Strangi

In *Albert Strangi et al. v. Commissioner,* No. 03-60992, (CA 5, July 15, 2005), the United States Court of Appeals for the Fifth Circuit has upheld the 2003 Tax Court decision that the full amount of the assets transferred to a family limited partnership must be included in decedent's estate under Code Sec. 2036(a). Shortly before his death in 1994, Mr. Strangi transferred 98% of his assets to a family limited partnership. The Tax Court held: (i) the partnership was valid under state law and would be recognized for estate tax purposes, (ii) Code Sec. 2703(a) did not apply to the partnership agreement, and (iii) the transfer of assets to the partnership was not a taxable gift. The Service requested leave to amend in order to add a Code Sec. 2036 claim whereby the estate would be required to include the assets transferred by Mr. Strangi to the partnership rather than just his partnership interest in partnership. The court denied the Service's request. *Estate of Albert Strangi v. Commissioner*, 115 T.C. No 35 (Nov. 30, 2000).

The Fifth Circuit disagreed with the Tax Court's denial of the Service's leave to amend and reversed the Tax Court on that issue. *Rosalie Gulig v. Commissioner*, No. 01-60538 (CA5 June 17, 2002). Upon remand, the Tax Court determined that the transfers to the partnership met the tests under both Code Sec. 2036(a)(1) and Code Sec. 2036(a)(2) and ruled that the full amount of the assets transferred must be included in decedent's estate. *Estate of Albert Strangi v. Commissioner*, T.C. Memo 2003-145 (No. 4102-99).

On appeal, the Fifth Circuit determined that there was no clear error in the Tax Court's finding under Code Sec. 2036(a)(1) that there was an implicit agreement with the Strangi children that Mr. Strangi would retain enjoyment of his property after the transfer to the partnership. Mr. Strangi held few assets outside the partnership and relied on partnership distributions to pay a number of personal expenses as well as many post death expenses. The estate also argued that the `bona fide sale for an adequate and full consideration' exception should apply to the transfer of assets to the partnership. While agreeing that there was full and adequate consideration, the Tax Court found there was no bona fide sale. Stating that a sale is bona fide if it serves a substantial business or other non-tax purpose, the Fifth Circuit found no 'clear error' by the Tax Court in rejecting the non-tax rationales advanced by the estate for Mr. Strangi's transfer of assets to the partnership, but not whether they would have reached the same conclusion.

Estate Tax Value Of Stock Reduced By, Discounted, Not Full, Built-In Capital Gain Tax

In *Estate Of Frazier Jelke III*, TC Memo 2005-131 (3/31/05), decedent's revocable trust owned a 6.44% interest) in a C corporation whose only activity was to hold and manage investments for the benefit of its shareholders. Decedent's relatives owned the remaining interests in the company through various trusts, none of whose terms prohibit the sale or transfer of corporate stock. The primary investment objective of the company was long-term capital growth, resulting in low asset turnover and large unrealized capital gains. As of the date of decedent's death, the board of directors had no plans to liquidate an appreciable portion of the company's portfolio, and they intended to operate the company as a going concern.

The company's holdings were mostly in marketable securities and the Service and the estate agreed as to the value of the company's underlying assets. They also agreed that a discount for the built-in capital gain tax was proper. However,

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they differed as to the amount of the reduction for the potential capital gain tax. The Court agreed with the Service that the built-in capital gain tax liability should be discounted to reflect when it is reasonably expected to be incurred rather than reducing the stock's value by the entire built-in capital gain as of the date of death as the estate contended. The court held that an assumption of liquidation was not appropriate in this case and that the tax liability for the capital gain should be calculated on the basis of the company's established history of securities turnover. On this basis, the Service allowed an 11.2% reduction in value for built-in capital gain tax liability. The court also allowed a 10% lack of control discount and a 15% discount for lack of marketability.

III. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

New Safe Harbor For CRTs Subject To Spouse's Elective Share

In Rev. Rul. 2005-24, 2005-16 IRB, the Service has issued a safe harbor for charitable remainder trusts created during life and which become subject to the grantor's spouse's right of election to take against the grantor's will. A trust whose assets under state law may be used to satisfy a spouse's elective share cannot qualify as a CRAT under Code Sec. 664(d)(1)(B) or as a CRUT under Code Sec. 664(d)(2)(B). These rules generally prevent a trust from qualifying as a charitable remainder trust if amounts other than the permitted annuity or unitrust amount may be paid to or for the use of a person other than the charity receiving the remainder interest.

This revenue procedure provides a safe harbor procedure under which the Service will disregard the right of election for purposes of determining whether the CRAT or CRUT meets the requirements of Code Sec. 664(d)(1)(B) or Code Sec. 664(d)(2)(B) continuously since its creation if the grantor's spouse irrevocably waives the right of election in the manner set forth in the revenue procedure.

For charitable remainder trusts that would be subject to the spouse's right of election under state law created on or after June 28, 2005, the failure of the spouse to waive the right of election will result in the CRAT or CRUT failing to qualify under Code Sec. 664(d) continuously since its creation, whether or not the spouse exercises the right. For those trusts created before June 28, 2005, the failure of the spouse to waive the right of election, combined with the spouse's exercise of that right of election, will result in the trust's failing to qualify under Code Sec. 664(d) continuously since its creation. A waiver of the spouse's right of election will provide certainty that the right of election won't cause the trust to fail to qualify under Code Sec. 664(d) continuously since its creation.

For CRATs or CRUTs created on or after June 28, 2005, the waiver must be effective on or before the date that is 6 months after the due date (excluding extensions of time to file actually granted) of Form 5227, Split-Interest Trust Information Return, for the year in which the later of the following occurs: (i) the creation of the trust; (ii) the date of the grantor's marriage to the spouse; (iii) the date the grantor first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from assets of the trust; or (iv) the effective date of applicable state law creating a right of election.

Rev Proc 2005-24, Sec. 5 includes several examples, some of which show how the safe harbor works, one which illustrates a situation in which a waiver is not needed, and one which explains the effect on a trust when no waiver is made.

