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Report of the Chair

By KEVIN P. GILBOY
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As usual, the real work of the Section is being done by our committees. In this report, I want to focus on an issue being considered by our ad hoc committee on the notice provisions of the Uniform Trust Act ("Act") – the five-year statute of limitations on claims by beneficiaries who have received appropriate notices (20 Pa. C.S.A. § 7785(a)(1)).

Some background – prior to the adoption of the Act, Pennsylvania trustees could cut off the claims of beneficiaries through the court accounting process (and they still can). But such accountings could cover many years and if issues arose from the distant past, the people involved might no longer be available to testify. The Act generally looks to beneficiaries to enforce their rights. Part of that enforcement process in the Act depends on notice given to the beneficiaries. In exchange, if such notice is given to the beneficiaries for five years and a beneficiary fails to make a claim disclosed by such notice, the claim is barred.

The Act's description of the required notice to trigger this five-year period appears to require the trustee to provide the beneficiary with an annual report for the year in which the transaction occurred and annual reports for each of the four subsequent years. The Pennsylvania Bankers Association expressed concern about the burden of delivering an annual report to beneficiaries in addition to the quarterly or monthly statements already provided to beneficiaries. The Executive Committee of the Probate Section also sought to avoid the unnecessary paperwork of additional beneficiary reports and asked its ad hoc committee dealing with the notice provisions of the Act to look at this issue as well.

The Pennsylvania Bankers Association prepared a draft amendment clarifying that quarterly or more frequent reports could satisfy the notice requirements; however, the bankers also proposed shortening the five-year claim period - first to two years and in the most recent draft to one year. The rationale for the shorter time frame is (i) several other states that have adopted the Uniform Trust Code have adopted one-year claim

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Inside this Issue...

Derivatives, Bear Markets, and Grantor Retained Annuity Trusts

By DAVID A. RUBEN, ESQ.

A Grantor Retained Annuity Trust ("GRAT") is an irrevocable trust to which the Grantor transfers assets and retains a fixed annuity of equivalent value. At the end of the GRAT term any balance remaining after the final annuity payment is transferred to the designated beneficiaries gift tax-free. While this is a well-established technique[1] for transferring wealth with minimal gift tax, a GRAT is successful only when assets appreciate at a rate in excess of the §7520 "hurdle rate." Appreciating assets, however, can be especially difficult to find in a bear market. This article discusses how investments using derivatives can be used to fund a successful GRAT in a bear market.

As derivatives may be a foreign topic to some readers it may be helpful to begin with a few definitions. An index fund is a mutual fund that aims to replicate the movement of a specific market index, such as the Dow Jones Industrial Average or the Standard & Poor's 500. This type of mutual fund has been around for years and offers a low cost way to track the performance of a desired index. A related investment vehicle is an exchange-traded fund, or ETF. An ETF is a basket of securities that is designed to generally track an index or market sector. It is similar to a mutual fund but is traded on an exchange. ETFs have exploded in popularity and now track nearly every imaginable index and market sector.

A derivative is a financial contract whose value is derived from the performance of an underlying asset. Derivatives offer the unique ability to take the opposite position in a futures market of the underlying asset - in other words, certain derivatives go up in value when the underlying asset goes down in value (and vice versa). Many mutual funds and ETFs now use derivative instruments to track the inverse of specific indexes or market sectors. An inverse mutual fund or ETF, therefore, appreciates when the market or sector to which it is keyed depreciates.

An estate planner whose client foresees an extended bear market may want to recommend a GRAT funded with an inverse mutual fund

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[1] In Rev. Proc. 2008-3, however, the IRS indicated it would not ordinarily issue a private letter ruling if the amount of the annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10 percent of the initial net fair market value of the property transferred to the trust.

Report of the Chair, continued

periods; and (ii) if the validity of a fiduciary decision is supposed to be judged not by hindsight but by the facts at the time, no purpose would be served by extending the claim time to see how the decision might play out.

Since the Section consists of members who represent beneficiaries as well as trustees, I do not believe the Section can support this reduction in the length of the claim period. But each member of the Section may wish to consider what the law should say on this subject. Are there claims which can only be recognized with the passage of a reasonable amount of time? What is that reasonable amount of time? With increasingly complex trust investment strategies, will beneficiaries be able to recognize potential claims within a one or two year time frame?

One fear is that disagreement over the statute of limitations issue will derail any legislative effort to pass technical corrections to the Act, including clarification of the type of report required to trigger the statute of limitations (whatever length it may be). Perhaps the better course would be to allow some experience to develop under the existing law regarding the length of time and concentrate on the technical corrections to the Act.

I urge all Section members to think about these issues and express your views. Even though the Section may not be able to present a united Section view, each member can let his or her position be known to members of the Joint State Government Commission Advisory Committee for Decedents' Estates Laws, to banker colleagues, and to the legislature. For the convenience of Section members, I would be happy to forward to the Advisory Committee any such messages sent to me at kgilboy@thlex.com.

CASE NOTES

The Orphans' Court Declines to Rule on the Validity of a Change in the Beneficiary Designation of an Annuity

By MARGARET SPAZIANI, ESQ.

In *Beinhower Estate*, the decedent's will named his wife as the sole beneficiary of his estate and his daughter as the Executrix of his estate. *Beinhower Estate*, 28-6, Fiduciary Reporter 2d. Montgomery County, 2008. Additionally, decedent named his son as his agent under a durable power of attorney.

Just two days prior to the decedent's death, the son used the durable power of attorney to change two of decedent's annuity policy beneficiary designations from decedent's wife to the son and other relatives.

Consequently, after decedent's death, the Executrix (petitioner) accused the son of self-dealing, exercising undue influence over decedent, and breaching his agency responsibilities under the durable power of attorney.

The Executrix filed a petition with the Orphan's Court, Division of the Court of Common Pleas of Cumberland County, Pennsylvania, which sought to compel the son to "show cause why an account[ing] should not be filed in accordance with 20 Pa. C.S.A. §5610" regarding the two policy beneficiary designations.

Section 5610 of the Pennsylvania Civil Statutes states in pertinent part:

An agent shall file an account of his administration whenever directed to do so by the court and may file an account at any other time. All

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Derivatives, continued

or ETF. If the index or sector being tracked depreciates at a rate in excess of the §7520 rate the balance remaining following the payment of the final annuity will pass to the beneficiaries gift tax-free.

There are inherent risks with any GRAT. There is always a possibility that the assets will fail to appreciate in excess of the §7520 rate. Even an unsuccessful GRAT, however, has minimal downside as the grantor will have made a nominal upfront taxable gift (assuming a nearly zeroed-out GRAT) and will have the amount originally transferred to the GRAT returned to him or her in the annuity payments. In addition, if the grantor should die during the GRAT term all of the GRAT property should be included in the grantor's estate.

Derivatives can also be used in GRATs as a hedge against unforeseen market fluctuations. This can be accomplished by funding two discrete GRATs with inversely-related assets. If GRAT #1 contains a fixed amount of any index fund or ETF and GRAT #2 contains the same fixed amount of an inverse fund or ETF tracking the same index or market, any appreciation in excess of the §7520 rate or depreciation in excess of the inverse of the §7520 rate will result in a successful GRAT. For example, using GRATs with a two-year term and assuming the current §7520 rate, if the index GRAT #1 replicates (and GRAT #2 inversely replicates) falls 8% the first year and 5% the second year, GRAT #2 will have a balance remaining at the end of the term that will pass to the beneficiaries gift tax-free. Alternatively, if the index GRAT #1 replicates rises 8% the first year and 5% the second year GRAT #1 will have a balance remaining at the end of the term that will pass to the beneficiaries gift tax-free.

This technique is not without risks. First, there is the possibility that the index or sector being tracked will fail to appreciate or depreciate to the extent necessary to result in a balance remaining at the end of the GRAT term. Second, if the two GRATs have identical terms the IRS might try to combine the assets into a single GRAT. For this reason the practitioner may wish to differentiate the terms of the GRATs to make combination less likely. Finally, the inverse correlation in returns is not always perfect.

Despite the risks, investments using derivatives can be very helpful in generating a successful GRAT in a bear market.

Case Notes, continued

accounts shall be filed in the office of the clerk in the county where the principal resides.

Under 20 Pa. C.S. §711(22), the Orphan's Court has mandatory jurisdiction over "all matters" pertaining to the exercise of powers by agents acting under powers of attorney.

