PHILADELPHIA BAR ASSOCIATION

Probate and Trust Law Section Newsletter

No. 115 Published by the Section on Probate and Trust Law of The Philadelphia Bar Association October 2006

Report of the Chair

By MARY JANE BARRETT, ESQUIRE
HARKINS AND HARKINS

How many times in our practices as trust and estate lawyers have we all thought in a moment of frustration that "somebody should do something" about (fill in the blank)?

Certainly there are many inefficient systems and institutions that have evoked this sentiment. A discovery that I've fully come to appreciate in the years of working with the committees of the Probate and Trust Section is that there are many "somebodies," who, with little personal recognition, make a genuine difference in the course of our practice. Recent events provide fresh examples.

The first instance is the work that the Section was able to undertake this summer to resist the adoption by the Pennsylvania Disciplinary Board of an ill-conceived amendment to Rule of Professional Conduct 1.15 and Rule of Disciplinary Enforcement 221, regarding safeguarding of client property. The efficacy of the work is yet to be determined, because the Disciplinary Board has not yet acted, but the fact that the Section was responsive to a complex proposal, that, with virtually no advance warning, was published for comment in the Pennsylvania Bulletin on June 10 with an original comment deadline of July 3 (later extended to August 10) is remarkable and a testimonial to the networking and cooperation of members of our Section and the Pennsylvania Bar Association (PBA), and even the Pennsylvania Bankers Association. Though conceived to address problems of disciplinary enforcement and the prosecution of dishonest attorneys who misappropriate client funds, the proposal would have required the deposit of client funds, including fiduciary investments, only in institutions which agreed to overdraft reporting -- which would eliminate typical investment firms. An attorney-fiduciary would have been subject to onerous restrictions not applicable to other individuals serving as fiduciary, even if a corporate fiduciary was also serving.

In effect, no attorney would have been able to serve as fiduciary. Other problems and ambiguities also existed. Thanks to the behind the scenes

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involvement of Section members who had followed the history of the Disciplinary Board's efforts, and thus were poised to digest the proposal and respond cogently, the Section was able to quickly generate a letter of opposition with a thorough analysis of the problems presented. Though the comment letter (which appears elsewhere in this newsletter) was signed by the Chair, it was largely the work product of Section member Kim Fetrow, also an active member of the PBA Committee on Legal Ethics and Professional Responsibility, with input from our Section's Legislative Committee Chair, Rob Friedman. Similar letters were sent by the Chair of the Allegheny County Probate and Trust Section, the Chair of the PBA Real Property, Probate and Trust Law Section, and a Co-Chair of the PBA Legal Ethics and Professional Responsibility Committee. The Pennsylvania Bankers Association also wrote in opposition to the rule, due to its deleterious impact on attorneys as co-fiduciaries. We can only hope that this formidable alliance of bar associations leaders and bankers, who in unison opposed the rules, will be effective. In any event, through the efforts of Kim, Rob and many others, we were able to try.

The second instance of proactive efforts to resolve a recurring and irritating problem facing practitioners arose from the reluctance or refusal of various financial institutions to accept lawyer drafted powers of attorney when presented for banking purposes. Many times a power is accepted only after it has been sent to the institution's legal department for review, which may take hours or days or even weeks. Other times, the institution flatly refuses to honor the power, insisting that its own form is the only acceptable form. (Granted, there may be instances in which the power is genuinely questionable, and the gripe is not about those cases). Back in the 1980's, the Probate Section, through the efforts of Gene Gillin, a Past Chair of the Section still active on the Rules and Practice Committee, developed a standard banking power of attorney that was acceptable to the local banking institutions. Those forms, sold essentially at cost by the bar in shrink-wrapped packages, were kept by lawyers in their offices so clients could sign them at the same time as the general power of attorney and other estate planning documents. However, when the power of attorney statute was amended in 1999 to require the mandatory notice to the principal and acknowledgment by the agent, those forms fell by the way side. Until now, that is. Once again, when distress calls over the lack of ready acceptance by lawyer drawn powers were sounded by several practitioners, Gene Gillin responded and revised the form so it now conforms to the current statutory requirements. The 2006 edition of the Power of Attorney Form for Banking Transactions has been approved by the Executive Committee, and will soon be introduced. Rather than residing in stacks in the attorney's office, the forms will be available on-line and capable of on-line completion on both the Probate Section's website and as a new component of the Philadelphia Estate Practitioner Handbook. While the local banking institutions have not provided an anticipatory blessing, it is the Section's expectation that the forms, which contain the Philadelphia Bar Association logo and imprimatur, will be widely disseminated and, once familiar to the institutions, will be readily accepted by them.

The talent, the industry and the sense of professional pride of Probate Section members when things seem broken is prodigious. Hats off to the somebodies who make a difference!

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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An Organized Trust Statute for Pennsylvania: Introduction to the Pennsylvania Uniform Trust Act

By C. THOMAS WORK, ESQUIRE
CHAIR, SUBCOMMITTEE ON THE PENNSYLVANIA UNIFORM TRUST ACT
ADVISORY COMMITTEE ON DECEDENTS' ESTATES LAWS
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What Is the Pennsylvania Uniform Trust Act?

The National Conference of Commissioners on Uniform State Laws undertook to prepare and propose a uniform codification of trust law and engaged Professor David M. English of the University of Missouri-Columbia School of Law to act as Reporter on the project. The Conference completed this project in 2000, although several amendments to the resulting Uniform Trust Code (the "UTC") have been added since that time.

Between 2001 and 2003, the Advisory Committee on Decedents' Estates Laws to the Pennsylvania Joint State Government Commission undertook through a Subcommittee to evaluate the UTC in context with Pennsylvania's law of trusts. Our Subcommittee found the provisions of the Pennsylvania Probate, Estates and Fiduciaries Code, as amended, 20 Pa. Cons. Stat. (the "PEF Code"), to be poorly organized and generally a farce. We also discovered that existing Pennsylvania statutory law fails to address a number of frequently encountered problems that arise in the context of trusts under agreement, and in some cases testamentary trusts as well. Here are some examples:

- The PEF Code does not address formalities of execution or, for that matter, whether oral trusts are enforceable.
- The rules of construction we take for granted in construing Wills and, consequently, trusts under Wills literally do not apply to trusts under agreement.
- Whether the grounds for contesting a Will also apply to a trust under agreement is unclear and the best we have are rules by analogy.
- There is no procedure to clear the claims of creditors of the grantor and, consequently, no road map for making distributions from a trust under agreement free of the claims of the grantor's creditors.
- How much information a trust beneficiary is entitled to receive, and under what circumstances a beneficiary or close member of the grantor's family is entitled to receive information, about the trust are not addressed.

Enacted into law as part of Act No. 98 of 2006, the Pennsylvania Uniform Trust Act (the "PA UTA") is the result of this process. It is the culmination of a five-year effort to borrow the best from the UTC, primarily its organization, to synthesize those provisions with existing Pennsylvania trust law, to nudge Pennsylvania trust law that is antiquated, and generally to promote uniformity where no strong policy dictates that Pennsylvania law should differ from the UTC

The PA UTA occupies new Chapter 77 of the PEF Code and repeals virtually every provision of the PEF Code that mentions or addresses trusts, with the notable exception of the Orphans' Court Division's jurisdictional provisions as they apply to trusts. It is generally effective November 6, 2006, but trustees have two additional years within which to implement the notice procedures required by the new statute.

Why Replace Pennsylvania's Statutory Law of Trusts with the UTA?

Besides the reasons set forth above, there are four others:

- To make it easier for Pennsylvania lawyers and judges to find the law.
- Recognizing that many trust relationships cross jurisdictions, to make it easier for lawyers and bankers outside of the state to identify salient nuances of Pennsylvania law that

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Introduction to the PA UTA, continued

might impact a trustee's relationship with a settlor or beneficiary.

• To promote uniformity in the law.

• To improve the law.

Philosophical Differences Between PA UTA and UTC; How Are Pennsylvania Differences Highlighted in the PA UTA?

When Pennsylvania considered the Uniform Probate Code decades ago, an effort that culminated in the 1972 enactment of the PEF Code, we placed most of the duty to police fiduciary conduct upon the beneficiaries. This was a radical departure from systems that persist in New England, and years ahead of the Uniform Probate Code. Those regimes require periodic accountings and other applications to the Court for the disposition of routine matters. Pennsylvania does not.

The UTC echoes the approach that Pennsylvania adopted in 1972 that the beneficiary must rattle the cage and the cage will not be rattled automatically by requirements for periodic accountings or applications to the Court to sell or otherwise manage assets and issues. In short, the UTC adopts what has been the orientation in Pennsylvania for at least three decades. However, both the UTC and the PA UTA implement notice requirements that provide the trust beneficiary with a quality, quantity and regularity of relevant information that justify this burden. No longer are trusts under agreement and their administration shrouded in secrecy.

Pennsylvania Comments following sections of the PA UTA identify material departures from the UTC and from existing Pennsylvania law.

In What Respects Will the UTA Materially Change Existing Law?

Notices

Section 7780.3 encourages, and in defined contexts requires, a trustee to communicate with the trust's beneficiaries. A trustee must respond to a beneficiary's reasonable request for information unless the trust is a revocable trust and the settlor is alive. The exception preserves the settlor's privacy and reflects the fact that a settlor of a revocable trust may change the at-death provisions of the document. The trustee must notify the trust's current beneficiaries in a variety of circumstances after the trust may no longer be amended or revoked. The contents of the notice are prescribed in the statute. Apart from the requirements of this section, a trustee may notify the beneficiaries of a trust whenever the trustee likes. While a settlor may not negate the notice requirements, the settlor may designate a nominee to receive the notices required by this section of the Act. A two-year transitional rule will allow Pennsylvania trustees enough time to prepare for the new notice requirements.

Revocable Trusts As Will Substitutes

Subchapter F, entitled "Revocable Trusts," essentially applies the same rules in force for Wills to revocable trusts and provides revocable trusts with a detailed statutory framework. The new provisions equate capacity to execute a revocable trust with capacity to execute a Will; impose similar periods of time to contest revocable trusts and Wills; require notices of the trust relationship to the settlor's spouse, children and beneficiaries that are akin to Pennsylvania Orphans' Court Rule 5.6 applicable to probate and intestate settlements; apply to revocable trusts the same rules of construction that apply to testamentary trusts; and set forth a road map for clearance of creditors' claims and interaction with the parallel administration of the settlor's estate outside of the revocable trust.