Death Benefit Paid Under Deferred Annuity Contract is IRD to Beneficiary

In Rev Rul 2005-30, 2005-201RB, decedent bought a deferred annuity contract with annuity payments to be made to him beginning as of a date specified in the contract. Decedent could surrender the contract during his life for a value determined by a specified formula. If he died before the annuity starting date, his named beneficiary would receive a death benefit equal to the account value as determined by the formula. The beneficiary could choose to receive the death benefits in a lump sum or as periodic payments. Decedent died before the annuity starting date and the beneficiary received the death benefit under the contract, which exceeded decedent's investment in the contract.

On the basis of these facts, the Service ruled that the death benefit is taxable to the beneficiary as income in respect of a decedent to the extent the amount received exceeds the deceased owner-annuitant's investment in the contract. The Service noted that had decedent surrendered the contract and received the amounts at issue while alive, the amount received would have been income to him under Code Sec. 72(e) to the extent it exceeded his investment in the contract. Accordingly, the amount that the beneficiary received in excess of decedent's investment in the contract is IRD under Code Sec. 691 and is includible in her gross income and she does not receive a basis adjustment in the contract. However, she is entitled to a deduction under

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Code Sec. 691(c) for any estate tax imposed on decedent's estate that is attributable to the contract. The result would be the same whether the beneficiary received the death benefit in a lump sum or as periodic payments.

Qualified Disclaimer of Interest in Decedent's IRA After Receiving RMD for Year of Death

In Rev. Rul. 2005-36, 2005-26 I.R.B. 1368, decedent died in 2004 the owner of an IRA. Decedent's `required beginning date' was prior to 2004, and decedent was receiving annual distributions from the IRA prior to the time of death, but had not received the required minimum distribution for the 2004 calendar year. The revenue ruling addresses three different fact situations:

1. In the first situation, decedent's spouse is designated as the sole beneficiary of the IRA after decedent's death and their child is designated as the contingent beneficiary if spouse predeceases decedent. Three months after decedent's death, the IRA custodian pays spouse the required minimum distribution for 2004. Seven months after decedent's death, spouse disclaims in writing a pecuniary amount of the IRA account balance plus the income attributable to the pecuniary amount earned after the date of death. As soon as the disclaimer is made, child, as successor beneficiary is paid the pecuniary amount disclaimed, plus that portion of IRA income earned between the date of death and the date of the disclaimer attributable to the pecuniary amount.

2. In the second situation, the facts are the same except that, instead of disclaiming a pecuniary amount, spouse validly disclaims 30% of spouse's entire interest in the principal and income of the balance of the IRA account remaining after the required minimum distribution for 2004 and after reduction for the pre-disclaimer income attributable to the required minimum distribution. As soon as the disclaimer is made, child is paid 30% of the excess of the remaining account balance over the income attributable to the required minimum distribution.

3. In the last situation, the facts are again the same as in Situation 1, except that child is designated as the sole beneficiary of the IRA after decedent's death, with spouse designated as the beneficiary in the event child predeceases decedent, and the required minimum distribution for 2004 is paid to child three months after decedent's death. Seven months after decedent's death, child disclaims the entire remaining balance of the IRA account except for the income attributable to the required minimum distribution. As soon as the disclaimer is made, the balance of the IRA account, less income attributable to the required minimum distribution, is distributed to spouse as successor beneficiary.

On the basis of these facts, the Service ruled that: (i) a beneficiary's disclaimer of a beneficial interest in a decedent's IRA is a qualified disclaimer under Code Sec. 2518 (if all of the requirements of that section are met), even though, prior to making the disclaimer, the beneficiary receives the required minimum distribution for the year of the decedent's death from the IRA; (ii) the beneficiary may make a qualified disclaimer under Code Sec. 2518 with respect to all or a portion of the balance of the account, other than the income attributable to the required minimum distribution that the beneficiary received, provided that at the time the disclaimer is made, the disclaimed amount and the income attributable to the disclaimed amount are paid to the beneficiary entitled to receive the disclaimed amount, or are segregated in a separate account; and (iii) a person disclaiming his or her entire remaining interest in an IRA will not be considered a designated beneficiary of the IRA for purposes of Code Sec. 401(a)(9), if the qualified disclaimer is made on or before September 30th of the calendar year following the calendar year of the account owner's death, and if, on or before that September 30th, the disclaimant is paid the income attributable to the required minimum distribution amount, so that the disclaimant is not entitled to any further benefit in the IRA after September 30th of the calendar year following the calendar year of the account owner's death.

In all three situations, the beneficiary's receipt of the required minimum distribution from the IRA constitutes an acceptance of corpus, plus the income attributable to that amount. However, the beneficiary's acceptance of these amounts does not preclude the beneficiary from making a qualified disclaimer with respect to all or a portion of the balance of the IRA.

In Situation 1, assuming the other requirements of Code Sec. 2518(b) are satisfied, spouse's disclaimer constitutes a qualified disclaimer under Code Sec.2518(b) of the pecuniary amount, plus the income attributable to the disclaimed amount.

In Situation 2, as in Situation 1, spouse's receipt of the distribution also constitutes acceptance of the income attributable to the amount distributed and spouse may

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not disclaim any portion of that income. Therefore, the disclaimer of 30% of spouse's entire interest in the principal and income of the balance of the IRA account remaining after the required minimum distribution for 2004 and after reduction for the pre-disclaimer income attributable to that amount constitutes a qualified disclaimer.

The results in Situations 1 and 2 would be the same if the amount disclaimed, plus that portion of the post-death IRA income attributable to the disclaimed amount, is not distributed outright to child, but instead is segregated and maintained in a separate IRA account of which child is the beneficiary as described in Regs. § 1.401(a)(9)-8, A-3.