However, the Orphan's Court dismissed the petition, stating that a "claim should be made in a lawsuit, not in an accounting." The court based its ruling on the fact that, although it has mandatory jurisdiction over all accounting matters involving agents with powers of attorney under 20 Pa. C.S. §711(22), even if in fact the son abused his agency relationship by changing the beneficiary designation to himself and other relatives, the Orphan Court did not have the authority to compel the two payers of the annuity policies to change beneficiaries. This made necessary the Orphan Court's "referral" to a court of law.

Abrams Estate, 27 Pa. Fiduc. Rep. 2d 512 (Bucks Co. 2007)

By KATHRYN H. CRARY, ESQ.
SAUL EWING LLP

A wife appealed an adjudication that found that her late husband's will did not enlarge the gift to her that was set forth in their prenuptial agreement. The prenuptial agreement provided that the wife was entitled to one third of her husband's post-marital assets, but that she would not have any interest in her husband's "businesses or business interests." The husband's will, however, stated that his wife should receive one third of the residue of his estate, with "[his] beloved wife's share subject to the terms and conditions of [their] Pre-Marital Agreement." After the husband's death, the husband's estate received several large referral fee payments.

The Orphan's Court found that the wife's one-third share under her husband's will did not include the legal referral fees because these fees were excluded by the terms of the prenuptial agreement. On appeal, the wife argued that her husband intended to enlarge her share of his estate by giving her a one third share in the "residue" of his "estate," rather than a one third share of his "post-marital assets." However, the court found that the only logical interpretation of the phrase "subject to the terms and conditions" of the prenuptial agreement is that the husband intended for the terms of the prenuptial agreement, which excluded business income, to be applied to the wife's share of the estate. Accordingly, the court found that the referral fees, as business income, were properly excluded from the wife's share of the estate.

A Note on Resources for Retirement Issues

For those many clients whose planning combines estates law, elder law and retirement issues, there is an excellent resource worth investigating knowing about, the Center for Retirement Research at Boston College, www.bc.edu/crr. The Center issues numerous working papers and other types of publications, most of which can be accessed online. In addition to very scholarly papers such as "The Trajectory of Wealth in Retirement", the Center has issued whimsical guides such as the "The Social Security Fix-it Book".

Book Review

The Number

A Completely Different Way to Think About the Rest of Your Life

By LEE EISENBERG

Reviewed by ROBERT H. LOUIS
SAUL EWING LLP

Clients sometimes ask whether they are able to make gifts to children and grandchildren, given their current wealth, or if they are able to maintain their current lifestyle after the death of a spouse. They are really asking whether their sources of income will allow them to cover all of their expenses and, if not, if their accumulated wealth will be sufficient to make up the difference.

A similar question is being asked more frequently in recent times: do I have enough to retire? The impending retirement of members of the baby boom generation has created a small industry of calculators, mostly online, to help people determine this question. These calculators are often linked to efforts to sell something, such as investment services, but many of them can give a general idea of the wealth and income needed to sustain a manner of living during retirement years.

But, much like online health advice, these calculators can only make general estimates. The specifics of an individual's situation will often be beyond their capabilities. The best method of determining the amount of wealth an individual will need in retirement or, after a spouse has died, or to be able to make gifts, is by thinking of the individual's

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Private Letter Ruling on IRA Distributions

Private letter ruling 200811028 illustrates a technique for salvaging the ability to take retirement distributions over life expectancy. A decedent had named his child as the beneficiary of two IRAs and had died before his required beginning date for distributions. No distributions were taken by the beneficiaries from either IRA by December 31 of the year following the year of death. Commencement of distributions by then was required to use the distribution method measured by the beneficiary's life expectancy. Once this error was discovered, the beneficiary took out IRA distributions for the current year and the two prior years based on the life expectancy rules. In addition, the beneficiary paid the 50% penalty tax, imposed pursuant to Code Section 4974, for the two prior years. The beneficiary sought a ruling that the remaining distributions could be taken out over his life expectancy; that he was not, by reason of the failure to take timely distributions in the first two years, consigned to the five year distribution method. In general, if a beneficiary does not need faster distributions, it is more advantageous to postpone distributions as long as possible, permitting growth on a tax-deferred basis for a longer period of time.

In permitting the beneficiary to continue to use the life expectancy method of distribution, the IRS noted that the default rule for post-death distributions, where there is a designated beneficiary and where the owner dies before his required beginning date, is the life expectancy rule. The plan or IRA may establish a different default provision, or the beneficiary may elect five year distributions, but neither of these occurred in the facts of the ruling. In fact, the documentation for each IRA provided for post-death distributions, where the owner died before his required beginning date, over the beneficiary's life expectancy, unless the beneficiary elected otherwise. Since the beneficiary made no different election, the life expectancy rule applied. In effect, the IRS ruled that the failure to take the first two distributions on a timely basis was not an election to use the five year method. It is not clear how this reasoning would apply in other fact situations, such as where the documents did not affirmatively elect a method of distribution, but the ruling gives some hope to those who discover that minimum distributions from a qualified plan or IRA have not begun in a timely manner.

Book Review, continued

unique set of resources, needs and aspirations. *The Number,* by Lee Eisenberg, makes a contribution toward that goal. Subtitled *"A Completely Different Way to Think About the Rest of Your Life,"* and published in 2006, the author spends about 250 pages helping people to understand the question and decide how they want to answer it.

The author makes the point, fairly obviously, that the number will be different for everyone, but the less obvious point is that the number can change from time to time for an individual, and that one individual can actually have several numbers at one time, depending on various paths he or she might take in life. They key to determining the number, it seems, is to decide first what you want to do. Or, to have a spectrum of possible actions, with a cost attached to each.

The author uses interesting examples and anecdotal evidence to illustrate the journey toward finding a number or numbers. He divides those who seek the number into four categories, procrastinators, pluckers, plotters and probers. In the end, he offers some bottom line advice (actually ten bottom line statements), including "obsess all you want, but don't be a sicko", and "those who say that this is either (a) the Apocalypse or (b) the Golden Age are both wrong."

The Number is written in a breezy, easy to read style, but beneath a sometimes humorous veneer is a method, perhaps not the only method, of thinking carefully about a topic of the greatest importance to our clients and us.

NEWSLETTER ARTICLES

Would you like to see something in future issues of the Probate and Trust Law Section Newsletter? Then, why don't you write it? If you are interested, please contact the Editor:

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Joint Committee on Taxation Reports

The recent burst of activity from the Senate Finance Committee on the subject of possible revisions to the federal estate tax has been accompanied by several scholarly papers on subjects related to that tax.

In preparation for public hearings before the Senate Finance Committee, the staff of the Joint Committee issued, on November 13, 2007, a paper titled "History, Present Law and Analysis of the Federal Wealth Transfer Tax System." This 48 page report starts with a history of taxation of wealth transfers, beginning in 1797. The tax similar to today's estate tax was first enacted in 1916. Rates reached a high point of 77% in 1941 and in the intervening years, items were added to the list of taxables, including life insurance and retirement benefits. A helpful chart on estate tax exemptions and gift tax exclusions is included.

This section of the paper is followed by a very detailed description of the present estate and gift tax system: includible assets, rates, basis issues, exclusions and deductions, family business provisions, etc. A short but useful description of generation skipping taxes is added. There are several charts describing the revenues raised by the estate and gift taxes and the numbers subject to the taxes. This excellent report is just about equivalent to a course on estate and gift taxes.

Another report, titled "Description and Analysis of Alternative Wealth Transfer Tax Systems", dated March 10, 2008, discusses rationales for taxing transfer of wealth and then describes alternatives to the current system described as a tax on transferors. A second method is called a deemed realization approach, which also imposes a tax on transferors as if transfers were sales generating capital gain.

An alternative to taxing transferors is an accession tax system, in which tax is imposed on the recipient of the transfer. An inheritance tax is an example of this kind of tax. In some countries, the receipt of a transfer is treated as income to the recipient, and this is referred to as the income inclusion approach.

Each of these types of taxation schemes is analyzed in detail, with examples of the countries that impose each of them. Then, each is analyzed under two standards: (a) distributional and equity issues and (b) administrative and compliance issues.

A third paper, titled "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform", was issued on April 2, 2008. This paper begins with an overview of the current estate and gift tax system and some proposals for change, including reunifying the estate and gift taxes and the transferability of unused exemptions between spouses.