Virtual Representation

Concepts of virtual representation have been broadened, refined and detailed. For the first time in Pennsylvania, a person may represent his minor and unborn descendants unless there is a conflict of interest between the ancestor and the descendant with respect to the matter at issue. The new rules apply to releases, accounts, settlements and other transactions outside of a judicial context as well as to matters before the Court. Departing from the UTC, the PA UTA requires the trustee to give written notice to person "A" if the trustee expects "A" to represent person "B" in a trust matter and recognizes "A's" right to decline the proposed representation in writing. The UTC and current Pennsylvania law assume that certain parties adequately represent others without any such notice or a clear right to opt out of the representation.

Choice of Law

A settlor may select the law that will govern the meaning and effect of the trust instrument unless that law contravenes one of the mandatory rules set forth in Section 7705 of the PA UTA, such as the set of rules requiring the trustee to communicate with the beneficiaries. The comments to the Uniform Trust Act and to the PA UTA suggest that there might be other public policy limitations upon choice of law.

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Introduction to the PA UTA, continued

Situs and Venue Are United

Section 7708 of the PA UTA permits a trustee to change the situs to another state or county having one of several prescribed relationships with the trust or its beneficiaries after notifying the trust's primary beneficiaries of the proposed transfer and obtaining their written consent. The notice must describe certain salient, practical implications of the transfer. The Court may also direct a change in situs. Under the PA UTA, venue automatically changes with situs.

Removal of Trustees

The statutory grounds for a trustee's removal have been updated. Each requires findings by the Court that removal best serves the interests of the beneficiaries, that removal is not inconsistent with a material purpose of the trust, and that a suitable co-trustee or successor trustee is available.

Spendthrift Clauses

The PA UTA codifies the effect of a spendthrift clause. A spendthrift clause is valid as against any creditor except a beneficiary's child, spouse or former spouse who has a judgment or court order against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of the beneficiary's interest in the trust. The same rules apply whether the action is by the beneficiary against the trustee, or by a creditor of the beneficiary against the trustee to compel or enjoin a distribution from the trust. A judgment for child support can reach both principal and income of a trust. Judgments for support of a spouse or former spouse can reach only trust income, as under current Pennsylvania law. A spendthrift provision does not bar a claim against the grantor. All of these rules, except the one exposing trust principal to judgments for child support, essentially restate existing Pennsylvania law.

Trusts Presumed *Revocable*

Trusts created on or after the effective date of the Act are presumed to be amendable and revocable. This reverses existing Pennsylvania law and facilitates correction of mistakes in drafting. However, it also places a premium upon the careful drafting of trusts that are intended to shift transfer tax and/or income tax burdens.

Trustees' Compensation

Intended to codify existing Pennsylvania law, Section 7768 clarifies some ambiguities in and replaces 20 Pa. Cons. Stat. Section 7185, which addresses the compensation of trustees.

Limited Codification of Laches Doctrine

Under Section 7785 of the PA UTA, a trustee who communicates essential trust information to the beneficiaries may implement a procedure that bars claims by a beneficiary after the passage of a specific period of time. To do so, the trustee must provide written reports of trust assets and transactions to the beneficiary for a period of at least five years and notify the beneficiary of the time by which challenges to trust transactions must be asserted. A claim with respect to a transaction that occurred in the first of those five years is barred six months after the beneficiary has received all such information for the five-year period unless the claim is presented to the trustee in writing before the end of that period. The requirement that basic information be provided for a period of at least five years recognizes that some breaches of trust, particularly investment losses, are not apparent except in a broad context.

Mandatory Rules

The PA UTA recites a series of mandatory rules that may not be countermanded in the trust instrument. These include the notice requirements, the formalities for creation of a trust, and the Court's authority in a variety of trust matters.

Oral Trusts

Trusts must be in writing. Oral trusts will no longer be recognized, if ever they were in Pennsylvania. This rule is prospective only.

Applicability

The PA UTA will apply to trusts created before or after its enactment, with a few transitional rules that were needed for existing trusts.

Important Definitions (PA UTA §7703)

The following terms and their definitions set forth in Section 7703 of the PA UTA are particularly important to an understanding of the PA UTA and are its hub:

"Current beneficiaries." A person 18 years of age or older to or for whom income or principal of a trust must be distributed currently or a person 25 years of age or older to or for whom income or principal of a trust may, in the trustee's discretion, be distributed currently. **[This defines the class of beneficiaries to whom the notices required by Section 7780.3 must be given.]**

"Qualified beneficiaries." Assuming non-exercise of all tes-

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tamentary powers of appointment, a beneficiary who, on the date the beneficiary's qualification is determined:

(1) is a distributee or permissible distributee of trust income or principal;
(2) would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (1) terminated on that date; or
(3) would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date. **[This particular species of "beneficiary" appears in several provisions of the Act that address nonjudicial changes in the trust relationship. Notable is the provision for a change in the trust's situs with the written consent of all "qualified beneficiaries."]**

"Revocable trust." A trust is revocable to the extent the settlor, immediately before the time as of which the determination is made, had the power, acting without the consent of the trustee or any person holding an interest adverse to revocation, to prevent the transfer of the trust property at the settlor's death by revocation or amendment of or withdrawal of property from the trust. The term does not include a trust that terminates to the settlor's personal representative or estate as a result of the settlor's death. **[This definition frames the breadth of Subchapter F of the PA UTA that places such trusts on the same footing as testamentary trusts.]**

"Trust instrument." A will or other written instrument executed by the settlor that contains trust provisions, including any amendments thereto. **[By implication, this excludes oral trusts and oral amendments to written trusts executed after the effective date of the Act.]**

REPEAL OF FLORIDA INTANGIBLES TAX

As previously reported in an email alert, the tax imposed by Florida on intangible property has been repealed. The repeal legislation was passed by the Florida legislature in April of 2006 and signed by Governor John E. Bush in July of 2006. Some planning techniques had been used to avoid the incidence of the tax, including transfers in trust, but no such planning will be necessary in the future. The repeal will be effective January 1, 2007, which is the next date as of which the tax could have been imposed.

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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Pension Protection Act of 2006 Offers Relief to Nonspouse Beneficiaries of Qualified Plans

By KATHLEEN A. STEPHENSON, ESQUIRE
PEPPER HAMILTON LLP

Effective for distributions after December 31, 2006, a nonspouse designated beneficiary of a deceased participant's interest in an "eligible retirement plan" the terms of which mandate a lump sum distribution may roll his or her interest into an individual retirement account. Included in the definition of an "eligible retirement plan" under IRC§402(c)(8)(B) are qualified trusts under IRC§401(a); individual retirement accounts under IRC§408(a) and certain individual retirement annuities under IRC§408(b).

The rollover must be a direct "trustee to trustee" transfer and must be made to an inherited individual retirement account created for the specific purpose of receiving the transferred funds. The rollover can be made only by the designated beneficiary or by the trustee of a trust which qualifies as a designated beneficiary. The inherited IRA must be in the name of the deceased participant and the designated beneficiary making the rollover must be the beneficiary of the IRA. Once transferred to the inherited IRA, the proceeds may not be subsequently rolled over to another IRA. A rollover is not available if the plan proceeds are payable to the estate of the deceased participant.

The effect of the rollover is to permit the designated beneficiary to use the minimum distribution rules applicable to inherited IRAs to extend withdrawal of the plan proceeds. Thus, if the participant was receiving minimum distributions at his or her death, the nonspouse beneficiary must withdraw the transferred proceeds from the inherited IRA at least as rapidly as was the deceased participant. If the participant dies before his or her required beginning date, the nonspouse beneficiary must withdraw the entire balance of the inherited IRA within five years following the participant's death or, within one year after the participant's death, the nonspouse beneficiary must commence taking withdrawals from the inherited IRA based on his or her own life expectancy.

Fourteen Going on Eighteen: The Kiddie Tax Grew Up Fast

By DREW A. MORRIS, ESQUIRE
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If you ask a parent how their children impact their lives, every parent has a different answer and many can go on for hours. However, ask a parent how children impact their tax return, and you might get a blank stare. Most parents know about tax credits and exemptions related to children, but few know more than that. In the past, wealthy, tax-savvy parents utilized their children to lower their tax bill by transferring investment assets into their minor children's names. This technique, called income shifting, worked by taking income out of the parents' higher tax bracket and placing it in the lower tax brackets of their children. Congress, of course, caught on, and to curtail the use of this technique, Congress enacted the "kiddie tax". Under prior legislation the kiddie tax provided that children under 14, who had more than a small amount of unearned (investment) income and at least one living parent, had to pay tax at their parents' highest marginal tax rate (the rate of tax on the last dollar earned). The threshold amount at which the kiddie tax kicks in is two times the amount allowed as a standard deduction for a dependent who has only investment income (for 2006, that amount is $850, so the kiddie tax applies when the child has more than $1,700 in unearned income).

In the recently enacted Tax Increase Prevention and Reconciliation Act, effective January 1, 2006, (the "Act") Congress raised the age, from 14 years of age to 18 years of

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Kiddie Tax, continued

age, at which the unearned income of minor children is taxed at the parents' highest marginal tax rate. In addition, the new law specifically exempts from the kiddie tax a child who is married and files a joint return for the tax year. Thus, under the Act the kiddie tax applies to a child who has not reached his or her 18th birthday by December 31, 2006, who has more than $1,700 of unearned income, who has at least one living parent at the close of the tax year, and who doesn't file a joint return for 2006.

The Act provides an additional exemption to the kiddie tax for distributions from certain qualified disability trusts, which are defined in Internal Revenue Code ("IRC") section 642(b)(2)(C)(ii), as: ... a disability trust described in Section 1917(c)(2)(B)(iv) of the Social Security Act (SSA) (42 U.S.C. 1396p); and ... all of the beneficiaries of which as of the close of the tax year are determined by the Commissioner of Social Security to have been disabled for some portion of that year (within the meaning of section 1614(a)(3) of the SSA, 42 U.S.C. 1382c(a)(3)). Specifically, for purposes of the kiddie tax, in the case of any child who is a beneficiary of a qualified disability trust, any amount included in the child's income under IRC section 652 (applicable to simple trusts) and IRC section 662 (applicable to complex trusts) during a tax year is treated as earned income of the child for the tax year. Therefore, distributions from the trust of taxable interest, dividends, capital gains, or other investment income from the trust are considered earned income for kiddie tax purposes, and thus are taxed at the child's tax rate.