Again in Situation 3, child's receipt of the required minimum distribution also constitutes an acceptance of the income that is deemed attributable to the required minimum distribution and child may not disclaim any portion of that income. Therefore, child's disclaimer of the entire principal and income balance of the IRA remaining after the payment of the required minimum distribution for 2004, except for attributable income from the distribution, constitutes a qualified disclaimer.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Disclaimer Of Joint Brokerage Account Qualified Despite Withdrawals And Purchases

In PLR 200503024, husband and wife opened a joint brokerage account with rights of survivorship. Each one contributed equally to the account during their joint lives, and each one could unilaterally withdraw his or her contribution and direct investment and distribution of assets from the account. Shortly after husband's death, on the advice of her stockbroker that the brokerage account could not be held under the social security number of a deceased individual, wife directed the stockbroker to transfer title to the account to her name. During the eight months after husband's death, wife directed the sale and/or purchase of certain securities in the brokerage account and withdrew cash from the account.

On the advice of the lawyer engaged by wife six months after her husband's death to administer his estate and within ninth months of husband's death, she disclaimed her survivorship interest in husband's share in the brokerage account minus the assets in that share (and earnings on those assets since husband's death) in which wife had accepted benefits. The stock broker was then directed to establish and fund three separate accounts, the TIC Account, the Wife's Account, and the Estate Account. The TIC Account, which was held by wife and the estate as tenants in common, consisted of assets that could not be evenly divided, not including proceeds from securities sold in the eight months following husband's death or any securities purchased during that period. The Wife's Account held assets attributable to her contributions to the brokerage account and assets attributable to husband's contributions with respect to which wife directed sales or purchases after husband's death. The Estate Account held assets attributable to husband's contributions with respect to which wife made no withdrawals and directed no sales or purchases after husband's death. Each account also held the earnings from the date of husband's death on the assets placed in the respective account. The Estate Account and the estate's one-half interest in the TIC Account represented the disclaimed interest.

On the basis of these facts, the Service ruled that under Reg. §25.2518-3(a)(1)(ii), wife's disclaimer of the assets held in the Estate Account and the estate's one-half share of the TIC Account was a qualified disclaimer. Each spouse's contributions to the account were incomplete gifts until husband's death and under Reg. §2518-2(c)(4)(iii), the transfer creating wife's survivorship interest in husband's share of the brokerage account occurred at husband's death; and under Code Sec. 2518(a), wife had nine months from his death to disclaim any part of her survivorship interest in husband's share. Wife's transfer of title to the account to her name did not result in an acceptance by wife of husband's share in the account because, under Reg. §2518-2(d)(1), the mere transfer of title to the account to wife's name is not treated as her acceptance of husband's interest in the account or as benefiting her for purposes of Code Sec. 2518. In addition, wife's cash withdrawals from the account during the eight months following husband's death did not affect the validity of the disclaimer because the cash and securities are severable assets.

Charitable Deduction Permitted for Transfers to Charities and Private Foundation

In PLR 200505008, decedent's Will directed his executor to distribute the remainder of his estate to his revocable trust. The trust directed his trustee to distribute to three Gift Trusts sufficient property to make gifts to several charitable and non-charitable beneficiaries. Gift Trust 1 is to distribute specific cash gifts to three charities and Gift Trust 2 and 3 are to distribute specific cash gifts to four noncharitable beneficiaries. Trustee is directed to distribute the balance to a private foundation, unless this would result in a loss of

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the charitable deduction, in which case the trustee is to distribute the balance to a fourth charity.

Each Gift Trust provides that the trustee is to distribute the trust property to each listed beneficiary after the trustee has determined: (i) that all of the death taxes and expenses of administration have been paid; (ii) that the beneficiary has not initiated a contest; and (iii) that the trust gift beneficiary has provided the trustee with a release containing all conditions the trustee requires and stating that the beneficiary will not initiate a contest.

On the basis of these facts, the Service ruled that the conditions as set forth in the revocable trust, including the condition precedent that the charitable beneficiaries of Gift Trust 1 would contest the will, are so remote as to be negligible and, under Reg. §20,2055-2(b)(2), do not preclude a deduction under Code Sec. 2055(a) for the amount distributed to Gift Trust 1. Further, citing Rev. Rul. 83-20, 1983-1 C.B. 231, the Service determined that the individual beneficiaries' interests and the charitable interests are severable; the noncharitable beneficiaries of Gift Trusts 2 and 3 take their bequests immediately and completely and do not retain any interest in the residuary or in Gift Trust 1. Therefore, the Service concluded that the estate is entitled to a deduction under Code Sec. 2055(a) for the amount distributed to Gift Trust 1 and to the foundation.

Marital Deduction Denied

In PLR 200505022, decedent, who died with a pre-1981 Will, was survived by his wife and children. Decedent bequeathed all his interest in his personal residence and all personal property to his wife. The residue of his estate passed to a trust for wife's primary benefit. During wife's lifetime, trustee is to distribute, subject to certain limitations, the net income to wife in such amounts and at such times as wife, in her sole discretion but in consultation with the trustee, desires for her maintenance, health, or support commensurate with her station in life. Additionally, if at any time, or from time to time in wife's opinion, trust income is insufficient, the trustee, taking into consideration all the sources of income or other available capital, is authorized and directed to distribute to wife portions of trust principal in such amounts as she desires, in her sole discretion but in consultation with trustee, for her maintenance, health and support. Any income not distributed is to be added to principal. At wife's death, all the principal and accrued net income of the trust is to pass to a trust for the benefit of decedent's children and their descendants.

The estate tax return treated the property passing to the trust as QTIP, and claimed a marital deduction for its value. Although the Will contained no reference to the estate tax marital deduction and no specific statement indicating decedent's intent that the trust qualify for the estate tax marital deduction, decedent's estate submitted file copies of two letters to decedent from the attorney who drafted the will, both stating that under the terms of the draft, wife has the right to obtain all income and principal from the trust by making the request to the trustee. In addition, decedent's estate submitted a letter from the attorney to a trust officer stating that decedent has `maintained his decision that he wants his wife to have complete discretion with respect to the disposition of the trust assets...'