The paper moves on to a familiar topic in discussions of estate and gift taxes, the effect of those taxes on farms and family-owned businesses; in particular, the liquidity issues created by the taxes. Special use valuation, installment payment and qualified family-owned business interest rules are described in detail. The success and lack thereof in the level of relief provided by these rules is reviewed, and numerous charts on liquidity issues are included.

Three reform options previously described by the staff of the Joint Committee are set forth in an Appendix: limiting perpetual dynasty trusts through prohibition on the allocation of generation-skipping tax transfers; more accurate determination of valuation discounts, through aggregation rules and looking through the assets of closely-held entities; and controlling the use of lapsing trust powers to increase the gift tax annual exclusion; that is, restricting substantially the use of the familiar Crummey powers. The Appendix is not clearly related to the theme of the paper: it merely sets out some proposals to increase tax collections, which perhaps could offset tax losses from proposals to assist the owners of farms and family-owned businesses.

JOIN A COMMITTEE

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

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Committee Preferences

First:
Second:
Third:

2008 ESTATE PLANNING AND BENEFITS NUMBERS

	2008	2007
Contribution and Benefit Limits		
§401(k), §403(b), §457(b) elective deferral limit	$15,500	$15,500
§401(k), §403(b), §457(b) catch-up deferral limit	$5,000	$5,000
Definition of highly compensated employee	$105,000	$100,000
Annual compensation limit for benefit purposes	$230,000	$225,000
Annual compensation limit for key employee determination	$150,000	$145,000
Defined benefit plan limit at age 62: Annual amount	$185,000	$180,000
Defined contribution plan limit: Annual amount	$46,000	$45,000
Percent of pay	100%	100%
Individual Retirement Account Contributions		
Traditional, spousal and Roth contribution limits	$5,000	$4,000
Catch-up contribution limit	$1,000	$1,000
Employee Stock Ownership Plans		
Maximum balance for 5 year distribution	$935,000	$915,000
Amount to lengthen 5 year period	$185,000	$180,000
Qualified Transportation Benefit – Monthly limits		
Parking	$220	$215
Transit pass/Commuter vehicle	$115	$110
Health Savings Accounts		
Single: Annual contribution limit	$2,900	$2,850
Deductible	$1,100	$1,100
Out-of-pocket maximum	$5,600	$5,500
Family: Annual contribution limit	$5,800	$5,650
Deductible	$2,200	$2,200
Out-of-pocket maximum	$11,200	$11,000
Estate Planning		
Annual gift tax exclusion	$12,000	$12,000
GST exemption	$2,000,000	$2,000,000
Amount used to calculate 2% portion of Sec. 6166 estate tax installments	$1,280,000	$1,250,000
Estate tax exemption	$2,000,000	$2,000,000
Gift tax exemption	$1,000,000	$1,000,000
Sec. 2032A special use real property reduction limit	$960,000	$940,000
Notice of gifts from foreign persons	$13,561	$13,258

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2008 Estate Planning and Benefit Numbers, continued

	2008	2007
Social Security		
OASDI tax rate	6.20%	6.20%
OASDI taxable wage base	$102,000	$97,500
Cost of living adjustment for benefits	2.30%	3.30%
Maximum annual benefit for person at full retirement age, assuming no earnings during the year	$26,220	$25,392
Retirement Earnings Test Exempt Amounts:		
Over full retirement age	No Limit	No Limit
Year full retirement age attained: Annual amount	$36,120	$34,440
Monthly amount	$3,010	$2,870
Below full retirement age: Annual amount	$13,560	$12,960
Monthly amount	$1,130	$1,080
Social Security Normal Retirement Age	66 years, 0 months (If born in 1943)	65 years, 10 months (If born in 1942)
Medicare		
Part A tax rate	1.45%	1.45%
Part A taxable wage base	Unlimited	Unlimited
Part A deductible	$1,024	$992
Part B deductible	$135	$131
Part B standard monthly premium	$96.40	$93.50
Deductible Long Term Care Insurance Premiums		
Age 40 or under	$310	$290
Age 41-50	$580	$550
Age 51-60	$1,150	$1,110
Age 61-70	$3,080	$2,950
Over Age 70	$3,850	$3,680
Education		
Threshold for expenses qualifying for Hope Scholarship Credit	$1,200	$1,100
Phaseout floor for Hope Scholarship and Lifetime Learning credits		
Joint returns	$96,000	$94,000
All other returns	$48,000	$47,000
Automobile Mileage		
Standard business Use	50.5¢	48.5¢
Charitable use rate	14¢	14¢
Medical use rate	19¢	20¢
Moving expense rate	19¢	20¢

ETHICS COLUMN

By PAUL C. HEINTZ
OBERMAYER, REBMANN, MAXWELL & HIPPEL LLP

The business agent of a well-know entertainer has asked you to handle the entertainer's estate planning, but advises that all communications with the entertainer must go through him. Should you accept that arrangement?

The longer a trust and estates attorney practices, the more likely he or she will encounter a client or prospective client who is purportedly too busy to meet with the attorney and wants to deal with the attorney through an intermediary.

The intermediary takes many forms. The busy and always-traveling executive has an executive assistant. Celebrities, sports figures and the extremely wealthy are surrounded by accountants and agents. Some accountants and business managers can be controlling. Often the more typical client has at his or her side, a spouse, parent, child, insurance agent, financial planner or an accountant. It is not unusual for the parent to say he or she speaks for the child or for the child to claim he or she speaks for the aged parent. The most challenging intermediary could well be colleagues in the attorney's own law firm.

There is nothing inappropriate about dealing with a client through an intermediary, so long as the attorney actually meets with the client at some point during the engagement, communicates directly with the client to elicit or confirm information about the assets and family and directly discusses the various estate planning options with the client. While it may appear that the intermediary has the authority to so serve, the attorney should always ask the client directly the degree to which and for what purposes the attorney may reveal confidential information to that person. Indeed, the intermediary can be most helpful in obtaining the information, moving the estate planning process along and doing whatever must be done to change asset ownership, life insurance beneficiary designations and to assure the completion of other steps essential to concluding the process.

The Rules of Professional Conduct, particularly Rules 1.1, 1.3 and 1.4 pertaining to competence, diligence and communication, respectively, require that the estate planning attorney meet with the client personally so that the attorney can properly gather the information and properly counsel the client. Even when the client or prospective client is aged or infirm, the attorney has an obligation pursuant to Rule 1.14 to make every effort to maintain a normal attorney-client relationship. If the intermediary interferes with that important relationship, and actually poses a barrier to the client, the estate planning attorney should not undertake, or should cease, the representation. Obviously, this goes beyond the issue of ethics. An attorney should have concerns about potential malpractice actions if he or she proceeds with the engagement without having appropriate access to the client.

The temptations to ignore these ethical principles are often highest when the risks, themselves, are highest: Dealing with the busiest and wealthiest clients, the insurance agent referral and the client of the attorney's law partner who knows nothing about fiduciary law.

Fortunately, however, when the attorney takes the time to explain to the intermediary both the ethical and practical issues created by lack of access, the barriers usually melt away and the intermediary becomes a most helpful ally. The estate planning attorney can often help the situation, too, by agreeing to travel to the client's home or office and to meet at a time convenient to the client regardless of the inconvenience to the estate planning attorney.

Perhaps there is one time an attorney can safely make an exception to the policy of not dealing exclusively through any intermediary. That is when the intermediary is a colleague in the law firm who is experienced in trust and estate matters willing to take full responsibility for the assignment and who will have his or her name on the documents' backers.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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TAX UPDATE

By JOAN AGRAN
MCCAUSLAND, KEEN & BUCKMAN

I. TREASURY REGULATIONS

Notice of Proposed Regs. on Code Sec. 529 Accounts

In REG.-127127-05, 73 Fed. Reg. 3441 (1/18/08), the Service issued advance notice of proposed regulations primarily addressing the transfer tax treatment of Code Sec. 529 qualified tuition program accounts in order to address concerns that current law on the transfer tax treatment of these accounts creates the potential for abuse.

The proposed regulations would include a general anti-abuse rule that would apply when a taxpayer establishes or uses a Code Sec. 529 account for transfer tax avoidance or evasion purposes or for other purposes inconsistent with Code Sec. 529. The proposed regulations would also address (i) the liability of the account owner for any gift and/or GST tax imposed on a taxable change of designated beneficiary, (ii) the liability of the account owner for any income tax imposed when the account owner withdraws funds from a 529 plan for his own benefit, (iii) the application of transfer taxes where a permissible contributor to a 529 account is an entity such as an estate or corporation, (iv) the allowance of contributions by individuals to 529 accounts for their own benefit and contributions from UGMA and UTMA accounts for the benefit of their minor beneficiaries, and (v) the distribution and inclusion of a 529 account in a designated beneficiary's estate for federal estate tax purposes in certain circumstances.