Although the opportunity to lower taxes by transferring income-producing assets to children under 18 is curtailed by the Act changes to the kiddie tax, investing a child's funds in investments that produce no current taxable income can help avoid the kiddie tax. Investments that produce no taxable income, and therefore are not subject to the kiddie tax, include tax-advantaged savings vehicles such as traditional and Roth IRAs (which can be established or contributed to if the child has earned income) qualified tuition programs ("529 plans") and Coverdell education savings accounts.

Speaking of 529 plans, recently enacted legislation in the Commonwealth of Pennsylvania now provides a deduction from Pennsylvania taxable income, for tax years beginning after December 31, 2005, for contributions to any qualified tuition plan under IRC section 529, including those offered by states other than Pennsylvania. Previously, there were no itemized deductions or authorized exemptions for amounts contributed to college savings plans. The amount deducted for each designated beneficiary may not exceed the federal annual gift limitation, which is currently $12,000; nor can any deduction result in taxable income of less than zero. Distributions used for qualified higher education expenses and undistributed earnings are not taxable; and federally qualified rollovers and beneficiary changes will not be considered taxable events for Pennsylvania purposes. Distributions that are not used for qualified higher education expenses are subject to tax.

June 26, 2006

Office of the Secretary
The Disciplinary Board of the Supreme Court of Pennsylvania
First Floor, Two Lemoyne Drive
Lemoyne, PA 17043

RE: Comments to proposed revisions to Pennsylvania Rule of Professional Conduct 1.15 and Rule of Disciplinary Enforcement 221 published in PA Bulletin 6/10/06

To the Members of the Board:

The Probate and Trust Law Section of the Philadelphia Bar Association is deeply concerned that the proposed amendments to Pennsylvania Rule of Professional Conduct 1.15 and Rule of Disciplinary Enforcement 221 (together the "Rules") which appeared in the Pennsylvania Bulletin on June 10, 2006, are flawed to such an extent that attorneys no longer will be able to serve as fiduciaries in the Commonwealth. The Section is apprehensive that such Rules could greatly disrupt the administration of certain estates and trusts in the Commonwealth. As the comment period is very short (responses required by July 3rd), we provide comments only on the major issues and have not attempted to address all technical drafting issues. The Section would be pleased to provide more specific drafting input at the Board's request.

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In short, the Rules are extremely complicated, ambiguous and confusing as to the duties imposed on an attorney serving as a fiduciary with respect to property held and administered in a fiduciary capacity. This is no reflection on the drafters. It is an inherently impossible task to integrate fiduciary investment obligations within the framework of an existing rule intended largely to address the regulation of cash that lawyers receive and hold for clients in the course of a representation without causing some confusion and conflict for an attorney-fiduciary.[1]

The threshold problem with any Rule of Professional Conduct that purports to govern the substantive conduct of a lawyer serving as a fiduciary is that the conduct and duties of certain fiduciaries such as an executor, trustee, and guardian are already governed by a comprehensive body of substantive common law, statutes and rules (which law can be altered in a myriad of ways by the applicable will or trust) specifically designed to protect the beneficiaries' interests. Such law includes, but is not limited to investments, accounting, notice and distribution. Trying to fit the administration of client funds and estate or trust funds together in a common rule can only result in conflicts and an analytical quagmire.

Although the recent proposed amendments attempt to address the most striking problem with prior proposals (i.e., the investment conflicts between Rule 1.15 and fiduciary law), it is not clear that this problem has been solved. When reading paragraphs (j) and (k) of Rule 1.15, it appears that an attorney-fiduciary may place fiduciary funds in any investment which satisfies the Prudent Investor Rule of the Pennsylvania Probate, Estates and Fiduciaries Code. In other words, the attorney-fiduciary is not required to place fiduciary funds in a "Trust Account" or "other investment agreed upon by the lawyer and the client or third person." This is a good start, and, as explained below, is the only way the Rules can work.[2] However, such intent is not entirely clear from the Rules. Paragraph (k) provides that all "Fiduciary Funds shall be invested in a Trust Account or in another investment which satisfies the requirements of the Prudent Investor Rule as set forth in. the Pennsylvania Probate, Estates and Fiduciaries Code and this Rule. " (emphasis added). "This Rule" might be construed to require that fiduciary funds must be placed in a Trust Account and otherwise comply with the rules for Trust Accounts. When reading the definitions and the other provisions of both Rules together, one might conclude that, notwithstanding paragraphs (j) and (k), Fiduciary Funds are in fact required to be held in a Trust Account subject to all of the other requirements of the Rules for Trust Accounts, including the requirement that such funds be placed in an account in an Eligible Institution which agrees to file with the Disciplinary Board an Agreement to report (and will in fact report) to the Lawyers Fund For Client Security Board whenever the Trust Account is overdrawn.

Without question, the Rules must not in any way impinge upon. the attorney-fiduciary's investment obligations and opportunities if attorneys are to continue to serve as fiduciaries in the Commonwealth. If the Rules limit the universe of investment opportunities available to an attorney-fiduciary (and thus to the beneficiaries of the fiduciary estate administered by the attorney-fiduciary) to those financial institutions which have implemented overdraft reporting systems and have filed an Agreement to that effect with the Board, the beneficiaries of such estate or trust are necessarily disadvantaged.[3] In fact, it might be a breach of fiduciary duty for an attorney named as fiduciary even to accept an appointment to serve in light of the fact that a corporate fiduciary or any other non-attorney individual serving in the same capacity would have no such limitations.[4]

Finally, if the goal of the amendments is to allow the Board to identify and discipline lawyers who steal estate or trust funds (which obviously is a laudatory goal), the new Rules do not accomplish this. The Rules are at once overinclusive and underinclusive. If, for example, the Rules are read to require that Fiduciary Funds be placed in a Trust Account, the cost of such rule (effectively preventing lawyers from serving as fiduciaries) is far out of proportion to the potential benefit (finding out that a lawyer-fiduciary--who has been daft enough to steal enough to overdraw the account-- has in fact overdrawn an estate or trust account, at which point it is too late for the victimized beneficiaries).[5] If on the other hand the Rules are read (as we believe they should) to mean that Fiduciary Funds placed in an investment account otherwise authorized by the PEF Code are by definition not "Trust Accounts," then the Rules as written go so far as to exempt an attorney-fiduciary from meeting the specific record-keeping requirements of the Rules, which would otherwise seem to be a reasonable requirement.

Our intention in making these comments is to ensure that attorney-fiduciaries have a clear and reasonable rule that allows them to meet both their obligations as lawyers and fiduciaries. To that end, is it not possible to

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leave the old IOLTA/trust account rules in place and simply create a new paragraph at the end of the Rule which is dedicated specifically to all property a lawyer holds as a fiduciary? Then, the old IOLTA/trust account regime is not muddied by these issues and we can have a clear rule that possibly even works better to identify thieving lawyer-fiduciaries. Instead of relying upon overdraft reporting, perhaps there is a better alternative. We would be pleased to consult with the Office of Disciplinary Counsel and/or the Board or to otherwise assist in any way we can to address the problems meant to be remedied by the proposed amendments.

Finally, the comments expressed in this letter are solely those of the Probate and Trust Law Section. The Philadelphia Bar Association will be asked to adopt the position of this Section, but the time restraints imposed by the short comment period may preclude its taking a formal position.

Thank you for your consideration of this letter.

Very truly yours,

Mary Jane Barrett

cc: Kathleen A. Stephenson, Esquire
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[1]For starters, the Rules: (1) direct that securities should be kept in a safe deposit box (according to comment [1}); (2) arguably require that fiduciary funds be invested in an eligible Pennsylvania institution required to report overdrafts, which conflicts with a fiduciary's investment obligations; (3) require notice, delivery and accounting rules that are incompatible with other applicable state law; and (4) do not contemplate that lawyers often serve as a co-fiduciary with another individual or corporate fiduciary that may keep the books and records.

[2]We note that this language must still be amended, however, in that the Prudent Investor Rule may not be the appropriate investment standard in a particular estate or trust; the provisions of the specific governing instrument may significantly alter the fiduciary's duties under state law. Additionally, the law of another jurisdiction may apply to a particular estate or trust.

[3]By way of example, consider the attorney serving as an executor of a $20 million estate which continues in trust for the decedent's children. Assume most of the decedent's investable assets (not real estate, IRAs/qualified plans, life insurance, etc.) are held in a brokerage account at ABC Investment House. The attorney wishes to continue to use ABC as the institution through which the estate assets are managed, but ABC is a New York institution, is not on the approved list and has no intention of ever being on that list.

[4]Financial institutions are not likely to implement overdraft reporting systems in their wealth management or trust departments. As we understand it, the current "overdraft reporting" system is easy for IOLTA/'trust Accounts because it involves simple depository accounts with extremely standardized, mechanized systems with little variation. On the other hand, investment accounts are not depository accounts and arc much more complicated and non-standard than simple depository bank accounts. We have been told that the proposed new rule, if applicable to fiduciary accounts, would require a vast re-working of systems, compliance, training, re-writing of agency and investment agreements and it will not be worthwhile, from a financial perspective, for financial institutions to

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ETHICS COLUMN

By PAUL C. HEINTZ, ESQUIRE
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When the question "in bin" begins to overflow, a potpourri column becomes necessary. That is the occasion for this column's format.

Question:
Is it ethical to provide a "second opinion" to a client already represented by another lawyer?

Answer:
Furnishing a second opinion does not constitute a breach of the Rules of Professional Conduct, specifically Rule 4.2, pertaining to communicating with a client already represented by a lawyer. See the Philadelphia Bar Association's Professional Guidance Committee Opinions 2004-1 and 91-32.