The Service denied the marital deduction, finding that the wife's income interest was not an unqualified right to receive all of the income from the trust payable annually, as required under either Code Sec. 2056(b)(5) or Code Sec. 2056(b)(7), because (i) wife is entitled to only so much of the income as desired for certain specified purposes, (ii) the amount of income to be distributed to wife is to be determined `in consultation with the trustee,' and therefore is subject to the trustee's approval, if not consent, and (iii) the trust provides that any income not distributed is to be added to principal, thus evidencing the understanding that not all trust income would necessarily be distributed to wife.

Although wife can also request a corpus distribution, her power is limited and does not meet the requirements of Reg. §20.2056(b)-5(f)(6), under which a power over corpus can cause the income requirement to be considered met. Like income distributions, principal distributions are to be made in consultation with the trustee, and are to be made only if trust income is not sufficient to provide for wife's maintenance, health and support, commensurate with her needs. Further, in authorizing a principal distribution, the trustee must take into consideration all the sources of income or other capital available. Thus, the power is not exercisable in all events, and cannot be exercised to draw down the entire corpus, as required under Reg. §20.2056(b)-5(f)(6).

Disclaimers Achieve Result That Deferred Comp Benefits Pass to Surviving Spouse Than to Rollover IRA

In PLR 200505030, decedent, a State employee who had participated in the State's eligible deferred compensation plan as defined in Code Sec. 457(b), died prior to attaining age 70 1/2. Under the

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terms of the plan, upon a participant's death, the plan proceeds become payable to the participant's designated beneficiary, or if there is none, to the participant's estate. Decedent failed to designate a valid beneficiary and the proceeds became payable to decedent's estate.

Under the terms of decedent's Will and revocable trust, the principal remaining at his death was to be divided into a marital trust and a credit shelter trust. On wife's death, the property of both trusts would pass to decedent's then living issue, per stirpes. If decedent had no then living issue, the remaining trust property would be distributable one-half to his sister-in-law, or her then-living her issue, per stirpes, and one-half to his sister, or her then-living issue, per stirpes.

All of the beneficiaries and prospective beneficiaries of the trust including a guardian appointed for the three minor beneficiaries proposed to disclaim their respective interests under the trust. Under state law, as a result of the disclaimers by all the trust beneficiaries, the disclaimants are treated as if they had all predeceased decedent and the estate residue (including the plan proceeds), after the payment of debts and expenses, will become distributable to decedent's intestate heirs. Decedent's issue further proposed to disclaim each of their intestate interests in decedent's estate. As a result, under state law, wife will become the sole beneficiary of decedent's residuary estate, including the interest in the plan benefits.

The proposed disclaimers will accord with state law and will be filed with the local county register of wills within nine months of decedent's date of death. Upon the approval filing of the disclaimers, the residue of decedent's estate, including the plan distribution, will pass to wife by operation of state law and within 60 days of receipt of the plan distribution, wife will roll over the distribution into an individual retirement account set up and maintained in her name.

On the basis of these facts, the Service ruled that: (i) the proposed disclaimers by the trust beneficiaries of their respective interests in the trust will be qualified disclaimers under Code Sec. 2518; (ii) the disclaimers to be executed by decedent's issue with respect to their interests as heirs at law, will be qualified disclaimers under Code Sec. 2518; (iii) an estate tax marital deduction will be allowed under Code Sec. 2056 for the value of the residue passing to the wife; (iv) as a result of the disclaimers, wife will be treated as having received decedent's interest in the deferred compensation plan directly from the decedent for purposes of Code Sec. 457(e)(16); (v) pursuant to Code Sec. 457(e), wife is eligible to roll over a distribution of decedent's interest in the plan into an individual retirement account set up and maintained in her name; and (vi) wife will not have to include in her federal gross income for the year of distribution and rollover any portion of the distribution from the plan timely rolled over into an IRA set up and maintained in her name.

Substantial Compliance Makes GST Allocation Timely

In PLR 200510026, taxpayer and his spouse each made contributions to a trust which was immediately divided into separate subtrusts for the benefit of each of their three sons and their descendants, each subtrust to continue for the maximum period allowed under the applicable rule against perpetuities.

The trust agreement provides, in part, that (i) a material purpose of the trust is to utilize the available exemption from the generation-skipping transfer tax, (ii) the initial contribution transferred to the trust by the taxpayer and his spouse is to constitute separate trusts for the sons, which is to be called collectively the exempt share, (iii) any additional transfers to this trust are to be held in separate trusts, which shall be called collectively the nonexempt share, (iv) discretionary distributions of principal from a trust shall be charged first against the nonexempt share until it is exhausted and thereafter against the exempt share, (v) distributions of principal or income to skip persons may be made from the exempt or non-exempt shares as the trustee, in his absolute discretion, determines will best minimize the taxes imposed.

The taxpayer reported the transfer to the trust on a timely-filed gift tax return but failed to make an entry on Schedule C allocating GST exemption to the trust. However, the trust agreement was attached to the return. The taxpayer requested a ruling that he had substantially complied with the requirements of making a timely allocation of GST exemption to the trust with respect to the gift tax return filed.

On the basis of these facts, the Service ruled that the trust agreement attached to the federal gift tax return contained sufficient information to constitute substantial compliance with the requirements for making a timely allocation of taxpayer's GST exemption to the trust. Although taxpayer did not comply with the instructions on Form 709, in that Schedule C of the gift tax return was left blank, a copy of the trust agreement was attached to the gift tax return, which trust agreement specifically stated that a material purpose of the trust was to utilize the available exemption from the generation-skipping transfer tax.

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Interest Payable On Advances From Related Partnership Not Deductible By Estate

In PLR 200513028, decedent's estate consisted primarily of his 99% interest in a limited partnership. One of his sons held the 1% general partnership interest. The partnership assets primarily consisted of 57.6% publicly traded stocks, bonds and cash, 17.5% real property 24.7% personal notes. Decedent's Will divided the residue of his estate into equal trusts for the benefit of his two children. The Will provided that all estate taxes were to be paid from the residue of his estate. His son and his accountant were executors of the estate and the accountant was also trustee of each trust.