In addition, rules relating to the function and operation of qualified tuition programs and 529 accounts will be proposed, including rules relating to the election to treat contributions to an account as being made over a five year period, the recognition of loss in a 529 account and rules regarding recordkeeping, reporting, and other administrative procedures.

The Service has indicated that the regulations would generally apply to Code Sec. 529 accounts after the effective date of the final regulations and that the Service would provide transition rules if necessary. However, the anti-abuse rules may apply retroactively. The regulations will provide a grace period of no less than 15 months to implement most changes.

Proposed Regs. Subject Charitable Remainder Trusts with UBTI to Excise Tax

In *REG.-127391-07, 73 Fed. Reg. 12313 (3/7/08)*, the Service has issued proposed regulations under Code Sec. 664(c), to be effective for taxable years beginning after December 31, 2006, which reflect a change made by the Tax Relief and Health Care Act of 2006.

For taxable years beginning before January 1, 2007, Code Sec. 664(c) provided that a charitable remainder trust was not exempt from income tax for any year that it had unrelated business taxable income ("UBTI"), the amount of which, according to Code Sec. 664(c)(2)(A), is determined under Code Sec. 512. For any such year, the trust is taxed as a nonexempt, complex trust. The proposed Regs. amend the regulations under Code Sec. 664(c) to provide that charitable remainder trusts with UBTI in taxable years beginning after December 31, 2006, are exempt from federal income tax, but are subject to a 100% excise tax on the UBTI.

A charitable remainder trust's income is allocated among Reg. §1.664-1(d)(1) trust income categories (ordinary income, capital gains, or other income) without regard to whether any part of it is UBTI. The proposed Regs. clarify that, consistent with Reg. §1.664-1(d)(1) and Reg. §1.664-1(d)(2), the excise tax imposed on a charitable remainder trust with UBTI is treated as paid from corpus, and the trust income that is UBTI is income of the trust for purposes of determining the character of the distribution made to the beneficiary. The proposed Regs. provide examples illustrating the tax effects of UBTI on a charitable remainder trust for taxable years beginning after December 31, 2006.

II. COURT DECISIONS

FLP Assets Included in Decedent's Estate Under Code Sec. 2036

In *Rector Est. v. Comr., T.C. Memo 2007-367 (12/13/07)*, decedent, a resident in a convalescent home since 1998, died in 2002 at age 95, leaving significant medical expenses. Her primary assets were her revocable trust and a life-estate

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Tax Update, continued

in a trust established at her husband's death. Decedent's sons were co-trustees of the revocable trust; one son, an investment manager, was also co-executor of her estate.

Decedent and her sons established a family limited partnership in 1998, on the advice of her son, the investment manager. They did not negotiate the terms of the partnership nor did they obtain independent legal advice. Decedent received a 2% general partnership interest in the partnership and her revocable trust received a 98% limited partnership interest. Three months later, she transferred all of her revocable trust assets, cash and over $8.6 million in marketable securities, to the partnership.

In 1999 and 2002, decedent, through her revocable trust, gave limited partnership interests to her sons. In 2001, she assigned her 2% general partnership interest to her revocable trust. When decedent died, the revocable trust owned a 70.272% limited partnership interest and a 2% general partnership interest in the partnership.

Decedent's estate tax return valued the revocable trust's interest in the family limited partnership at approximately $4.7 million, after applying a 19% discount for lack of control and marketability. After audit, the Service assessed a $1.6 million federal estate tax deficiency claiming decedent had retained possession and enjoyment of the assets under Code Sec. 2036(a)(1). The Service also assessed a $92,790 Code Sec. 6662 accuracy-related penalty, because the estate had negligently failed to include decedent's cash gifts made to her sons in 1991 and 1999 as adjusted taxable gifts.

On the basis of these facts, the Tax Court held that (i) the assets decedent transferred to the family limited partnership were included in her estate under Code Sec. 2036(a)(1), and (ii) decedent's estate was liable for the Code Sec.6662 accuracy-related penalty for failing to include decedent's cash gifts as adjusted taxable gifts.

The court held that decedent and her sons had an implied understanding that decedent would retain the lifetime beneficial enjoyment of the transferred assets, because (i) the partnership agreement gave decedent the ability to control the assets through her status as general partner and majority owner of the partnership, either directly or indirectly as co-trustee of her revocable trust, which she could revoke, (ii) the transfer of practically all of decedent's liquid wealth to the partnership left decedent with insufficient liquid assets with which to pay her living expenses, (iii) the principal of the trust created by her husband was not available to pay decedent's living expenses, and (iv) decedent derived economic benefit from using the partnership assets to pay her living expenses, pay tax obligations, and make gifts to her family.

The court also found that decedent's assets were not transferred to the partnership in a bona fide sale for adequate and full consideration because (i) decedent and her sons did not negotiate the partnership terms or retain independent counsel, (ii) decedent made all transfers to the partnership and the transfers constituted the bulk of her wealth, (iii) decedent and her revocable trust were the only initial partners, (iv) decedent did not fund the partnership until three months after it was formed, and (v) the partnership never had a business plan or investment strategy, traded or acquired investments, or issued financial statements, the partnership paid most of decedent's living expenses and gift tax liabilities and also borrowed money to pay decedent's estate tax liabilities.

In finding the estate liable for the Code Sec. 6662(a) accuracy-related penalty, the court, noting that decedent's son, who signed the return as co-executor, had extensive financial expertise and either knew or should have known about the omission because he was co-trustee of the revocable trust and a donee of the gifts, determined that the estate was negligent in failing to report the prior gifts as adjusted taxable gifts on decedent's estate tax return. Lastly, the estate produced no evidence of reasonable cause or good faith for the omission.

Doctrine of Substantial Compliance Does Not Apply to CRT Reformation

In *Tamulis Est. v. Comr., No. 06-4141 (7th Cir. 11/29/07)*, the Seventh Circuit affirmed a Tax Court decision that a trust created by decedent was not a qualified charitable remainder unitrust. As previously reported in the Fall of 2006, decedent, a priest, died in 2000, having created a trust that provided, for a term to last until the later of 10 years or the joint lives of his brother and sister-in-law, for payments and transfers to relatives and other non-charitable beneficiaries, with the remainder interest passing at the end of the term to a Roman Catholic Diocese.

The estate claimed a charitable deduction for the estimated value of a charitable remainder interest which would eventually pass to the diocese. The Service disallowed the deduction stating that

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the instrument did not specify that the trustee was to pay the income beneficiaries either a fixed dollar amount or a percentage of the trust's fair market value and therefore the trust did not meet the requirements of Code Sec. 2055(e).

The Tax Court upheld the Service's position. The trust did not meet the Code Sec. 2055(e) reformable interest test because some payments made to noncharitable beneficiaries, such as the payment of real estate taxes on the decedent's home and the requirement to pay the grandnieces the balance of the trust's annual net income, were not expressed as either a specified dollar amount or a fixed percentage of the trust's fair market value, as required by Code Sec. 2055(e)(3)(C)(ii). The only remaining method for reformation was to begin a judicial proceeding to reform the trust within 90 days after the estate tax return was due, and because no such proceeding was commenced, the remainder interest did not qualify for a deduction.

The court rejected the taxpayer's arguments that (i) the return statement amended the trust into a charitable remainder unitrust, (ii) the return statement was equivalent to commencing a judicial proceeding within the meaning of Code Sec. 2055(e)(3)(C)(iii), or (iii) the reformation provisions were met because the trust was actually managed in conformance with the charitable remainder unitrust requirements.

The Seventh Circuit affirmed, holding that the trustee, who was represented by counsel, knew that a substantial tax deduction was at stake and had no excuse for not starting the required judicial proceeding to reform the trust. The court further concluded that the substantial compliance doctrine cannot be used to excuse a failure to comply with the statutory requirements.