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comply with the rule. Moreover, the whole concept of what constitutes an overdraft would have to be redefined in the fiduciary context of income and principal accounting. Thus, as a practical matter, not all, and perhaps very few, financial institutions are going to "sign up" to report overdrafts for non-depository accounts, thus limiting the investment options available for the beneficiaries of an estate or trust administered by an attorney-fiduciary.

[5]We note also that the stocks and bonds of the estate or trust seem never came within the purview of the Rules in any event (other than the general rules of (b), (c) and (d)) because of the use of the term "funds" and the definition of non-qualified funds.

Question:
May a lawyer, when either serving as an executor or as counsel for an executor, retain estate funds in the lawyer's trustee account and pay estate bills and distributions from that account?

Answer:
The retention of fiduciary funds in a lawyer's trustee account is improper. Rule 1.15(a) specifically requires a lawyer to keep such property separate from the lawyer's own property. The Pennsylvania Code pertaining to the retention of fiduciary funds also makes that clear: 204 Pa. Code §81.104(a) and (e). See *Krause Estate*, 25 Fiduc. Rep. 2d 430 (Allegh. O.C. 2004) and *Albright Estate*, 545 A.2d 896 (Pa. Super. 1988).

Question:
May a lawyer representing a bank as a corporate fiduciary ask that bank to consent in advance to the representation by that lawyer of clients with interests adverse to the bank in commercial matters?

Answer:
Comment 22, added to Model Rule 1.7 as part of the ABA 2002 revision of the Model Rules of Professional Conduct, would seem to permit advance waivers of such potential conflicts. Furthermore, the ABA Standing Committee on Ethics and Professional Responsibility in its opinion 05-436 opines that a lawyer may obtain a client's consent to possible future conflicts even though such conflicts cannot be specified. The four criteria are: (1) The client must be a sophisticated user of legal services (2) and independently represented by counsel and (3) the future conflicts must be unrelated to the subject of the current representation and (4) there should be no circumstances envisioned that could materialize in the future that would make the conflict non-consentable.

Question:
When representing the beneficiary of a trust fund from which the trustee has embezzled funds, is it proper for the lawyer to pressure the trustee to return the funds by threatening to report the trustee and its actions to the local District Attorney?

Answer:
If there is a legitimate applicable criminal remedy, there is no prohibition to the use of threats to bring, or have the District Attorney bring, criminal actions in an effort to press for the resolution of civil matters. See Rule 8.4 (c) and Philadelphia Bar Association Guidance Committee Opinions 89-17 and 88-20.

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

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TAX UPDATE

By JOAN AGRAN, ESQUIRE
MCCAUSLAND, KEEN & BUCKMAN

I. COURT DECISIONS

Contingent Revocable Spousal Interests in GRATs Not Qualified Interests for Code Sec. 2702 Purposes

In *Focardi Est. v. Comr.*, T.C. Memo 2006-56 (3/27/06), in 1996, decedent and his spouse each transferred stock to separate two-year and four-year GRATs. Except for the annuity terms and the percentages used to calculate the annuity payments, the four GRATs had identical provisions. If a grantor died before the end of the annuity term, the trustee was to hold the remaining trust assets in a marital trust for the grantor's spouse, if living, with the annuity amount then payable to the spouse for the remainder of the annuity term. Each grantor retained the right to revoke the surviving spouse's contingent interest. Each GRAT stated that the grantor intended the grantor's retained annuity interest and the spouse's annuity interest, if any, to be Code Sec. 2702(b)(1) qualified annuity interests and that no right or power under the GRAT would be effective to the extent the right or power caused the grantor's retained annuity interest or the spouse's interest, if any, to fail to qualify under Code Sec. 2702(b)(1).

The Service determined that the 1996 gift taxes should be calculated by reducing the value of decedent's and his spouse's transferred stock by the value of single-life annuities. The Service claimed that the spousal interests in the GRATs were not qualified interests because the interests, which were contingent on the grantor failing to survive the applicable GRAT term, were not fixed and ascertainable and were not payable for the term holder's life, a term

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Answer:
The answer to these questions, perhaps the questions most frequently asked of Ethics Committees, was featured in the Ethics Column in December 2005. Rules 1.15 and 1.16 should be considered, but are not comprehensive. For more comprehensive treatment, see ABA Formal Opinions 1376 and 1384 (1977), Pennsylvania Bar Association Ethics Committee Opinion 99120 and Philadelphia Bar Association Guidance Committee Opinions 88-17 and 87-1. See also §46 of the Restatement 3d of the Law Governing Lawyers (2000).

Question:
Do the Rules of Professional Conduct specifically prohibit a lawyer's entering into a consensual sexual relationship with a client?

Answer:
The question was the subject of an earlier article in the Ethics Column which referred to opinion 97-100 issued by the Pennsylvania Bar Association's Committee on Legal Ethics and Professional Responsibility. That opinion noted there was then no specific prohibition but said that such a relationship would constitute a breach of the Rules of Professional Conduct. The most recent amendment of the Rules makes it clear: New Rule 1.8(j) specifically states that "A lawyer shall not have sexual relations with a client unless a consensual relationship existed between them when the client-lawyer relationship commenced."

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Send your questions and ideas to:

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or years, or the shorter of those periods, as required by the Code Sec. 2702 regulations. Decedent's estate and spouse claimed, based on *Schott v. Comr.*, 319 F.3d 1203 (9th Cir. 2003), that the spousal interests in the GRATs were qualified.

On the basis of these facts the Tax Court held that the revocable spousal interests in the four GRATs were not Code Sec. 2702(b) qualified interests. In this case, the spouse will never receive any payments if the grantor survives the annuity term and, thus, the spousal interests were not fixed and ascertainable at the GRATs' inception. Citing *Cook v. Comr.*, 115 T.C. 15 (2000), aff'd, 269 F.3d 854 (7th Cir. 2001), the court stated that neither Code Sec. 2702 nor the regulations thereunder allow transferors like decedent and spouse "to reduce the value of a remainder interest simply by assigning a value to a spousal interest which may never take effect." The court also indicated that the spousal interests failed as qualified interests under the Regs. §25.2702-3(d)(3) duration requirements.

As to the taxpayers' reliance on *Schott*, the court distinguished the GRAT at issue there from the GRAT in *Cook* on the ground that *Cook* involved an expressed contingency that the spouses remain married at the grantor's death. The GRATs at issue revealed "a strong implicit understanding of a marriage contingency for any payment under the spousal interests."

The court noted that the Treasury had amended the Code Sec. 2702 regulations in 2005 to clarify the revocable spousal interest rules. Although the 2005 amendments to Code Sec. 2702 were not applicable to decedent's and spouse's GRATs, under the amendments revocable spousal interests like decedent's and spouse's would not be qualified interests.

Court Values Gifts of Partnership and LLC Interests With Minority and Marketability Discounts

In *Temple v. U.S.*, AFTR 2d, 2006-660 (E.D. Tex. 3/10/06), taxpayer with his son formed a limited partnership that owned and operated a ranch and with his daughter formed an LLC that owned and operated a vineyard. Taxpayer also formed two family limited partnerships, one with each of his children, that owned stock of two publicly traded companies. In 1997 and 1998, taxpayer gave gifts of his interests in these four entities to his two children, his daughter-in-law and his eight grandchildren. The Service increased the value of the gifts and assessed additional gift tax. Taxpayer and his wife paid these assessments and timely filed for a refund which was denied.

On the basis of these facts, the district court held that taxpayer was entitled to recover over $7 million in federal gift tax and related interest. Citing *Jones Est. v. Comr.*, 116 T.C. 121, 130 (2001), the court concluded that taxpayer's gifts of limited partnership interests and LLC interests in the ranching business and vineyards should be discounted by 33% for a combined lack of marketability and lack of control and that an additional incremental lack of marketability discount of 7.5% applied to the limited partnership interests because of their status as private and nonregistered interests.

The Court also allowed lack of control discount for one large 76.6% interest gift despite the majority size of the interest but that didn't necessarily carry dissolution power under applicable California law. Also, moderate discounts for gifted interests in the partnership formed to hold publicly traded stock and other assets were applied.

Restrictive Agreement Fixes Estate Tax Value of Closely Held Stock

In *Estate of Pearl I. Amlie,* TC Memo 2006-76 (4/17/06), decedent, whose financial affairs were managed by a conservator, owned a minority stock interest in a closely held bank. Her stock was the center of disputes between her children and was subject to several restrictive transfer agreements, including a 1995 family settlement agreement that would obligate her estate to sell the stock at $118 per share. The agreement further required that all bequests to her son or a trust for his benefit under decedent's Will be satisfied 'in kind' with the bank stock and that any stock remaining in decedent's estate after satisfaction of her bequests to her son would be subject to reciprocal put/call options for a designated post-death period under which decedent's personal representative could require son to purchase, or the son could require decedent's personal representative to sell to son, the remaining bank stock at the $118 price.

Son later entered into an agreement with the bank to sell his stock and his trust's stock at a substantially higher price. Following decedent's death, son's trust exercised its call option to purchase all the bank stock remaining in decedent's estate after satisfaction of the bequests of such stock to the son's trust. Son's trust then sold the stock to the bank at the higher agreed upon price.

The estate tax return stated the value of the stock as that set by the 1995 Family settlement agreement. The additional amount received by son's trust from the bank was reported as capital gain on the trust's income tax return. The

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Service issued a notice of deficiency finding that the estate tax value of the bank stock was the higher purchase price under the son's agreement with the bank.

On the basis of these facts, the Tax Court found that the 1995 agreement operated to restrict the value of all of decedent's bank stock. The conservator and decedent were prohibited from transferring her bank stock without the consent of the son or his trust. At her death, all of her bank stock had to be transferred to the son's trust at the $118 price. Accordingly, the Tax Court concluded that the 1995 agreement satisfied the pre- Code Sec. 2703 requirements that it set a fixed and determinable price, and that it be legally binding during life and at death. The Tax Court also found that the requirement of Code Sec. 2703(b)(1), that a restrictive agreement must further some business purpose, was met because the conservator, in securing the 1995 agreement, was seeking to exercise prudent management of decedent's assets by mitigating the risks of holding a minority interest in a closely held bank.