The partnership advanced funds to the estate to pay Federal estate taxes and the state death tax. Decedent's son and the accountant, as executors, and son, as general partner, executed a promissory note designating the estate as the borrower and the partnership as the lender. Interest was to accrue on advanced funds until the note matured in 10 years, at which time all principal and interest would be due. Prepayment of principal or interest was prohibited. On the estate's federal estate tax return, the executors claimed a deduction under Code Sec. 2053(a) for the interest to be paid to the partnership on the due date of the note.

On the basis of these facts, the Service concluded that the interest payable by the estate in 10 years was not a deductible administration expense because the transaction could not properly be viewed as necessary to the estate's administration. In reaching this conclusion, the Service noted that administrative expenses are deductible from the gross estate under Code Sec. 2053 in calculating the amount of federal estate tax due only if, under Reg. §20.2053-3(a), the expense is (i) incurred in the administration of the decedent's estate, (ii) actually and necessarily incurred, and (iii) allowable by the laws of the jurisdiction under which the estate is being administered.

In this case, the loan was not necessary because (i) the partnership held substantial liquid assets and, on decedent's death, the estate succeeded to his 99% partnership interest, (ii) the partnership was not engaged in any active business that would necessitate the retention of liquid assets, nor was there any fiduciary restraint on son's ability to access the funds, and (iii) the same parties (closely related family members whose proportionate interests in the estate were virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction.

Life Insurance Proceeds Not Includible in Estate

In PLR 200518005, taxpayer is to receive the net income of two trusts for her life. Taxpayer did not establish either trust. Upon taxpayer's death, the principal of both trusts is to be held for taxpayer's children. On a date certain, taxpayer renounced all of her rights as a co-trustee of both trusts as to insurance policies on her life. Subsequently, the trusts purchased insurance policies on taxpayer's life with trust principal. Taxpayer later resigned as a co-trustee of each of the trusts. Taxpayer will not contribute assets to either trust or maintain the insurance policies with her personal assets.

Based on Rev. Rul. 84-179, 1984-2 C.B. 195, the Service ruled that the proceeds of the life insurance policies held as assets of each trust will not be included in taxpayer's gross estate under Code Sec. 2042(2) or Code Sec. 2035, as long as the premiums are not paid from trust income. The Service concluded that taxpayer will not possess any incidents of ownership in the policies because taxpayer renounced her rights as co-trustee in connection with the policies and ultimately resigned as co-trustee. The Service noted that taxpayer will not contribute assets to either trust or maintain the policies with her own assets.

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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In the course of the attorney's representation of the executor of a Will, a brother of the executor, not included as a beneficiary in the Will, initiates a Will contest alleging that the executor-client, a named beneficiary, procured the Will through undue influence. May the attorney continue to represent the client both as an executor and beneficiary during the Will contest?

Generally, it would be permissible under the Rules of Professional Conduct to continue representing the client as the executor. That representation is different from the representation of the client as an individual and as one who has been accused of improperly procuring the benefits of the Will. Furthermore, the subject of the Will contest is the distribution of the estate, not its administration.

Whether the attorney may represent the client, accused of improperly procuring benefits of the Will, in the course of the Will contest is the more difficult question. If the attorney is going to be called as a fact witness, and the scrivener is frequently called as such, the attorney would normally be precluded by Rule 3.7 from acting as an advocate in the Will contest hearing. The Rule is based on concerns that a lawyer's credibility may be enhanced once he or she is sworn in as a witness or, if that lawyer's credibility is effectively questioned during cross-examination, the lawyer's persuasiveness as an advocate may be diminished. Furthermore, combining the roles of lawyers and witnesses may diminish the effectiveness of our system of justice and may raise the appearance of impropriety.

Pennsylvania courts have on occasion permitted trial counsel to act as both witness and an advocate, particularly in a bench trial where no jury is involved, but the practice is discouraged. Two Pennsylvania cases provide helpful understanding of the application of the Rule: Comm. v. Gibson, 670 A.2d 680 (Pa. Super. 1996) and Comm. v. Willis, 552 A.2d 682 (Pa. Super. 1988).

Although the attorney-scrivener should not serve as an advocate at the hearing, the attorney may have someone else in his or her firm serve as trial counsel at the hearing. Rule 1.10, which imputes disqualification to others in one's firm, does not apply to Rule 3.7 matters. Furthermore, Pennsylvania courts apply Rule 3.7 fairly liberally so the attorney-scrivener would even be permitted to help the advocate prepare for the hearing.

However, if the attorney-scrivener is somehow implicated in the action and accused of some form of wrongdoing, it would not even be appropriate for the law firm of the attorney-scrivener to represent the executor in his capacity as a beneficiary. It is highly probable that Rule 1.7 principles would apply.

See Opinion 94-153 issued by the Pennsylvania Bar Association Committee on Legal Ethics and Professional Responsibility.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

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New Bankruptcy Act Extends Broad Creditor Protection to Retirement Plans

By SUSAN G. COLLINGS
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The recent amendment to the Bankruptcy Code, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), provides broad protection from bankruptcy creditors for qualified retirement plan benefits and IRAs. Prior to the 2005 Act, ERISA plans such as pension and profit sharing plans generally were shielded from the reach of creditors in a bankruptcy proceeding, but IRAs, Roth IRAs and SEPs did not uniformly enjoy similar protection. The 2005 Act covers more than ERISA type plans and extends this protection to IRAs and Roth IRAs, as well as to section 457 deferred compensation plans and 403(b) tax-deferred annuities. Although the 2005 Act resolves many important issues concerning the ability of bankruptcy creditors to reach retirement benefits, there are numerous ambiguities arising under the statute that need to be clarified.

This article will analyze the provisions of the 2005 Act as they relate to retirement plan benefits. To start, however, it may be useful to review the federal law prior to enactment of the 2005 Act.

BACKGROUND

Under the Bankruptcy Code, a debtor's estate is broadly defined to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a). Property can be removed from the bankruptcy estate in two ways—either through an exclusion or through an exemption.