No Charitable Deduction for Gift of FLP Interests

In *Smith v. Comm'r, TC Memo. 2007-368 (12/17/07)*, taxpayers made charitable contributions of minority interests in a family limited partnership. The partnership included in its assets a closely held corporation for which a qualified appraiser had prepared an appraisal. Taxpayers' income tax returns, which showed income tax deductions for the charitable contributions of the partnership interests, did not include a formal appraisal of the partnership interests at the time of the gifts nor did the returns include a summary or explanation of the appraisal of the corporation.

On the basis of these facts, the Tax Court denied an income tax deduction for the charitable contributions. The court based its decision on the facts that (i) the appraisal prepared by the qualified appraiser valued only the underlying closely held corporation, rather than the limited partnership interests, (ii) an appraisal prepared by the taxpayers' CPA was not a qualified appraisal as the CPA had no qualifications as an appraiser nor did he offer a complete explanation of the analysis, and (iii) brief letters from the appraiser attached to some of the returns did not include the material required of an appraisal summary.

Marital Deduction Denied for Property Passing to Predeceased Spouse

In *Estate of Lee v. Comm'r, TC Memo. 2007-371 (12/20/07)*, decedent's and his wife's Wills both expressed the intent that wife should be deemed to have survived decedent if decedent died within six months after wife's death. Decedent died 46 days after wife. Decedent's estate claimed a marital deduction for property that was transferred to wife as if wife had survived decedent. The Service disallowed the marital deduction and the estate petitioned the Tax Court for a redetermination.

On the basis of these facts, the Tax Court held that despite decedent's testamentary intent that he be deemed to have predeceased his wife, Code Sec. 2056, which permits a marital deduction for a surviving spouse, requires that the spouse actually survive the decedent in order to be a surviving spouse. The court rejected decedent's estate's argument that Code Sec. 2056(b)(3) permits the modification of the timing of the actual deaths of a husband and wife if they die within six months of each other.

All Beneficiaries of Decedent's Trust Must Share Estate and Inheritance Taxes.

In *Hale v. Moore, No. 2005-CA-001895-MR (Ky. Ct. App. 1/4/08)*, decedent died in 1996, a Kentucky resident. Her will provided for debts, administration expenses, and all taxes payable by reason of her death to be paid from the estate. After a specific bequest to a church, the remainder of her estate passed to her revocable trust, which stated that it was governed by Pennsylvania law. The trust provided that if her probate estate was insufficient to pay all taxes and expenses, the trustee would deliver sufficient funds to her executor to pay those amounts. The trust assets were then to be divided into 12 equal shares and distributed to various relatives, with the share of

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a predeceased daughter to pass to two colleges. The trust contained no provision exempting the colleges from the payment of taxes.

The Pennsylvania trustee distributed the assets to the beneficiaries in 1999 with an accompanying waiver/release stating that Pennsylvania law governed and under Pennsylvania law, the colleges' shares were not charged with federal estate or state inheritance and estate taxes. All beneficiaries signed the waiver/release but were not informed that under Kentucky law, the colleges would have shared in the tax burden. Subsequently, the noncharitable beneficiaries challenged, among other things, the tax-free distribution to the colleges.

On the basis of these facts, a Kentucky circuit court held that (i) Kentucky law governed the administration of decedent's estate because decedent was a Kentucky resident and her will was admitted to probate in Kentucky, (ii) the waiver/release signed by the beneficiaries was void because decedent's executrix failed to fully inform them of all of the facts, and (iii) the beneficiaries should have shared the tax burden equally as intended by the trust's terms.

The Kentucky Court of Appeals affirmed, holding that, although Pennsylvania law governed the trust, Kentucky law governed the estate administration. The court concluded that decedent's intention was that the taxes and debts owed at her death be paid before any assets were distributed, based on the fact that the trust provided (i) that payment of trust funds be made to decedent's executrix if decedent's probate estate lacked sufficient funds for the debts and taxes, (ii) that distributions be made to the beneficiaries in 12 equal shares, and (iii) distribution to the colleges if decedent's daughter predeceased decedent with no special treatment stated.

Trust's Investment Advisory Fees Deduction Subject to 2% Floor

In *Knight v. Comr., No. 06-1286 (U.S. 1/16/08)*, a trust established by decedent claimed a deduction on its 2000 Form 1041 for investment-management fees paid to an advisory firm hired by the trustee as a deduction not subject to the Code Sec. 67(a) 2% floor applicable to miscellaneous itemized deductions.

In 2003, the Service issued a notice of deficiency, permitting a deduction for only the portion of the fees in excess of 2% of the trust's adjusted gross income. The trustee disputed the assessment, claiming that the trustee's fiduciary duties regarding prudent investments required investment advisory services for the proper administration of the trust's stock portfolio and were therefore fully deductible under Code Sec. 67(e)(1).

The Tax Court held that the fees were deductible only to the extent they exceeded 2% of the trust's adjusted gross income pursuant to Code Sec. 67(a). The Second Circuit affirmed, holding that Code Sec. 67(e)(1) unambiguously exempts from the Code Sec. 67(a) 2% floor only those costs incurred by a trust that could not have been incurred if an individual held the property.

The U.S. Supreme Court affirmed, but rejected the Second Circuit's test, holding that Code Sec. 67(e)(1) excepts from the 2% floor only those costs that it would be uncommon, unusual or unlikely for an individual to incur, or in other words, costs which would not have been incurred if the property were not held in trust.. Although the opinion is in regard to trusts the Court stated that the analysis also applies equally to estates.

The Court observed that the courts of appeal are divided on this issue. The Sixth Circuit held in *O'Neill v. Comr., 994 F.2d 302 (6th Cir. 1993)* that such fees are fully deductible. The Fourth Circuit in *Scott v. U.S., 328 F.3d 132 (4th Cir. 2003)* and the Federal Circuit in *Mellon Bank, N.A. v. U.S., 265 F.3d 1275 (Fed. Cir. 2001)* held that such fees are subject to the 2% floor because the fees are commonly or customarily incurred outside of trusts.

The Court rejected the trustee's argument that the statute allows a full deduction for costs incurred by virtue of a trustee's fiduciary duty, concluding that under the trustee's approach, every trust-related expense would be fully deductible and render superfluous Code Sec. 67(e)(1)'s second clause, which limits full deductibility to costs that would not have been incurred if the trust property were held by an individual.

In applying this standard to the present case, the Court found that the trustee had not satisfied its burden of showing that it was entitled to the deduction. The trustee, who has the burden of establishing entitlement to the deduction, failed to demonstrate that it was uncommon or unusual for individuals to hire an investment adviser. The Court stated that it would be difficult to say that the incurrence of investment advisory fees would be unusual or uncommon if an individual with the same investment objectives held the trust property. Even though the government had conceded that some

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trust investment advisory fees might be fully deductible if the advisor imposed some special or additional charge on fiduciary accounts, there was no evidence to indicate that was the case here.

Disclaimer Not Qualified and Estate Tax Charitable Deduction Disallowed

In *Christiansen Est. v. Comr., 130 T.C. No. 1 (1/24/08)*, decedent's will, which left everything to her daughter, provided that if daughter disclaimed anything, 25% of the disclaimed property would go to a charitable foundation and 75% to a charitable lead trust. The charitable lead trust was to pay a 7% annuity to the foundation for a 20 year term, at the end of which the remaining principal would be paid to daughter if she was then living.

Daughter executed a partial disclaimer with an adjustment clause that provided that the value of the disclaimer would be based upon the fair market value of the property as finally determined for federal estate tax purposes. Daughter did not disclaim the contingent remainder interest in the charitable lead trust.

On the estate tax return, the estate deducted as charitable contributions the disclaimed property passing to the foundation and the present value of the annuity passing to the charitable lead trust. When the Service and the estate subsequently stipulated to a value of the estate much higher than that originally reported on the estate tax return, the estate asserted that if the disclaimer were applied to the increased value then it was entitled to a larger charitable deduction both for the interest passing to the foundation and for the interest passing to the trust based on the formula adjustment in the disclaimer. The Service objected to any charitable deduction for property passing to the trust, and to any increase in the deduction for the property passing to the foundation based upon the disclaimer's adjustment as contrary to public policy.

On the basis of these facts, the Tax Court held that (i) no deduction is allowed for any of the property passing to the trust because the partial disclaimer of that property was not a qualified disclaimer under Code Sec. 2518, and (ii) the entire value of the property passing to the foundation, including the increased amount passing because of the increased valuation of the estate, is deductible because the disclaimer was a qualified disclaimer under Code Sec. 2518, and because no public policy bars increasing the amount of the deduction.