The Tax Court also disagreed with the Service's position that the agreement was a testamentary device in violation of Code Sec. 2702(b)(2) because only son benefited from it. Decedent received significant consideration under the 1995 agreement - specifically, a fixed price for a minority stock interest, the value of which was otherwise uncertain and subject to substantial litigation hazards. The prospective heirs other than son entered into an arm's-length decision, agreeing to the price in the 1995 agreement and, therefore, the Tax Court also concluded that the record supported the conclusion that the terms of the 1995 agreement were comparable to arrangements entered into at arm's length and thus met the requirement of Code Sec. 2703(b)(3).

Estate Can Sell Marital Residence to Pay Taxes Despite Elective Share Rules

In *DeShazo v. Smith*, 97 AFTR 2d 2006-843 (E.D. Va. 4/18/06), decedent, the sole owner of his residence, died in 1994, a resident of Virginia. Under his Will, the residence passed to a marital trust for his wife. Because wife renounced decedent's Will and claimed an elective share of decedent's estate, the residence was never placed into the marital trust. Although decedent's estate tax return listed the residence as "received" by wife and claimed a marital deduction for it, decedent's co-executors never properly deeded the residence to wife.

In 1995, the Service assessed nearly $1 million in federal estate taxes against decedent's estate and in 2005 filed a notice of federal tax lien specific to the residence. The estate's receiver, who did not hold adequate funds to pay the estate's tax obligations, planned to sell the residence to fulfill the estate's federal tax obligations, whereupon wife filed an action to block the sale. Various claims and cross claims were filed by the executors, decedent's children, the receiver, wife and the Service.

In late 2005, the court stayed all cross claims until a decision could be rendered as to whether the receiver could sell the residence to satisfy the federal estate tax. In 2006, the executors, the Service, and wife all filed motions for summary judgment. Wife claimed that the elective share protects the residence, for which the estate claimed a marital deduction, from federal estate tax claims and that her rights in the residence passing to her under the state's elective share statute vested at the date of decedent's death, even though the residence was not properly deeded to her. She further argued that decedent's Will specifically directed that no estate taxes be charged against the marital share of the residue of his estate "unless said taxes are attributable to the marital share."

On the basis of these facts, the district court granted the executors' and the Service's summary judgment motions and denied wife's summary judgment motion, holding that the residence belonged to decedent's estate and, therefore, the federal liens arising from the Service's assessments were valid. The court cited the fact that decedent was the sole owner of the residence at death, wife had no proof of a deed, local records had listed the property as the estate's for many consecutive years, and Schedule M of decedent's estate tax return was not binding authority of any transfer. The court also indicated that it was not persuaded that the Will's tax provision supported wife's claim; the marital share the Will referred to is exactly what wife rebuked when she elected to take against decedent's Will and that she could not find relief in the protections afforded to the marital trust that wife knowingly rejected. Because the residence was never legally transferred to wife, it remained the estate's property. The lien on the residence arose when the Service assessed the property, the lien was valid at that time and remained valid and the Service was not barred from acting on its valid lien simply because wife was supposed to receive the residence early in the estate's management.

The court distinguished *Alexandria National Bank v. Thomas*, 213 Va. 620 (1973), which held that an executor did not have authority under Virginia law to

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apportion federal tax liabilities to elective share property because marital deduction property was not included in the decedent's taxable estate. The court noted that this case did not involve federal tax liens or an insolvent estate. The court also found unpersuasive *Reno Est. v. Comr.*, 945 F.2d 733 (4th Cir. 1991), which held that tenancy by the entireties property passing to a surviving spouse escaped any federal estate tax burdens because such property passed outside the Will and the spouse became the fee simple owner at the decedent's death by operation of law. The court found this to be significantly different than elective share property.

Retirement Plan Payment Processed After Participant's Death Not IRD

In *Andrew J. Eberly*, TC Summary Opinion 2006-46, decedent died on February 28, 2000, survived by three sons, including the taxpayer involved in this case. At the time of his death, decedent was a participant in a Code Sec. 403(b) tax-sheltered annuity plan sponsored by TIAA-CREF. Decedent had retired in late 1999, and was required to begin distributions no later than April 1, 2000.

Under the TIAA-CREF annuity's death benefits provision, if the participant dies before the annuity starting date, TIAA-CREF pays the participant's accumulated annuity funds to the participant's named beneficiaries. On February 21, 2000, before the annuity start date, decedent executed a Request for Retirement Annuity Withdrawal directing TIAA-CREF to withdraw $600,000 from his accumulated annuity fund balance and deposit it into his savings account. The withdrawal request was signed and dated by decedent and mailed to TIAA-CREF's home office in New York City by priority mail. The withdrawal request was received at the home office on February 28, 2000, and, as provided by the TIAA-CREF annuity, made effective as of that date.

On February 21, 2000, decedent also executed a Beneficiary Designation, which was mailed to TIAA-CREF's home office by priority mail and received on February 29, 2000. It named his three sons as beneficiaries, each entitled to a death benefit equal to 25% of the annuity fund balance, with the remaining 25% to be equally divided among three specifically identified charitable organizations.

On February 28, 2000, TIAA-CREF was orally notified of decedent's death. Pursuant to his withdrawal request, on March 3, 2000, TIAA-CREF electronically transferred $480,308 to his bank account. This amount included interest for the three days from the date the withdrawal request was received until March 3, less $120,000 of federal income tax withholding. For the year 2000, TIAA-CREF issued to decedent a Form 1099-R, reporting the gross amount and taxable amount of the distribution to him, as well as the withheld tax. The amount distributed was divided among his three children by the personal representative of his estate in accordance with his Will.

On decedent's 2000 income tax return, the personal representative reported the lump-sum distribution from TIAA-CREF as reflected on the Form 1099-R, but erroneously reported the taxable amount of the distribution to be $149,949. Taxpayer's son did not include the $150,000 distribution received from his father's estate on his 2000 return. The Service issued a notice of deficiency stating that the $150,000 received by taxpayer was includible in his 2000 return as IRD. The son acknowledged that the personal representative did not report the correct amount on decedent's final return, but said that the lump-sum was properly reportable on that return and that the $150,000 wasn't IRD.

On the basis of these facts, the Tax Court held that the lump-sum distribution was properly includable in decedent's 2000 gross income. Accordingly, it held that the $150,000 received by son was not includible in his gross income as IRD under Code Sec. 691(a).

Sales of Closely Held Shares Between Family Members are Arm's-Length Transactions

In *Huber v. Commissioner*, T.C. Memo. 2006-96, May 9, 2006, between 1997 and 2002, taxpayers, a number of members of the Huber family, made various gifts of stock in a family owned corporation. The corporation, with sales in excess of $500 million, has approximately 250 shareholders, including members of the Huber family, the Huber Foundation, and various independent nonprofit organizations. The prices used in the stock transactions were based on appraised values, including a consistently applied 50% discount for lack of marketability. The annual appraisals were used for all transactions, including intra-family sales, gifts to nonprofit organizations and corporate redemptions.

The Service challenged both the appraised value and the arm's-length nature of the shareholder transactions. The Court focused on the arm's-length argument as the threshold issue and did not deal with the Service's attack on the taxpayer appraisal.

Rejecting the Service's arguments, the Court concluded that

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the sales were arm's-length because (i) the family connections were not particularly close, (ii) the sellers were not under any compulsion to sell and many of the transactions took place between parties that were unrelated and who had fiduciary obligations to obtain the best price, (iii) the sellers reasonably relied on the independent valuation prepared by the appraiser, and (iv) there was no evidence of an intention to make a gift to the buyers.

Charitable Deduction Denied for Split Interest Trust

In *Galloway v. U.S.*, No. 05-50 Erie (W.D. Pa.5/9/06), at decedent's death in 1998, his revocable trust provided for the residue to pass in four equal shares to his son, granddaughter, and two charities on two separate dates. Each residual beneficiary received half of his, her, or its share in early 2006 and is to receive the balance of his, her, or its share in 2016, when the trust will terminate. If an individual beneficiary is not living at the time of the final distribution, his or her share will be distributed to the other beneficiaries. If both individual beneficiaries are not living, the entire balance of the trust will pass to the two charities.

Decedent's estate claimed a Code Sec. 2055(a) estate tax charitable deduction for the amount it anticipated would ultimately pass to the two charities. The IRS denied the deduction and assessed additional estate taxes, claiming that the trust was a split-interest trust for which no deduction was allowed under Code Sec. 2055(e)(2).

The district court granted the Service's motion for summary judgment and denied the estate's motion, holding that the trust is a split-interest trust and that the Service correctly denied the estate's charitable deduction on the basis of Code Sec. 2055(e). Although Code Sec. 2055(e)(2) contains a limited exception allowing a deduction for a split-interest trust created in one of three specified forms, it was undisputed that the trust was not in one of these specified forms.

The court rejected the estate's arguments that the trust is, in practical effect, two separate trusts, with the charitable beneficiaries having an undivided 50% interest, and that the statute created an ambiguity and, therefore, it was appropriate to examine the legislative history. In reaching its decision, the court indicated that the trust involved the precise dangers feared by the drafters of Code Sec. 2055(e)(2). Due to the fact that if either of the individual residuary beneficiaries died before final distribution, his or her share would pass to the other residual beneficiaries rather than to his or her heirs, an individual beneficiary might decide to invest the trust's assets in high-income/high risk ventures, seek to maximize short-term income and profits, and deplete the trust before final distribution.

FLP Interests Included in Decedent's Estate Under Code Sec. 2036(a)(1)

In *Estate of Rosen v. Comr.*, T.C. Memo 2006-115 (6/1/06), decedent, who had been in poor health and suffering from Alzheimer's Disease since approximately 1994, died in 2000 at age 92. She was survived by a daughter and a son (who were personal representatives of her estate and trustees of her revocable trust) and other more remote descendants.

Daughter's husband, an attorney, had regularly advised decedent on estate planning. In 1979, decedent began making regular annual gifts to family members, which daughter, as her agent under a power of attorney, continued on decedent's behalf after 1994. After attending a seminar on family limited partnerships, daughter's husband had another attorney form a Florida family limited partnership on decedent's behalf in 1996 to reduce the value of decedent's estate. Five months after the FLP was formed, daughter and son, who had not participated in any discussions about the FLP terms, as trustees of the trust contributed over $2.4 million of the trust's cash and marketable securities to the FLP in exchange for a 99% limited partnership interest. Daughter and son each contributed approximately $12,000 to the FLP for a respective 0.5% general partnership interest.