Exclusions

Under §541(c)(2) the bankruptcy estate is narrowed to exclude a debtor's beneficial interest in a trust that includes a restriction on transfer that is enforceable under applicable nonbankruptcy law. Thus, a trust that includes a spendthrift provision enforceable under nonbankruptcy law will be excluded from the debtor's bankruptcy estate.

ERISA requires that all qualified retirement plans include a spendthrift provision restricting assignment or alienation of such benefits by the participant. 29 U.S.C. §1056(d)(1). In *Patterson v. Shumate*, 504 U.S. 753 (1992), the Supreme Court ruled that an anti-alienation provision in an ERISA-qualified pension plan constitutes a restriction on transfer enforceable under "applicable nonbankruptcy law" and, accordingly, such property is excludable from the debtor's bankruptcy estate.

Not surprisingly, creditors sought to limit application of the Patterson ruling. For example, in *Yates v. Hendon*, 541 U.S. 124 (2004), a bankruptcy trustee sought to include in the debtor's bankruptcy estate his interest in an ERISA profit sharing plan where the creditor, who was the sole shareholder and president of a professional corporation, was one of four participants in the plan. The bankruptcy trustee argued that, as sole shareholder, Yates was an employer rather than an employee and under ERISA did not qualify as a participant who could enforce the plan's anti-alienation provision. Consequently, argued the bankruptcy trustee, such provision did not constitute an enforceable restraint on alienation under nonbankruptcy law for purposes of §541(c)(2). The Court held that if a plan covers one or more employees other than the business owner and his or her spouse, then the working owner qualifies as a participant in the ERISA plan and qualifies for the protections ERISA provides other plan participants. Accordingly, the anti-alienation provision constituted an enforceable restraint on alienation under applicable nonbankruptcy law for purposes of §541(c)(2).

Similarly, there has been considerable litigation over the question whether IRAs are excluded from the bankruptcy estate by reason of §541(c)(2). IRAs are not creatures of ERISA, and there is no federally mandated requirement that IRAs include an anti-alienation provision. Because IRAs are generally considered self-settled trusts under state law, an anti-alienation provision in an IRA would be ineffective. Nevertheless, many states, including Pennsylvania, have enacted state laws exempting IRAs from creditors' claims.

The courts have reached inconsistent conclusions on the question whether or not to apply the exclusion under §541(c)(2) to IRAs. For example, in *In re Yuhas*, 104 F.3d 612 (1997), the Third Circuit held that a New Jersey debtor's rollover IRA was excludable from the bankruptcy

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estate because the New Jersey statute exempting the IRA from creditors' claims constituted a restriction on transfer within the meaning of §541(c)(2). The court articulated five requirements for determining whether an IRA is excluded from the bankruptcy estate under §541(c)(2): (1) the IRA must constitute a "trust" within the meaning of 11 U.S.C. 541(c)(2); (2) the funds in the IRA must represent the debtor's "beneficial interest" in that trust; (3) the IRA must be qualified under Section 408 of the Internal Revenue Code; (4) the state statute exempting IRAs from the claims of creditors must be a "restriction on the transfer" of the IRA funds and (5) this restriction must be "enforceable under nonbankruptcy law."

Applying the *Yuhas* test to Pennsylvania debtors, the courts have reached a contrary result. In *In re Clinton*, the bankruptcy court held that an IRA does not constitute a trust within the meaning of §541(c)(2) and therefore cannot be excluded from the bankruptcy estate. *In re Clinton*, 290 B.R. 83 (2003). The bankruptcy court distinguished the Third Circuit's holding in *Yuhas*, concluding that the Pennsylvania exemption statute, unlike its New Jersey counterpart, fell short of declaring a custodial IRA a "trust," and the debtor's IRA did not possess the necessary characteristics of a trust, such as separation of legal and beneficial title. Id. at 87-89. See also *In re Galloway*, 308 B.R. 709 (2001) (neither IRC §408 nor Pennsylvania exemption statute deems a custodial IRA to be a trust and therefore custodial IRA is not excluded from bankruptcy estate under §541(c)(2)); Cf., *In re Davis*, 108 Fed. Appx. 717 (3rd Cir. 2004)(remanded to bankruptcy court to determine whether under either Pennsylvania exemption statute or Internal Revenue Code IRA constitutes a trust for purposes of §541(c)(2)).

Exemptions

Although property initially may be included in the debtor's bankruptcy estate and not subject to exclusion, various exemptions apply to remove certain interests. Under the Bankruptcy Code, debtors have the option of electing exemptions provided under federal law or state law, unless the governing state law has "opted out" of the federal exemptions, in which case debtors must choose the state exemptions. Pennsylvania has not opted out of the federal exemptions and therefore both alternatives, federal and state, are available to Pennsylvania debtors. 2 NORTON BANKR. L. & PRAC. 2d §46:5 (2005).

Section 522(d)(10)(E) of the Bankruptcy Code provides that the debtor may exempt from the debtor's estate the right to receive "a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. . . ." Because the federal exemption statute does not explicitly address the exemption of IRAs, numerous cases have litigated whether or not IRAs are covered by the statute. The issue was finally resolved by the recent Supreme Court case of *Rousey v. Jacoway*, 125 S. Ct. 1561 (2005). In *Rousey*, the Court concluded that a rollover IRA is sufficiently similar to the types of plans explicitly included in the exemption under §522(d)(10)(E). Therefore, the Court ruled that, to the extent needed for the support of the debtor and his dependents, a debtor who chooses the federal exemption statute may protect his IRA from a bankruptcy creditor. Following *Rousey*, a bankruptcy debtor could exempt an IRA only upon a showing of need and only if the federal exemptions were elected -- if the state exemptions were chosen, exemption of the IRA was still subject to the vagaries of state law. The significance of Rousey appears to have been rendered moot by Congress' enactment of the 2005 Act.