With respect to the property passing to the charitable lead trust as a result of daughter's disclaimer, due to her retention of the contingent remainder interest, the property was not going to a person other than the disclaimant, as required for a qualified disclaimer. Under Regs. §25.2518-2(e)(3) and §25.2518-3(a)(1) daughter had retained an interest in unseverable and undivided property and therefore the disclaimer was not a qualified disclaimer with respect to any portion of the trust property.

With respect to the property passing to the foundation, the entire value was held to be deductible because that portion of the disclaimer was a qualified disclaimer, and increasing the amount of the charitable deduction was not void as against public policy; the adjustment clause did not undo the transfer but simply reallocated the value of the property passing to daughter, the foundation and the trust.

Loans Do Not Qualify as Interest in Family Business Under Code Sec. 2057

In *Farnam Est. v. Comr., 130 T.C. No. 2 (2/4/08)*, decedents, husband and wife, who died in 2001 and 2003 respectively, owned and managed, with other members of the family, a closely held corporation. Beginning in 1981, and every year thereafter, members of the family, including husband and wife, loaned funds to the corporation which were used in its business operations and for which the corporation issued promissory notes in favor of the family members. The notes were unsecured and subordinate to claims of the corporation's outside creditors.

Federal estate tax returns filed on behalf of both estates claimed QFOBI deductions under Code Sec. 2057 of $625,000 and $675,000, respectively. The common stock in the corporation and the notes husband and wife owned at the times of their deaths, either directly or through the limited partnerships they had created, were included in the calculation of the QFOBI 50% liquidity test under Code Sec. 2057(b)(1)(C). Without the inclusion of the loans, each estate would have failed to meet the test. The Service issued statutory notices determining estate tax deficiencies and disallowed the QFOBI deductions.

On the basis of these facts, the Tax Court denied the deductions, holding that the corporate loan interests were not QFOBIs for purposes of Code Sec. 2057(b)(1)(C). The court stated that for an estate of a decedent dying before January, 2004, to qualify for a QFOBI deduction, the value of the QFOBIs

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owned by the decedent at death must exceed 50% of the total value of the decedent's adjusted gross estate (the 50% liquidity test). Code Sec. 2057(e)(1)(B)(i) defines a QFOBI as an interest in any entity carrying on a trade or business, if least 50% of such entity is owned by the decedent and members of the decedent's family and states that such interests must be "equity" interests; Code Sec. 2057(e)(3)(A) and (B), which provide rules for calculating the family-ownership test, has express references to equity interests by the use of the words "stock," "capital" and, "ownership interest."

Non-Transferability of Annuities No Affect on Estate's Valuation

In *Anthony v. U.S., No. 07-30089 (5th Cir. 3/4/08)*, decedent, who died in 1996, was the beneficiary of three non-assignable annuities. The estate initially estimated the present value of the remaining annuity payments under the Code Sec. 7520 annuity tables. The estate reported a tax liability of $468,078, which the Service increased by $142,605 after an audit. The estate paid the tax but then filed a refund claim for $472,620, stating that it had overvalued the annuities in its initial filing, and that the annuities should have been assigned their fair market value without regard to the annuity tables because the non-transferability clauses rendered the annuities subject to a restriction under Reg. §20.7520-3(b)(1)(ii). The Service denied the claim and the estate then sued in district court, where it lost. It then appealed to the Fifth Circuit.

In the Fifth Circuit, the estate argued that (i) the marketability restrictions rendered each annuity a restricted beneficial interest under Reg. § 20.7520-3(b)(1)(ii), and (ii) even if the 'restricted beneficial interest' exception did not apply, valuation under the tables in this case was still inappropriate because the tables yielded an 'unreasonable and unrealistic' result.

The Fifth Circuit disagreed with the estate, holding that non-transferable private annuities must be valued, for estate tax purposes, in accordance with the tables under Code Sec. 7520. The court explained that the regulations define a 'restricted beneficial interest' to include an annuity that is subject to any contingency, power, or other restriction. The court held that 'other restriction' does not include restrictions on transferability because such a restriction does not threaten to end an annuitant's right to receive future payments like the restrictions expressly covered in the regulations. The court further determined that the estate's estimate that the fair market value of the annuities was 50% less than that prescribed by the tables does not make use of the tables 'unrealistic or unreasonable.'

FLP Interests Not Includible in Decedent's Estate

In *Mirowski Est. v. Comr., T.C. Memo 2008-74 (3/26/08),* decedent's husband was part of a team of scientists who developed an electronic cardioverter defibrillator device. During husband's lifetime, he held various patents relating to the device and received royalties under an exclusive license agreement for the use of those patents. Pursuant to husband's will, the patents, his interest under the license agreement, and other assets passed to decedent.

Following husband's death, decedent created an irrevocable trust for each of her three daughters and their respective issue, funding each trust with a 7.2616% interest under the license agreement, while decedent held a 51.09% interest.

In 2001 decedent created an LLC for the stated purposes of (i) joint management of the family's assets by her daughters and eventually her grandchildren, (ii) maintenance of the bulk of the family's assets in a single pool of assets to permit greater investment opportunities, and (iii) providing for each of her daughters and eventually her grandchildren on an equal basis. She transferred the patents, her 51.09% license agreement interest and other property consisting of securities and cash to the LLC in exchange for a 100% LLC membership interest. Decedent retained substantial personal assets and she expected to receive substantial income from royalty payments as an LLC member. The LLC's operating agreement appointed decedent as general manager and as such, she was subject to restrictive operating agreement provisions and also subject to Maryland law, which imposed upon her fiduciary duties to the other members.

Shortly after forming the LLC and understanding that she would owe gift tax, decedent made a gift of a 16% interest in the LLC to each daughter's trust. There was no express or unwritten agreement among the LLC members (i) that decedent, at her own discretion, could have access to any of the assets that she transferred to the LLC for her own possession or enjoyment, the right to income from the assets, or the right to determine who could possess or enjoy those assets, or (ii), that decedent would retain during her life the economic use and benefits of the assets that she transferred to the LLC.

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Decedent died suddenly and unexpectedly in September, 2001. Decedent's 52% LLC membership interest in the LLC passed in equal shares to the three trusts. The trusts have continued to operate the LLC, reinvesting the substantial cash flow not required for payment of taxes and expenses. Following the filing of the federal estate tax return, the Service determined that the date-of-death fair market values of all of the assets that decedent transferred to the LLC were includible in her gross estate under Code Sec. 2036(a) and issued a notice of deficiency to the estate.

On the basis of these facts, the Tax Court held that decedent's primary purposes in creating the LLC were legitimate and based on nontax reasons and therefore, under Code Sec. 2036(a), the assets transferred to the LLC were not includible in Decedent's estate.

Regarding the inclusion in the estate of decedent's gifts of LLC interests to her daughters' trusts, the court determined that there was no inclusion under Code Sec. 2036 because at the time of the transfers there was no express or implied agreement that decedent retain the possession or the enjoyment of, or the right to the income from, the respective gifts; additionally decedent did not retain, either alone or in conjunction with any person, the right to designate the persons who would possess or enjoy the property or the income therefrom. Next, the court found that under Code Sec. 2038, at no time was the enjoyment of the gifts to the trusts subject to any change through decedent's exercise of a power, alone or in conjunction with any other person, to alter, amend, revoke, or terminate. Finally, the court determined that because Code Secs. 2036 and 2038 did not apply to the transfers to the LLC, Code Sec. 2035 did not apply to the gifts.

III. IRS REVENUE RULINGS, REVENUE PROCEDURES & NOTICES

Bundled Fiduciary Fees Fully Deductible on 2007 Income Tax Returns

In *Notice 2008-32, 2008-11 IRB*, the Service has stated that for tax years beginning before January 1, 2008, nongrantor trusts and estates will not have to "unbundle" fiduciary fees into costs that are fully deductible and those that are subject to the 2% floor. Instead, for each such tax year, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the 2% floor. Payments to third parties for expenses subject to the 2% floor which are readily identifiable must be treated separately from the otherwise bundled fiduciary fee.

As reported in this issue, in January 2008, the Supreme Court, resolving a conflict in the circuit courts, held in *Knight, supra*., that investment advisory fees paid by a trust are deductible only to the extent that they exceed 2% of the trust's AGI. Prior to the decision, in July 2007, the Service had issued proposed Regs. providing that an estate or non-grantor trust that pays a single fee that includes costs that are unique to estates and trusts and costs that are not, would have to use a reasonable method to allocate the single fee between the two types of costs. The Service plans to issue final Regs. consistent with the Supreme Court's holding in *Knight*, but because the final Regs., which will only apply prospectively, will not be issued before the due date for filing 2007 income tax returns, the Service has issued interim guidance.