The trustees set up a brokerage account for the FLP but otherwise did not materially change the management of or investment strategy for the transferred assets nor did they hold meetings or maintain any books or records. Daughter, as decedent's agent, made various gifts of limited partnership interests to family members. Because decedent did not retain sufficient assets for her day-to-day living expenses or for her annual family gifts, the FLP made distributions for decedent's living expenses and family gifts, but did not make any distributions to the other partners. The FLP paid decedent's funeral expenses, estate administration expenses, legal fees, bequests, and estate taxes. At decedent's death, the trust held approximately a 35% limited partnership interest in the FLP.

In 1996, daughter, as decedent's agent, had issued an $80,000 demand note to the FLP after the first FLP distribution on decedent's behalf. The note, which stated that decedent would pay

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interest at the IRS blended annual rate, had no maturity date or security and stated that the FLP could transfer additional funds for decedent's benefit on the same terms. The FLP never demanded payment of the notes. After decedent died, the FLP redeemed the trust's interest in the FLP for $743,263, retaining $401,286 of the redemption price in payment of decedent's debts to the FLP. The Service sought to include the FLP assets in decedent's estate under Code Sec. 2036(a)(1).

On the basis of these facts, the Tax Court first held that the assets decedent transferred to the FLP were included in decedent's estate under Code Sec. 2036(a)(1), finding decedent had an express or implied agreement or understanding to retain lifetime possession or enjoyment of, or the right to income from, the transferred assets. The FLP was not a business operated for profit, decedent's relationship to her assets did not change, and the transfer was made on the advice of counsel to minimize transfer taxes.

The Court then held that decedent's transfer to the FLP was not a bona fide sale for full and adequate consideration, rejecting the estate's arguments that decedent transferred assets to the FLP for legitimate and significant nontax reasons of (i) protecting the assets, (ii) facilitating gifts that preserved value and could not be easily liquidated, (iii) facilitating decedent's annual gift program, and (iv) providing common management. The court concluded that decedent's overwhelming reason for forming the FLP was to avoid estate and gift taxes.

Finally, citing various factors, the court rejected the estate's argument that the FLP's distributions on decedent's behalf were actually loans.

Supreme Court Won't Hear Appeal in Estate of Ida Abraham

The Supreme Court has declined to review the decision in *Estate of Ida Abraham*, (2005, CA1) 95 AFTR 2d P2005-1018, where the First Circuit held that the value of property transferred, on behalf of an incapacitated individual under court supervision, to family limited partnerships was includible in the individual's gross estate under Code Sec. 2036(a)(1). In that case, the First Circuit had affirmed the Tax Court's finding that inclusion was proper because there was an implied agreement to use the income from the transferred property for the incapacitated individual's support. *See* Probate and Trust Law Section Newsletter No. 112, August 2005, for a synopsis of this case.

District Court Finds Remittance of Funds Prior to Assessment to be Deposit, Not Payment

In *Blom v. U.S.*, No. 05-2383 (E.D. Pa.5/31/06), the executrix of an estate believed the estate consisted of two distinct parts - approximately $600,000 of decedent's own assets and approximately $400,000 of decedent's late husband's assets held in trust. The executrix requested the transfer of the trust to decedent's estate, which the trustee declined to do, and the parties ended up in litigation over disbursement of the trust. The executrix had filed for an extension of time to file the estate tax return, and paid a total of $140,000 to the Service in November of 1996. The Service accepted the checks, categorizing them as payment of estimated taxes on the estate, and approved the requested extension.

Due to the litigation, the executrix failed to file the estate tax return within the requisite time period and the Service issued two delinquency notices. When the estate filed its estate tax return, reflecting no taxes due, the Service treated the return as a request for a refund of the $140,000 paid in 1996 and, while acknowledging that no taxes were owed, declined to issue the refund, because the request was made after the three year statute of limitations had run. The executrix filed suit to recover the $140,000, contending that she intended the payment to be a "deposit in the nature of a cash bond," rather than a payment, and that therefore the statute of limitations does not apply and the Service must refund the money under Code Section 6511.

On the basis of these facts, the district court held that, under the facts and circumstances, the remittance was a deposit. The court noted that the executrix (i) did not consult with a tax attorney or accountant to estimate the taxes owed, (ii) had not seriously thought about the potential tax liability prior to actually writing the check, and (iii) made the remittance so that no penalties would be assessed against the estate due to untimeliness. The court further ruled that under §4.04 of Rev. Proc. 84-58, 1984-2 C.B. 501, (later superseded by Rev. Proc. 2005-18, 2005-13 I.R.B. 798) because the remittance was undesignated, it should have been treated by the Service as a deposit in the nature of a cash bond, and therefore, the estate was entitled to a refund under Code Sec. 6511.

Early Distribution From Taxpayer's IRA Subject to 10% Penalty Tax Despite Rollover of Late Husband's IRA

In *Gee v. Comr.*, 127 T.C. No. 1 (7/24/06), the taxpayer was named the primary beneficiary of her husband's IRA. Following husband's death and at taxpayer's request, the entire balance in husband's IRA was

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transferred to taxpayer's IRA, in the form of a direct rollover. Taxpayer, who was age 51 at the time of the rollover, transferred her IRA funds to a different financial institution. In 2002, while still under age 59½, taxpayer requested and received a distribution from her IRA. She reported the IRA distribution on her income tax return for 2002 as 'a distribution of IRA for her deceased husband.'

The Service determined that although the distribution would have been exempt from the 10% additional tax when it was made to taxpayer's IRA upon husband's death, the funds became subject to the 10% additional tax when distributed to taxpayer from her own IRA. The Service also determined that taxpayer was liable for the Code Sec. 6662(a) accuracy-related penalty for substantial understatement of income tax. Taxpayer filed a petition with the Tax Court, contesting these determinations.

On the basis of these facts and in a case of first impression, the Tax Court held that the distribution was subject to the additional tax under Code Sec. 72(t) but that taxpayer was not liable for the accuracy-related penalty under Code Sec. 6662(a). The court explained that the distribution taxpayer received was not occasioned by the death of her deceased husband nor made to her in her capacity as beneficiary of his IRA. Taxpayer received the distribution from her own IRA and the source of the amount received, whether originating from her deceased husband's IRA or her own contributions, was irrelevant. Once taxpayer chose to roll the funds over into her own IRA, she lost the ability to qualify for the exception from the 10% additional tax on early distributions, as the funds became her own and were no longer from her deceased husband's IRA. The Court found no merit to taxpayer 's argument that the rolled over funds retain their character because she did not redesignate her IRA.

However, regarding the Code Sec. 6662(a) penalty, the court found that taxpayer made a reasonable attempt to comply with the Code in circumstances involving an issue of first impression and in light of all the facts and circumstances, the court found that the petitioner acted reasonably and in good faith with respect to the underpayment for 2002 and was not liable for the accuracy-related penalty.

Estate Properly Valued Decedent's Stock in Closely Held Company

In *Kohler v. Comr.*, T.C. Memo 2006-152 (7/25/06), decedent died in March of 1998 at age 54, owning 12.85% of all of the outstanding stock of a company that manufactured plumbing, kitchen and bathroom products. The company also manufactured and sold other products that made its mix unique and in addition owned and operated a resort, spa, and golf courses. 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 three months after decedent's death. Decedent's estate chose to receive new shares and as a result of the reorganization and the elimination of the outside shareholders, the estate's stock ownership increased in May 1998 to 14.45% of the company's outstanding stock.

Based on an appraisal from a well-known appraisal company that was familiar with the company, the estate tax return valued decedent's stock at about $47 million on the alternate valuation date (which was after decedent's estate received the new shares in the reorganization). The Service sought to increase this value to $144.5 million, based on its appraisal. The Service claimed that the estate's pre-reorganization stock should be valued on the alternate valuation date or, alternatively, that the transfer restrictions and purchase option should be ignored in valuing the post-reorganization stock. The Service also imposed Code Sec. 6662 accuracy-related penalties of over $10 million.

On the basis of these facts, the Tax Court held that the value of the stock was the value reported by the estate and therefore did not address the accuracy-related penalties. Rejecting the Service's arguments, the court valued the estate's post-reorganization stock, including the transfer restrictions and purchase option, on the alternate valuation date. Citing Regs. §20.2032-1(c)(1), the court observed that stock exchanged for stock of the same corporation in a tax-free reorganization is not treated as distributed, sold, or otherwise disposed of under Code Sec. 2032(a) and therefore, the stock should be valued on the alternate valuation date because it was not treated as disposed of on the reorganization date.

After reviewing the reports of the parties' experts, the court stated that it gave no weight to the Service's expert's valuation of the stock and that the Service produced no evidence or arguments to persuade the court that the estate's value was incorrect. In contrast, the estate's experts (i) were both certified appraisers, (ii) spent sufficient time with the company and its management, (iii) used the correct projections and (iv) took

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into account the importance of the company's dividend payments in the valuations.

II. IRS REVENUE RULINGS, REVENUE PROCEDURES AND NOTICES

Service Clarifies Requirements for QTIP Trusts Funded with IRAs

In Rev. Rul. 2006-26, 2006-22 I.R.B., the Service has clarified when a surviving spouse is considered to have a qualifying income interest for life in an IRA for which the marital deduction trust is the designated beneficiary. The ruling modifies and, as modified, supersedes Rev. Rul. 2000-2, 2000-3 I.R.B. 305.

Under the facts of the ruling, which presents three different variations on one set of facts, decedent died in 2004 at age 68, owning an IRA and survived by his spouse. He designated as the IRA beneficiary a testamentary marital trust. Decedent's children, all younger than wife, are the remainder beneficiaries of the trust. Wife can require the trust and the IRA to invest in productive assets and has the right to compel the trustee to withdraw the IRA income from the IRA each year and distribute that amount to her. The IRA document does not prohibit withdrawal of amounts in excess of the Code Sec. 408(a)(6) annual required minimum distribution amount. Decedent's estate elected QTIP treatment for the trust and the IRA under Code Sec. 2056(b)(7). The trustee elected to have annual minimum required distributions paid out over wife's life expectancy.