THE 2005 ACT

Statute Applies Broadly, Including IRAs

The 2005 Act explicitly exempts a broad range of ERISA and non-ERISA plans. Moreover, the exemption for such plans applies regardless of whether the state or federal exemptions are elected. Under §522(b)(3)(A) of the 2005 Act, a debtor who chooses the state exemptions (or who is forced to use such exemptions under his or her applicable state law) may exempt from the bankruptcy estate any assets exempted under the state exemption statute and, as provided in subparagraph (C) of that section, "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986." 11 U.S.C. §522(b)(3)(C). Similarly, if the federal exemptions are elected pursuant to §522(b)(2), subparagraph (d)(12) has been added to provide the same exemption as provided in subparagraph (b)(3)(C) applicable to state exemptions. The exemptions do not depend on the existence of an anti-alienation clause (as in *Patterson*) or whether there is a "trust" (as required by Yuhas and its progeny). Instead, the exemptions apply to a broad range of plans, as long as they are exempt from tax under the Internal Revenue Code. Thus, IRAs (§408), Roth IRAs (§408A) and

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SEPs (§408(k)) are explicitly covered by the exemptions under the 2005 Act, regardless of whether the state or federal exemptions are elected. Furthermore, a sole business owner's interest in a qualified plan should now be exempt even if there are no other participants as was required by the Yates ruling.[2]

Cap Imposed on Certain IRAs

In the case of IRAs and Roth IRAs, however, the 2005 Act imposes a limitation on the exemption, thereby providing somewhat less favorable treatment to these retirement vehicles. New subparagraph (n) of §522 provides as follows:

> (n) For assets in individual retirement accounts described in section 408 or 408A of the Internal Revenue Code of 1986, other than a simplified employee pension under section 408(k) of such Code or a simple retirement account under section 408(p) of such Code, the aggregate value of such assets exempted under this section, without regard to amounts attributable to rollover contributions under sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8) of the Internal Revenue Code of 1986, and earnings thereon, shall not exceed $1,000,000 in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require.

Thus, the statute imposes a $1,000,000 cap on the "contributory" portion of an IRA and Roth IRA, but allows unlimited exemption for the portion attributable to qualified rollovers and the earnings on those rollovers.[3] Because the $1,000,000 cap applies solely to the "contributory" portion of an IRA, and not to any amounts rolled over, the cap will likely have limited impact for the near future. The Internal Revenue Code imposes limitations on the amount that can be contributed annually to an IRA and, therefore, the maximum amount that could have been contributed to an IRA would be $67,000 ($69,000 for a person over age 50).[4] In order to exceed the $1,000,000 cap, annual investment returns would need to have consistently exceeded 15%. See Choate, ESTATE PLANNING FOR RETIREMENT BENEFITS: RECENT DEVELOPMENTS, ALI-ABA Advanced Estate Planning Practice Update—Spring 2005.

In practice, many individuals have combined IRAs funded by rollover contributions with IRAs funded by annual contributions. The statute provides no guidance on how to calculate the fully exempted portion and the portion subject to the $1,000,000 cap. In the absence of further guidance on this issue, presumably some sort of tracing or formulaic approach may be used to make this determination. Nevertheless, for future rollovers it would be advisable to maintain such rollovers in a separate IRA rather than combine them with one funded by annual contributions.

In order to exempt the rollover portion of an IRA from the $1,000,000 cap, subparagraph (n) provides that such rollover must fall within certain enumerated sections, all of which pertain to rollovers from certain qualified plans.[5] Thus, an IRA- to-IRA rollover cannot be used to convert IRA assets subject to the $1,000,000 cap to fully exempt assets that have no cap. However, where funds initially are rolled over from a qualified plan to an IRA and subsequently rolled over to another IRA, the second rollover should not preclude the funds from being exempted from the $1,000,000 cap. Although the statute is not explicit on this latter point, the provisions of subparagraphs (b)(4)(C) and (D) of §522 can be read to reach this conclusion. These subparagraphs provide that retirement funds resulting from rollovers (either direct or within 60 days of distribution) from either a qualified plan or IRA to either a qualified plan or IRA "shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12)" by reason of such rollover. 11 U.S.C. §522 (b)(4)(C) and(D). Since funds initially held in a qualified plan would enjoy full exemption under subparagraphs (3)(C) or (d)(12), neither the initial rollover (by reason of subparagraph (n)), nor any subsequent rollover (by reason of the above-quoted rollover provisions) should change that result.

The statute does not explicitly address the consequences of a spousal rollover. Nevertheless, funds rolled over by a surviving spouse from a deceased spouse's qualified plan should be exempt from the $1,000,000 cap as such rollover is authorized under §402(c)(9) of the Internal Revenue Code and therefore falls within one of the sections enumerated in subparagraph (n) of the 2005 Act. Similarly, a spousal rollover of an IRA should not subject funds to the $1,000,000 cap where the initial source of the decedent's IRA was a qualified plan. See §522 (b)(4)(C) and (D). Although the statute is silent with respect to treatment of an IRA that a surviving spouse has elected to treat as his or her own pursuant to Regulation §1.408-8, A-5(a) under the Internal Revenue Code, there seems to be no policy basis to treat such an IRA differently from a spousal rollover of an IRA. Nevertheless, in the absence of any guidance on this point, if creditor protection is any concern, it would be more advantageous for a surviving spouse who inherits an IRA from his

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or her spouse to do a spousal rollover rather than elect to treat such IRA as his or her own.

An additional issue arising under the 2005 Act is whether the $1,000,000 cap under subsection (n) is intended to apply to IRAs exempted under state law. Section 522(b)(3) allows a debtor who chooses the state exemptions to exempt an IRA under the state exemption statute and under the exemption provided by new subsection (b)(3)(C). If the state exemption statute allows for exemption of a contributory IRA in excess of $1,000,000, it is unclear whether the $1,000,000 cap imposed under subsection (n) is intended to override the state exemption or whether its application is limited solely to IRAs exempted under new subsection (b)(3)(C).[6]

A further issue under the 2005 Act is whether inherited funds fall within the overall protection afforded retirement funds under §522. Although an inherited plan might be exempt from taxation under the sections of the Internal Revenue Code enumerated in §522(b)(3)(C) and §522(d)(12) and therefore fit within the literal language of such exemption provisions, query whether such inherited benefits constitute "retirement benefits" within the meaning of the statute.