The Service is considering various modifications to Prop Reg. §1.67-4 that may include safe harbors for determining the allocation of a bundled fiduciary fee between costs subject to the 2% floor and those that are not. Comments are requested on whether safe harbors would be helpful and suggestions on how they may be formulated.

Service Will not Follow Alternate Valuation Decision

The Service has issued *nonacq. 2008-9 I.R.B. AOD 2008-01 (3/3/08)*, to the Tax Court's decision in *Kohler v. Comr., T.C. Memo 2006-152 (7/25/06)*, stating that it will not follow the decision permitting alternate valuation of closely held stock that was subject to reorganization during the six-month post-death period. As previously reported in 2006, decedent, who died in 1998, was a shareholder in a closely held corporation which had been controlled by the Kohler family since its founding.

In 1996 the company's management decided to reorganize the company to eliminate outside shareholders, facilitate estate planning, and resolve control and ownership issues. The reorganization, which was tax-free under Code Sec. 368(a), was completed 3 months after decedent's death. The family shareholders, including decedent's estate, had the option of either redeeming their shares or exchanging them tax-free for new stock that was subject to transfer restrictions and a purchase option. Decedent's estate chose to receive new shares rather than have them redeemed.

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The estate valued the stock on the Code Sec. 2032 alternate valuation date (which was after decedent's estate's received the new shares in the reorganization). The Service disagreed with the valuation, arguing that the stock did not qualify for Code Sec. 2032 valuation, because the new stock (i) was not the same asset as the stock held by decedent at death, and (ii) could not be valued by taking into consideration the transfer restrictions and purchase option that were added in the reorganization.

The Tax Court held for the estate, accepting the estate's valuation and rejecting the Service's Code Sec. 2032 arguments. The Service has now stated that (i) it disagrees with the court's decision on the issue of whether the post-reorganization stock could be valued by taking the transfer restrictions and purchase option into account, and (ii) although it has not appealed the Tax Court decision, it will not follow this decision in disposing of other cases.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Charitable Lead Trust Can Be Funded With S Stock

In *PLR 200747001*, husband and wife propose to create a charitable lead annuity trust, to which they will each transfer voting common stock of an S corporation. Under the terms of the trust, the trustee will pay an annuity amount equal to a percentage of the initial net fair market value of the trust assets to a qualified charitable organization. The trust will end on the earlier of the expiration of a five-year period or on the death of both husband and wife, at which time the trustee has the power to distribute all or any part of the trust assets to one or more charitable organizations, to be selected by the trustee, in his sole discretion; any remaining trust assets will be distributed to husband's and wife's then living issue, per stirpes.

Trustee is a nonadverse party under Code Sec. 672(b). The trust agreement provides that if the trustee dies or becomes unable or unwilling to serve, a successor trustee who is a nonadverse party and who is not related or subordinate to husband and wife under Code Sec. 672(c) will be appointed by the management committee of a certain law firm. Husband and wife are prohibited from serving as trustees. The trust agreement further contains all of the provisions required for a valid grantor charitable lead annuity trust.

On the basis of these facts, the Service ruled (i) the transfers of S corporation stock by husband and wife to the trust will constitute completed gifts because the trust will be irrevocable and husband and wife will have retained no interest or reversion in the trust, (ii) the annuity payable under the trust will qualify as a guaranteed annuity under Code Sec. 2522(c)(2)(B) and Reg. §25.2522(c)-3(c)(2)(vi) and therefore the transfers will qualify for gift tax charitable deductions under Code Sec. 2522(a), (iii) no portion of the value of the trust assets will be included in the gross estate of husband or wife under Code Secs. 2036, 2037, 2038, 2042 or 2035 for federal estate tax purposes, (iv) the trust is a grantor trust under Code Sec. 674 due to the inclusion of grantor trust provisions, and therefore, during the lives of husband and wife, the trust will be a permitted shareholder of the S corporation under Code Sec. 1361(c)(2)(A)(i) and (v) husband and wife will be entitled to an income tax charitable contribution deduction under Code Sec. 170(f)(2)(B) for the present value, on the date of the contribution, of the guaranteed annuity interest.

Guidelines Reviewed for Accepting Closely Held Stock as Security under Code Sec. 6166

In *CCM 200747019*, the Office of Chief Counsel set forth procedures and guidelines whereby the Service will accept, in appropriate situations, closely held stock or other business interests to secure the deferred payment of estate taxes on a closely held business interest under Code Sec. 6166. Included in the areas discussed are (i) when stock can be pledged for a special lien, (ii) criteria used to determine the adequacy of stock as collateral, (iii) requirements the Service may impose on an estate that pledges stock as collateral for a special lien, (iv) securing the Service's interest in the pledged stock, (v) recording the Code Sec. 6324A lien, (vi) whether or not a full audit is required where an estate tax return proposes using closely held stock as security under Code Sec. 6324A, (vii) the proper procedure to determine whether the stock adequately secures the deferred taxes and interest, (viii) the proper procedure for denying or terminating a Code Sec. 6166 election, and (ix) Service review of the continuing sufficiency of collateral securing a Code Sec. 6324A lien that is already in place.

No Incidents of Ownership in Life Insurance

In *PLR 200747002*, three shareholders owned life insurance policies pursuant to the terms of a buy-sell agreement covering two companies that they jointly owned. The policies covering any one of the three of them were owned by the

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other two. The buy-sell agreement provided that the proceeds of the policies must be used by the surviving shareholders to purchase the deceased shareholder's stock in the two companies to the extent the proceeds do not exceed the fair market value of those interests.

In accordance with the buy-sell agreement, the three shareholders organized an LLC (of which they were the three members), appointing a bank as manager, and designated the LLC as the owner and beneficiary of the policies. The LLC operating agreement requires the members to make contributions to the LLC equal to the premiums on the policies, which will then be allocated to their capital accounts. Subject to the buy-sell agreement, the LLC manager will distribute the proceeds of the policies to the members in proportion to their respective capital accounts. If the members dissolve the LLC by written consent, the LLC is directed to distribute the policies consistent with the buy-sell agreement.

On the basis of these facts, the Service ruled that the three shareholders will not possess incidents of ownership under Code Sec. 2042 with respect to the life insurance policies owned by the LLC. The LLC's operating agreement precludes any of the shareholders/members from exercising any control over LLC's management, investment, and business decisions. Prior to the transfer of the polices to the LLC, no shareholder had any incidents of ownership in the policies insuring his life. As long as the LLC operating agreement is not amended, none of the shareholders/members will possess any incidents of ownership with respect to the policies held by the LLC.

Property Will Qualify as Personal Residence for QPRT Purposes

In *PLR 200751022*, grantor owns a multi-acre parcel of real estate, similar in size to neighboring properties, on which are a main house, two free-standing garages, a maintenance building, two greenhouses, and a caretaker house. The property is assessed as one parcel for real estate tax purposes and is subject to a conservation easement.

Grantor uses the main house as her personal residence. Friends and relatives have used the caretaker house at no cost; it has also been rented to third parties. Grantor plans to rent the caretaker house to an unrelated third party, providing no services other than ordinary maintenance. Grantor deeded her interest in the entire property to a nominee trust whose beneficiaries are three other trusts, each of which is intended to be a qualified personal residence trust under Reg. §25.2702-5(c).

On the basis of these facts, the Service ruled that the rental of the caretaker house will not disqualify the three trusts as qualified personal residence trusts. Noting that under Reg. §25.2702-5(c)(2)(iii) a residence will not qualify as a personal residence if used to provide transient lodging accompanied by the provision of substantial services or if, during any period not occupied by the term holder, its primary use is other than as a residence, the Service concluded that the primary use of the trust property is as grantor's residence, despite the rental of the caretaker house. In addition, grantor will not be providing substantial services to the lessee, and therefore the rental of the caretaker house will not cause the property to fail to qualify as a personal residence.

Nonqualified Disclaimer of QTIP Interest

In *PLR 200801009*, a trust that became irrevocable on decedent's death was divided into a QTIP trust for the benefit of decedent's surviving spouse and a trust for the benefit of decedent's children. Spouse wishes to disclaim her interest in the QTIP trust, and the trustees have received a court ruling that the disclaimed property will be distributed as if originally a part of the children's trust.