In Situation 1, the trust is governed by state law that allows the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries, with special provisions applicable to IRAs. Each year, the trustee determines the total return of the trust assets, exclusive of the IRA, and then determines the respective portion of the total return allocated to income and principal. The trustee distributes the amount allocated to income to wife. The trustee makes a similar analysis for the IRA's total return and, if wife exercises her withdrawal power, distributes the income portion to her.

In Situation 2, the trust is governed by state law allowing trust income to be a unitrust amount of 4% of the fair market value of the trust's assets valued annually. The trustee determines 4% of the trust's assets, exclusive of the IRA, and distributes that amount to wife each year. The trustee makes a similar determination for the IRA and, if wife exercises her withdrawal power, distributes that amount to her.

In Situation 3, the trust is governed by state law using a traditional definition of income. In determining the amount of income wife can withdraw from the IRA each year, the trustee applies state law allocation rules without the power to allocate between income and principal. As in Situations 1 and 2, the trustee determines trust income separately from IRA income.

The Service ruled that, under the circumstances described in the three situations, a surviving spouse will be considered to have a qualifying income interest for life for Code Sec. 2056(b)(7) purposes in the trust and in the IRA (or some other defined benefit qualified retirement plan described in Code Sec. 4974(c)). The trust's income and the IRA's income are determined separately in each case and without taking into account the IRA distribution made to the trust. If a marital deduction is desired, the QTIP election must be made for both the IRA and the trust. The Service stated that the results in Situations 1, 2, and 3 would be the same in each case if the trust directed the trustee annually to withdraw all IRA income and distribute at least the IRA income to wife (rather than giving wife the power to compel the trustee to do so each year).

The Service explained that Regs. §20.2056(b)-7(d)(2), by cross-reference to Regs. §20.2056(b)-5(f)(1), provides that a surviving spouse is entitled to all income for life from a trust if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during his or her life that trust law principles accord to a person who is unqualifiedly designated as the trust's life beneficiary. The spouse is also entitled to all income for life if he or she is entitled to all income as determined under an applicable local law that provides for a reasonable apportionment of the trust's total return between the income and remainder beneficiaries and that satisfies Regs. §1.643(b)-1, which defines income as the trust's income for the taxable year as determined under the governing instrument and local law.

The Service noted that wife will not be the sole designated beneficiary of decedent's IRA in situations in which any portion of any distribution from the IRA to the trust may be held in the trust for future distribution (rather than being distributed to wife currently). In such cases, both wife and the remainder beneficiaries must be taken into account as designated beneficiaries for IRA distribution purposes.

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New Guidelines For Extension of Time for Payment of Estate Tax Where Interest in Closely Held Business Consists of Real Estate

In Rev. Rul. 2006-34, 2006-26 I.R.B. 1171, the Service has listed factors that it will consider in determining whether a real estate interest will be an interest in a closely held business under Code Sec. 6166(b)(1), qualifying the estate for extended estate tax payments under Code Sec. 6166(a)(1). In determining whether a decedent's interest was an active trade or business immediately before his death, the Service will consider: (i) the amount of time devoted to the trade or business; (ii) whether an office was maintained during regular business hours; (iii) involvement in finding new tenants and negotiating leases; (iv) provision for landscaping, grounds care, and other services; (v) involvement in repairs and maintenance; and (vi) handling tenant repair requests and complaints. In evaluating these factors, the involvement of the decedent will be examined, as well as that of decedent's employees and agents. Also, because management companies are often used in the management of real estate, the activities of a management company in which the decedent had a significant ownership interest will be considered the activities of the decedent.

The ruling contains five hypothetical situations which illustrate the guidelines. In all but the second situation, the Service concluded that the decedent had been carrying on an active trade or business, because the services to tenants were provided by the decedent or by the employees and agents of entities in which he had a 20% or greater ownership interest.

The Service revokes Rev. Rul. 75-365, 1975-2 C.B. 471, and the portion of Rev. Rul. 75-367, 1975-2 C.B. 472, that had concluded that the rental of single family homes by a decedent was not an active trade or business for Code Sec. 6166(b)(1) purposes.

III. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

QTIP Election Does Not Apply to Assets Not Validly Disclaimed

In *PLR 200612001*, two of decedent's children were named as his co-executors and were also co-attorneys-in-fact for decedent's spouse, who was unable to make financial decisions. On the advice of the decedent's family's attorney, the children executed disclaimers on behalf of spouse so that certain assets would pass directly to decedent's six children and his grandchild rather than to a QTIP trust created by decedent for spouse. The attorney made the Code Sec. 2056(b)(7) election for the assets passing to the QTIP trust, with the exception of the disclaimed property, and did not list the property subject to the disclaimers on Schedule M of the estate tax return.

When the children discovered that the disclaimers were invalid under their terms and under state law, decedent's family entered into a restitution agreement, which was approved by a state court and which provided that decedent's children and grandchild would make restitution to decedent's estate for the value of the purportedly disclaimed property that had been transferred to them.

On the basis of these facts, the Service ruled that the estate's QTIP election did not apply to the purportedly disclaimed property that passed to the trust because such property was not listed on Schedule M of decedent's estate tax return. The Service explained that the property subject to the disclaimers passed to the trust because the disclaimers were invalid and that decedent's executor made a timely QTIP election for only the assets listed on Schedule M. In response to the estate's alternative ruling request for an extension of time to amend the QTIP election to include the purportedly disclaimed property, the Service ruled that Regs. §301.9100 did not apply; the estate was not seeking an extension of time to make the QTIP election but, instead, was seeking to change a previously made election to include additional property. This is not permitted under Regs. §20.2056(b)-7(b)(4)(ii), which provides that a QTIP election, once made, is irrevocable and that, if an executor makes a QTIP election for one or more properties on the estate tax return, the estate cannot make a subsequent QTIP election for other property included in the gross estate after the estate tax return has been filed.

Estate Tax Deferral Not Lost After Partnership Interest is Distributed to Trust Beneficiary

In *PLR 200613020*, the residue of decedent's estate, which included an interest in a partnership that engages in forest products ownership, harvesting, and sale, and invests in other real estate and in securities, passed under her Will to a trust for the benefit of her daughter. The remaining partnership interest was held by an irrevocable trust that decedent established during her lifetime. The trust under decedent's Will provided that when daughter reached a specified age, she could withdraw up to one-half of the trust assets and up to all the remaining trust assets upon attaining a second specified age. Daughter had already attained the first age and, apparently, would soon be attaining the second

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age. Daughter planned to exercise her right to withdraw up to one-half of the trust assets, including one-half of the partnership interest. She planned to withdraw some additional portion of the trust assets upon attaining the second age specified in the Will.

On the federal estate tax return, decedent's executor elected under Code Sec. 6166 to defer payment of the tax attributable to the partnership interest owned by decedent at the time of her death and later transferred to the trust under her Will.

On the basis of these facts, the Service ruled that the distribution of part or all the partnership interest from the trust to daughter would not cause the Code Sec. 6166(a) extension of time for the payment of decedent's estate taxes to cease to apply. In reaching its conclusions, the Service observed that Code Sec. 6166(g)(1)(D) indicates that Code Sec. 6166(g)(1)(A) does not apply to a transfer of a decedent's property to a person entitled by reason of the decedent's death to receive the property under the decedent's Will, the decedent's trust, or applicable law. Under the regulations, an executor's transfer of a closely held business interest to a beneficiary or trustee named in the decedent's Will is not a distribution for purposes of the 50% disposal/withdrawal rule. The Service stated that the ruling assumes that the Code Sec. 6166(a) election was valid and that the partnership is a closely held business.

No Inclusion in Grantor's Estate From Judicial Reformation of Irrevocable Trust Due To Scrivener's Error

In *PLR 200615025*, grantor created a revocable trust, of which he is the primary beneficiary and trustee. The revocable trust provides that, upon grantor's death, if wife survives, the trustee will divide the assets into two trusts, a marital trust and a family trust. Upon wife's subsequent death, any remaining assets in the marital trust will pass to the family trust. Upon the death of the survivor of grantor or his wife, the family trust will be distributed to the children and their descendants, per stirpes.

Grantor also created an irrevocable trust that is primarily for the benefit of his spouse and three of his children, with an unrelated corporation as trustee. The irrevocable trust owns life insurance policies on grantor's life and grantor is prohibited from exercising withdrawal rights in any capacity, including but not limited to a fiduciary capacity. The irrevocable trust provides that, upon grantor's death, specific pecuniary amounts will be distributed to specified beneficiaries. The remainder will be held for the benefit of his wife and children. Following wife's death or at grantor's death if wife does not survive him, the trustee is to distribute the remaining principal to the revocable trust to be added to and administered under the terms of the family trust created thereunder or if no family trust is established, trustee is to distribute the remaining principal to the children and their descendants per stirpes.

Upon subsequent review of the trust provisions, grantor, his wife and their attorneys discovered that the trust mistakenly provided for distribution of the trust assets upon the death of the survivor of spouse and grantor to the revocable trust rather than distribution under the terms of the irrevocable trust, which was not grantor's intention. Because as drafted, upon grantor's death, the assets of the irrevocable trust would be included in grantor's gross estate for estate tax purposes, grantor petitioned the appropriate local court to reform the irrevocable trust.

The court found that the scrivener had made a mistake in drafting the irrevocable trust that did not reflect the intentions of grantor and issued an order reforming the trust, effective as of its date of execution, to read that after the death of the survivor of grantor and his wife, the trustee will distribute trust assets pursuant to Section 6 of the irrevocable trust.

On the basis of these facts, the Service ruled that: (i) the value of the property in the irrevocable trust, as reformed, will not be includible in grantor's gross estate under Code Secs. 2033, 2035, 2036, 2038, 2041, or 2042; (ii) the reformation of the irrevocable trust will not constitute the exercise or release of a general power of appointment by grantor, within the meaning of Code Sec. 2514(b); and (iii) the reformation of the irrevocable trust will not be treated as a deemed transfer of an interest in the irrevocable trust by grantor for gift tax purposes under Code Sec. 2501.