Finally, the 2005 Act adds uncertainty to the question whether plan benefits are protected from creditors' claims even after distribution from the plan. A technical reading of the statute suggests that certain distributions from qualified plans continue to be exempt from creditors' claims even if not rolled over to another qualified plan or IRA.[7] The majority of circuit courts that addressed this issue prior to the 2005 Act concluded that the anti-alienation provision required by ERISA serves to protect such benefits only while in the hands of the plan administrator and not after they are distributed to the participant.[8] The 2005 Act seemingly gives preferential treatment to qualified plan distributions compared to IRA distributions. Thus, distributions from IRAs need to be rolled over in order to continue to enjoy continued creditor protection.

Conclusion

The 2005 Act goes far in extending creditor protection in bankruptcy proceedings to IRAs and other non-ERISA type plans and provides uniformity to an area that previously allowed disparate results depending on the applicable state law governing a debtor's rights. Consequently, retirement benefits will generally not be a factor for a bankruptcy debtor deciding whether to elect state or federal exemptions. Nevertheless, the 2005 Act raises many issues, and, as with any new legislation, the issues will need to be resolved by the courts or technical corrections.

FOOTNOTES

1 The author wishes to thank Mark M. Brown and Nora E. Pomerantz for their review and comments. However, any mistakes belong to the author.

2 A qualified plan under §401(a) need not have participants other than the owner/employee. See IRC §401(c)(1)(A) and §401(c)(3)-(4).

3 An initial reading of the statute might raise the question whether the $1,000,000 cap also applies to earnings on rollovers. It would be possible to read the phrase "and earnings thereon" as relating to "the aggregate value of such assets exempted under this section"-- i.e., the IRA and Roth IRA assets subject to the cap-- rather than to the "amounts attributable to rollover contributions". However, since "value" of an asset ordinarily includes the earnings thereon, the phrase "and earnings thereon" would seem to be superfluous if read to relate to the value of assets subject to the cap rather than to amounts attributable to rollover contributions. Moreover, excluding the earnings on any rollover amounts from the $1,000,000 cap is consistent with the statute's overall intent to afford unlimited protection to qualified plan assets. Therefore, a better reading of the statute is that the $1,000,000 cap does not apply to earnings on rollover contributions.

4 IRAs, which were created by Congress in 1974, were initially subject to a contribution limit of $2,000. The $2,000 limit increased to $3,000 for contributions in 2002-2004, and $4,000 for 2005-2006. 26 U.S.C.A. §219.

5 For purposes of this article, this includes plans qualified under 401(a), 403(b) and 457. However there is some ambiguity whether the cap applies to amounts rolled over from a 457 plan.

6 For example, the Pennsylvania exemption statute limits the contributory portion that can be shielded from creditors to amounts contributed by the debtor that do not exceed $15,000 within a one-year period. As long as the contributions made within each one-year period are below $15,000, Pennsylvania provides no overall limitation on the amount that can be protected from creditors' claims, regardless of subsequent appreciation or income on such contributory portion. See 42 Pa.C.S. §8124(b)(ix). Depending on investment performance, it is

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possible that the contributory portion could exceed $1,000,000.

[7] New section 522(b)(4)(D) provides exemption for any distribution that is either an "eligible rollover distribution" within the meaning of IRC §402(c) or that is described in clause (ii) of §522(b)(4)(D). Internal Revenue Code §402(c), which relates to qualified plan rollovers, defines "eligible rollover distribution" to mean any distribution made from a qualified plan to a plan participant, other than a minimum required distribution, a hardship distribution, or a distribution that is part of a series of substantially equal payments over the life of the participant (or the participant and his or her beneficiary). Subparagraph (c)(3) of §402 generally requires that such "eligible rollover distribution" be rolled over into an eligible retirement plan, which includes a qualified plan, IRA, or 457 Plan, within 60 days in order to avoid income tax on the distributed funds. Thus, in order to be an "eligible rollover distribution," such distribution need not be rolled over, although income tax deferral will only be achieved if a rollover is accomplished in accordance with subparagraph (c).

By contrast, clause (ii) of new section 522(b)(4)(D) includes any distribution from certain enumerated exempt funds, including IRAs and Roth IRAs, to the extent such distribution is deposited in another such fund within 60 days. Thus, clause (ii) clearly requires that the rollover of funds be completed in order to enjoy continued creditor protection, but no similar requirement is imposed on the receipt of "eligible rollover distributions".

[8] Compare *Hoult v. Hoult*, 373 F.3d 47 (1st Cir. 2004)(post-retirement receipt of ERISA benefits required to be placed in specified bank account to satisfy judgment against participant); *Wright v. Riveland*, 219 F.3d 905 (9th Cir. 2000)(ERISA anti-alienation provision does not preclude Department of Corrections from making mandatory deductions from benefits received by prisoners from qualified plans to meet costs associated with incarceration and victims' compensation); *Robbins v. DeBuono*, 218 F.3d 197 (2nd Cir. 2000)(no violation of ERISA anti-alienation provision where state social service department considered amount of pension benefits institutionalized participant could transfer to non-institutionalized spouse for purposes of determining Medicaid eligibility); *Guidry v. Sheet Metal Workers Nat'l Pension Fund*, 39 F.3d 1078 (10th Cir. 1994(en banc)(garnishment of qualified pension benefits not precluded by ERISA anti-alienation provision following distribution of benefits to participant); *Trucking Employees of North Jersey Welfare Fund v. Colville*, 16 F.3d 52 (3rd Cir. 1994)(ERISA anti-alienation provision no bar to recovery where funds no longer in hands of plan trustee and have been distributed to a beneficiary) with *U.S. v. Smith*, 47 F.3d 681 (4th Cir. 1995)(ERISA's anti-alienation provision precludes restitution order from reaching qualified plan benefits received by participant after retirement).