On the basis of these facts, the Service ruled that (i) under Code Sec. 2519, spouse will be deemed to have made a transfer of all of the QTIP trust's assets, other than her qualifying income interest and will be treated as having made a gift of the fair market value of the trust, determined on the date of disposition, reduced by the value of the qualified income interest and by the amount that spouse is entitled to recover for gift taxes related to the transfer under Code Sec. 2207A(b), (ii) the transfer of spouse's income interest resulting from her disclaimer is a transfer by spouse, under Code Sec. 2511, and the amount of that gift will be the value of the qualified income interest on the date of disposition, (iii) after spouse disclaims her interests, no portion of the trust assets will be included in her estate for federal estate tax purposes under Code Sec. 2044, (iv) based upon information submitted, a standard Code Sec. 7520 income factor and a standard Code Sec. 7520 remainder factor should be used to determine the value of the disclaimed income interest and the remainder interest, (v) because spouse's basis in the disclaimed property is greater than the gift tax recovered under Code Sec. 2207A(b), spouse will not be liable for income tax as a result of

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the disclaimer, and (vi) because the basis of the QTIP trust assets exceed their fair market value, the basis of the trust assets will not be increased under Code Sec. 1015(d) and for purposes of determining gain, the basis of the assets in the hands of the persons receiving them will be same as the basis of the QTIP trust assets at the time of the transfer.

Assignment of Annuity to Charities not Taxable Under Code Sec. 691(A)(2).

In *PLR 200803002*, decedent named a trust created by him during his lifetime as the beneficiary of his nonqualified deferred annuity, purchased after October 21, 1979. At his death, the annuity had not yet reached its starting date and pursuant to the terms of the trust, the trustees assigned the annuity to named charities in satisfaction of their residuary interests in the trust.

On the basis of these facts, the Service ruled that the assignment of the annuity to the charities in satisfaction of their residuary interests in the trust will not be a transfer under Code Sec. 691(a)(2) and that only the charities will include the IRD from the annuity in their gross income when distributions from the annuity are received.

The Service stated that, under Code Sec. 691(a)(2), if a right to receive an amount is transferred by the estate of a decedent or a person who received the right as the result of the decedent's death, the estate or other person must include in its gross income for the taxable period in which the transfer occurs the fair market value of such right at the time of transfer, plus the amount by which any consideration for the transfer exceeds such fair market value. Reg. §1.691(a)-4(b) provides that if an estate of a decedent or any person transmits the right to IRD to another who would be required by Code Sec. 691(a)(1) to include such income when received in his gross income only the transferee will include such income in his gross income when it is received; in this situation, a transfer within the meaning of Code Sec. 691(a)(2) has not occurred. Under Reg. §1.691(a)-4(b)(3), if a trust which receives a decedent's right to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in his gross estate when received.

The Service noted that this is consistent with the ruling in *Rev. Rul. 2005-30, 2005-1 C.B. 1015*, which holds that, for annuity contracts purchased after October 21, 1979, if the owner-annuitant of a deferred annuity contract dies before the annuity starting date and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as IRD.

Service Provides Advice on Special Lien Under Code Sec. 6166

In *CCA 20080316*, decedent owned an LLC interest at his death. The executors of his estate met the Code Sec. 6166 election requirements to defer the payments of estate tax attributable to the LLC interest. In lieu of a bond, the executors drafted a written agreement consenting to the placement of a 15-year estate tax lien under Code Sec. 6324A on the LLC interest, and in addition submitted a proposed Pledge and Escrow Agreement in which the LLC interest would be held in escrow by the estate's attorney subject to the estate tax lien.

The Chief Counsel advised that (i) if the three requirements (outlined below) under Code Sec. 6324A are met, the Code Sec. 6324A special lien arises and the LLC interest must be accepted by the Service, (ii) Code Sec. 6324A(c) requires a written agreement protecting the Service's interest in the collateral securing the special lien but does not preclude the Service from entering into any additional agreements concerning the collateral, and (iii) in order to perfect the security interest, the Service should file a Notice of Federal Tax Lien for the Code Sec. 6324A special estate tax lien in the LLC interest with the U.S. District Court in the appropriate jurisdiction. Because the law on the residence of an estate is unsettled, the Chief Counsel recommended that the lien be filed based on the residences of the executors and the decedent at the time of death.

The Chief Counsel found that the LLC interest will qualify as collateral under Code Sec. 6324A(c)(1)(A) and that the Code Sec. 6324A lien will arise and the Service must accept the collateral if (i) the collateral is expected to survive the deferral period and retain its value, (ii) the collateral is identified in the required written agreement, and (iii) the value of the collateral is sufficient to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the deferral period. The Chief Counsel noted that the Service does not have the authority to reject collateral offered by the estate on the grounds that it would be burdensome for it to determine the value or because it would prefer other collateral.

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Section 529 Plan Gifts in the Year of Death

By KEVIN P. GILBOY, ESQ.
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Under IRC section 529(c)(2)(B), a taxpayer can accelerate 5 years of annual exclusion gifts (currently $12,000 per year) into a qualified tuition program. If a decedent made such 5 years' worth of "accelerated" gifts to a section 529 plan in the year of his or her death and had used all of his or her $1 million lifetime gift tax exemption, pause before you complete the decedent's final gift tax return.

If you make the section 529(c)(2)(B) election by checking the box in Schedule A of form 709 to qualify the accelerated 5 years of contributions for gift tax annual exclusions, no gift tax will be due as result of the gifts. But 4 years of such gifts will be pulled back into the decedent's gross estate for federal estate tax purposes (see section 529(c)(4)(C)).

If instead you do not elect to qualify the accelerated 5 years of contributions for gift tax annual exclusions, gift tax will be payable for the 4 years of "accelerated" gifts. The payment of this gift tax does not produce federal estate tax savings because gift tax paid on gifts made within 3 years of death is pulled back into the gross estate under section 2035(b), creating a wash with the deductible debt. But the gift tax debt will be deductible for Pennsylvania inheritance tax purposes without any pull-back of the gift tax paid.

A $48,000 taxable gift at a 45% gift tax rate produces gift tax of $21,600. A $21,600 deduction against the 4.5% inheritance tax saves $972 - not a home run, but perhaps a clutch single.

Please note that accounts under Pennsylvania's section 529 plans are exempt from Pennsylvania inheritance tax. 24 Pa.§6901.316(b) provides that "Contributions made pursuant to a Tuition Account Program Contract; any increase in the value of those contributions, the retention, or transfer during life or as a result of death of any legal interest in a Tuition Account Program Contract; and payment of qualified higher education expenses of beneficiaries made pursuant to Tuition Account Program Contracts shall be exempt from all taxation by the Commonwealth and its political subdivisions." A Tuition Account Program Contract is defined in 24 Pa.§6901.302 as "A Tuition Account Guaranteed Savings Program Contract or a Tuition Account Investment Program Contract entered into by an account owner and the department to provide for savings to meet the future qualified higher education expenses of a beneficiary attending an eligible educational institution." These two types of contracts are the two choices available under the Pennsylvania version of section 529 plans.

The exemption from PA taxation of 24 Pa. C.S.A. §6901.316(b) would not apply to other states' section 529 plans. Grossman and Smith, *Pennsylvania Inheritance Tax*, §9107(b) suggests that it would be logical for the Pennsylvania inheritance tax treatment of excess accelerated contributions to a section 529 plan to be the same as under federal law.

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In the present case, the second requirement, identification of the collateral, had been satisfied by the written agreement, but it was not clear whether the first and third requirements had been met because the Service's analysis was not sufficiently detailed. The Chief Counsel stated that if the Service's analysis concluded that the LLC interest is expected to survive the deferral period and that its value is sufficient to pay the deferred taxes plus the required interest then the statutory requirements under Code Sec. 6324A have been met and the special estate tax lien arises requiring the Service to accept the collateral.

Regarding whether the Service should enter into an additional agreement to provide any additional security to the Code Sec. 6324A written agreement, the Chief Counsel observed that the proposed pledge and escrow agreement requires the estate to (i) provide annual reports or certified financial statements each year of the deferral period, which could assist the Service in monitoring whether the LLC interest has retained its value, and (ii) assign the LLC interest to its attorney as the escrow agent. Chief Counsel recommended that the LLC interest be assigned directly to the Service to eliminate the third party in case of default.