Proceeds of Life Insurance Will Not be includible in Wife's Estate

In *PLR 200617008*, husband created an irrevocable trust for the benefit of his wife. She did not provide any of the funding for the trust. During husband's lifetime, the trustees are directed to pay such amounts of income and principal to wife and husband's issue, as the trustees in their absolute discretion shall determine. On husband's death, the trustees are to set aside a percentage of the Trust corpus as a separate trust for wife's benefit. The Trustees are to pay wife the entire net income and so much of the principal of this separate trust as the trustees in their absolute discretion

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determine. This trust is to terminate upon wife's death and the balance of the corpus is to be paid to husband's then living issue, per stirpes.

The Trust provides that if any person currently eligible to receive any principal or income from any trust created under the terms of the Trust is acting as a trustee, then such trustee shall have no power whatsoever to make or participate in making decisions affecting in any way the disposition of the income or principal of such trust to himself or herself, including determining how much income or principal should be distributed and whether the trust should be terminated.

Husband died and wife, who is a co-trustee, intends to resign as a trustee and, after her resignation, the trust will apply for a policy of insurance on her life. The trust for wife's benefit will be the owner and beneficiary of the policy. It is represented that the principal of the trust will be used to pay the premiums on the policy and that wife will not pay any premiums with respect to the policy or otherwise contribute towards the maintenance of the policy. All the income of the trust will continue to be paid to wife.

On the basis of these facts, the Service ruled that the proceeds of the life insurance policy to be acquired by the trust, as described above, will not be includible in wife's gross estate under Code Sec. 2042(2) or under Code Sec. 2035(a), if wife dies within three years of resigning as co-trustee of the trust. Because wife is resigning as co-trustee prior to the acquisition of the policy, she will never possess, or have the power to exercise, any incidents of ownership in the policy to be acquired by the trust, nor will she relinquish or transfer any incidents of ownership in the policy by resigning as co-trustee prior to the acquisition of the policy. Further, only trust principal will be used to pay the premiums on the policy. Citing Rev. Rul. 84-179, 1984-2 C.B. 195, the Service advised that the above conclusions assume that wife is not reinstated as co-trustee and is not serving as co-trustee at the time of her death, or after being reinstated, subsequently resigns within three years of death.

No Taxable Gifts Made

In *PLR 200617002*, decedent and his wife each created an eight-year QPRT, the terms of which were identical. If either decedent or his wife became unable to serve as trustee, each appointed the other and then their daughter as successor trustees. They each conveyed a one-half undivided interest in their principal residence to each respective QPRT. Each QPRT provides that the grantor's interest will be converted into a qualified annuity interest if the trust ceases to be a QPRT. When the QPRT terms end, the remaining assets are to be distributed to the couple's daughters. Decedent and his wife each filed a gift tax return, reporting the transfers of the residence to the QPRTs.

Eight months before the end of the QPRT terms and in violation of the QPRTs' provisions and without informing their daughters, decedent and his spouse executed deeds conveying the residence held by the QPRTs to their own revocable trusts. The daughters became aware of the deeds several years after the QPRTs ended, when the parties began the process of selling the residence. On the advice of counsel, the daughters demanded the sales proceeds based on fraud, breach of fiduciary duty, and tortious interference with their interests in the residence.

Following decedent's death, his estate and his wife offered to settle the dispute and avoid litigation costs by delivering the sales proceeds to the daughters. The daughters agreed to accept the proceeds in full settlement of all claims against decedent's estate and his wife.

On the basis of these facts, the Service ruled that (i) the daughters did not make taxable gifts upon decedent's and his wife's transfer of the residence to the revocable trusts because the daughters did not relinquish or otherwise transfer their respective remainder interests in the QPRTs upon that transfer, (ii) the payment of the sales proceeds to the daughters in settlement of their claims to the residence will not be a taxable gift by wife or by the beneficiaries of decedent's revocable trust or estate, (iii) the daughters should report the gain on the sale of residence in the year of the sale because they had an enforceable claim to the residence as the QPRTs' remainder beneficiaries and, thus, owned the residence, (iv) the daughters cannot exclude any gain under Code Sec. 121 because the daughters do not satisfy the requirements of that section, and (v) the daughters' basis in the residence will be determined by reference to the basis in the hands of the trust grantors and that the daughters' holding period will include the holding period of decedent and his wife.

In determining that the daughters had an enforceable claim to the residence, the Service observed that: (i) the QPRTs provided for distribution of the residence to the daughters, (ii) the QPRTs contained no provisions providing for distribution of the corpus to decedent and his spouse, (iii) the QPRTs were irrevocable and not subject to amendment, (iv) decedent's and his spouse's action in withdrawing the residence from the

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QPRTs was not authorized, and (v) the daughters were not aware of, and did not consent to, the transfer of the residence to the revocable trusts.

Property Subject To Qualified Conservation Easement Qualifies for QPRT Treatment

In *PLR 200617035*, taxpayer plans to transfer property used solely as his vacation residence to trusts intended to qualify as QPRTs. Taxpayer does not conduct any commercial activity on the property, which is located on an agricultural, rural, and sparsely populated island. The property consists of two contiguous parcels that are part of a larger tract taxpayer owns. One parcel includes a single residence and a bathhouse; the other parcel contains a pavilion (a one-room structure with no plumbing) and part of the road that provides the only access to the residence, bathhouse, and pavilion. The property is comparable in size to that of nearby properties used for residential purposes. Before making the transfer to the trusts, the trust plans to put a qualified conservation easement on the property by making a Code Sec. 170(h)(1) qualified conservation contribution.

On the basis of these facts, the Service ruled that the property is a personal residence within the meaning of Code Sec. 2702(a)(3)(A)(ii) and Regs. §25.2702-5(c)(2). For Regs. §25.2702-5(c)(2)(ii) purposes, the Service concluded that the property includes adjacent land not in excess of that reasonably appropriate for residential purposes (taking into account size and location) and that taxpayer uses the residence and appurtenant structures exclusively for residential purposes.

Special Needs Trust Recipient of Decedent's IRA

In PLR 200620025, decedent, who owned an IRA of which his four sons were equally named beneficiaries, died prior to attaining his required beginning date. One son is disabled, and his mother is his legal guardian. The disabled son's eligibility to receive Medicaid and other public benefits could lapse if he directly owned a portion of the IRA. His share has not been distributed from the IRA except for required minimum distributions made to his mother on his behalf. The subdivision of the IRA into separate IRAs for the three other brothers (with his share remaining in the IRA) was done on an equal, pro rata, basis.

A state court, acting on mother's petition, issued an order authorizing the creation of a trust for son's benefit, intended to qualify as a "special needs trust" under state and federal law. Son is the sole beneficiary of the trust during his lifetime and mother, as trustee, may distribute to or apply for his benefit so much of the net income and principal of the trust as appears advisable in her sole discretion. Trustee may accumulate any or all of the trust income; income not distributed in the current year will be added to principal. Upon son's death, the balance of the trust is to be distributed to the State Department of Children and Families to the extent necessary to satisfy the total medical assistance paid for son's benefit by that department during his life. The remaining balance is to be distributed to son's heirs at law. Mother proposed to transfer, with state court approval, son's share, as one-fourth beneficiary of father's IRA to an IRA benefiting the trust and its beneficiaries.

On the basis of these facts, the Service ruled that (i) the trust currently is a grantor trust all of which is treated as owned by son under Code Secs. 671 and 677(a), and therefore, the transfer of his share of the IRA to the trust is not a sale or disposition of the share of the IRA for federal income tax purposes and is not a transfer for purposes of Code Sec. 691(a)(2); and (ii) the trustee may calculate the annual distributions required under Code Sec. 401(a)(9) to be made to the trust from the IRA now in the name of the trust by using son's life expectancy.

Divorce-Related Payment Received By Estate Found To Include Interest, but was not IRD To Estate

In *PLR 200624065*, before husband and wife divorced, they agreed to a property settlement, which was incorporated into the divorce decree. Pursuant to the Agreement, upon entry of the divorce decree, husband gave wife a non-interest bearing promissory note, which provided that a specified amount was payable six months after the death of the first to die of husband and wife; if wife wasn't living on the date the payments were due, they were to be made as provided in her Will, or, in the absence of a Will, equally to four named beneficiaries. The note also provided that the stated principal amount would be adjusted each year to reflect increases in the Consumer Price Index.

Wife died and then, later, husband died. Wife's personal representative filed a claim in probate against husband's estate for the amount due on the note as increased by the CPI adjustments. The claim was allowed and husband's estate paid it in three installments. Although the note was payable by its terms directly to the four named beneficiaries, it was paid to wife's estate.

All parties agreed that (i) Code Sec. 1041 did not apply, because the divorce decree was

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executed before the effective date of Code Sec. 1041, and the parties to the decree didn't elect the application of Code Sec. 1041, and (ii) the subject payments received by the estate weren't alimony under former or current Code Sec. 71.

The first issue addressed was whether the note called for stated interest. Although the Service and the courts have agreed that the release of marital rights in exchange for cash or other property is not considered a taxable event and interest is not imputed in connection with payments incident to a divorce, the non-taxability of post-divorce payments does not extend to payments of stated interest received by a former spouse. In such cases, only the portion of the payments that represents principal is excluded from the gross income of the recipient. In evaluating whether the note had stated interest, the ruling stressed that it is not essential that interest be computed at a stated rate, but only that a definitely ascertainable sum be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower.

The Service concluded that the CPI adjustment was compensation for (i) the decrease in the value of the stated principal amount due to inflation, and (ii) the delay in the payment of the stated principal amount and, therefore, was interest. The CPI adjustment under the note was 'stated' in the sense that it was a sum definitely ascertainable pursuant to an agreement. Therefore, the CPI adjustment amount was stated interest, even though the note provided that it was not interest bearing.

The second issue addressed was whether the stated interest gave rise to IRD to the estate under Code Sec. 691(a)(1). The Service found that the excess of the amount payable under the note over the stated principal amount was IRD, because that amount would have been taxable to wife as interest income had the note been paid to her. However, because, under the note's terms, all amounts were payable to the four named beneficiaries rather than to wife's estate, the estate did not acquire the right to receive the amount from wife under Code Sec. 691(a)(1)(A) and therefore was not taxable to her estate as IRD.