PHILADELPHIA BAR ASSOCIATION

Probate and Trust Law Section Newsletter

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Report of the Chair

By KEVIN P. GILBOY
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While all seems quiet on the Probate Section waters this summer, the Section's committees have been busy paddling below the surface. Actually, quite visibly above the surface, the Education Committee in June put on the best attended quarterly luncheon in memory. Uniform Trust Act Notices: Only Five Months To Go! provided practical advice on how to deal with the notice requirements of the Uniform Trust Act. Kudos to panelists Michelle Hong, Bruce Rosenfield and Perry Teillon and course planners Christina Alt, Michelle Hong and David Schwartz.

Committee chair Karen Stockmal and the rest of the Education Committee deserve our thanks for consistently presenting high quality CLE on topics of interest to our Section. We look forward to the October 7, 2008 quarterly luncheon on Special Needs Trusts and Medicaid being planned by committee members Christina Alt and Olivia Stoner.

Rise Newman, Keelin Barry and Suzanne Pritchard, members of the Committee working on the new guardianship manual, met with Judge Lazarus whose helpful suggestions are being incorporated into the draft manual. The Executive Committee looks forward to reviewing the draft.

The Rules and Practice Committee has been preparing proposed changes to Philadelphia County Orphans' Court Local Rule 6.9.D relating to papers to be filed with accounts by an agent under a power of attorney. Following Committee Chair Bernice Koplin and Tom Bell's presentations about the proposed changes to the Executive Committee during the spring, a subcommittee consisting of Bernice Koplin, Mary Jane Barrett and Tracy De Vlieger has been working over the summer to review the proposed changes to Rule 6.9.D and the comments thereto to make sure the Rule is consistent with changes in practice since the adoption of electronic filing and the adoption of uniform statewide Orphans' Court forms.

With the help of Kate Crary, the Section's Young Lawyers Division representative, and Laura Stegossi,

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Estate Remains Liable for Balance of Charitable Pledge Not Reduced by Lifetime Gifts and Legacies in Will

By KATHLEEN HUANG
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In *Brownfield Estate v. St. Vincent Archabbey*, 28 Pa. Fiduc. Rep. 2d 231 (Westmoreland Co. 2008), at issue was whether and to what extent an estate remained liable for the balance of a decedent's pledge of $1,500,000 to a charitable organization.

In 2001, the decedent entered into a letter of understanding with the respondent, the archabbey, in which she pledged to the respondent's capital campaign six annual payments of $150,000 from 2001 to 2006 and one payment of $600,000 in 2007. In return, the decedent obtained certain naming rights to a building associated with the capital campaign. In 2004, due to mutual concern over the financial burden of the pledge hindering the decedent's standard of living, the parties executed a revised letter of understanding that reduced the annual payments to $100,000 and extended the term to 2014. Until her death in 2005, the decedent made all of the scheduled pledge payments in full. In addition to the pledge payments, the decedent often made gifts and donations, usually on a monthly basis, of various amounts to the respondent.

After the decedent's death, the executors of her estate took the position that the pledge had been fulfilled by three legacies in the decedent's will and the inter vivos gifts and donations made by the decedent. In examining the executors' claims, the Court first addressed whether the legacies in the decedent's will fulfilled the pledge. The executors argued that language in the letters of understanding stating, "[the decedent] will make estate arrangements that provide for the fulfillment of this pledge" showed the decedent's intent to treat the legacies as payment to fulfill the pledge. The Court observed, however, "No presumption of payment arises when, as here, the legacy is less than the debt and…in order to consider a legacy as payment of a debt, the indication must be clear and certain." *Dembinski's Estate*, 316 Pa. 61, 173 A. 314 (1934). Because the total value of the legacies in the decedent's will was less than the outstanding pledged amount and there was no clear indication that the decedent intended that the legacies in her will be payment toward fulfillment of the pledge, the Court determined that no presumption of payment arose and that the legacies could not be considered payment of the pledge. Furthermore, the Court noted that the language relied on by the executors is actually superfluous because a pledge, whether supported by consideration or not, constitutes a binding contract; as such, the decedent's inter vivos pledge created a debt that the executors are bound to honor before even considering the distribution provisions of the decedent's will.

Lastly, the Court addressed whether the inter vivos gifts and donations made by the decedent to the respondent should offset the outstanding balance of the pledge agreement. The decedent's financial advisor had told the decedent that she could more easily afford the $150,000 payments on the pledge (the amount due each year before the agreement was modified in 2004) if she stopped making monthly gifts to the respondent. The executors contended that this advice was evidence that the decedent intended the con-

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Report of the Chair, continued

the Section co-hosted a happy hour on July 17 for the age forty and under members of the Section and the Philadelphia Estate Planning Council.

The indefatigable Gene Gillin again arranged the annual meeting of the Tax Committee with representatives from the Pennsylvania Department of Revenue. Paul Dibert, Warren Klunk and Jim Millar from the Department of Revenue will attend the Tax Committee's October 7 meeting.

The Section's Executive Committee will host a cocktail reception for the Orphans' Court Judges from the five county area on October 6. Thanks to Bernie Glassman for arranging the use of Blank Rome's Marvin Comisky Conference Center for this event.❖

Interpreting the Impact of the U.S. Economy on Art and Valuations

By SAMUEL T. FREEMAN, III
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Recent headlines and horror stories about our economy have created uncertainty within the industry of valuing and selling art and antiques. There are plenty of examples in the financial and housing markets that point to instability and price fluctuations. While oil is an interesting topic unto itself, for our purposes, it is not impacting the middle and high-end art and antiques market the way it impacts the average consumer.

All businesses have cycles, however, the art and antiques markets are more difficult to predict. There is a larger emotional content with respect to how decisions are made about valuing and marketing these collectibles. In addition, as there are multiple disciplines within the broad industry, each discipline will have its own cyclic issues to contend with. As an example of this, Modern & Contemporary Art and Sculpture are performing quite well. Conversely, Pennsylvania Impressionist paintings are struggling to maintain values from the recent past.

In each area of collecting, there are those that retain the ability to support their specific interests. However, in challenging economies, instead of large numbers of these able bodied collectors, we find fewer are empowered to support prices for a rising market. In addition, some markets have reached 'saturation'. This means that those that have built an interest in a particular collecting area have acquired those items that interest them and have no further need or desire to add to their respective collections with minor exceptions.

The scenario described has the added impact of affecting valuations. This has the attention of the IRS Art Review Board. There have been a few sensational cases in which the IRS has justifiably questioned valuations as they relate to gift and estate tax returns. However, when the market 'slides' in a particular collecting area or if it runs wildly up, questions are bound to be raised about the accuracy of appraisals.

There have been numerous attempts within the appraisal discipline to establish certain minimum standards for appraisals and the reports that are delivered to the client. However, the professional who is collecting the various inputs to create a filing for the IRS is still in need of an appraisal that can be supported into the future. Very often, the records kept by the original appraiser can mean the difference between a successful defense and painful fees and penalties.

Historically, an appraisal report has been a simple matter of describing, researching and valuing the item accordingly. Recent IRS requirements have now made the retention of notes, photographs and research information an absolute necessity. In some cases, the need for comparable justifications and supporting documentation may not be known for as many as three years or more. In all cases, it is imperative that the tax preparer be knowledgeable about the capabilities of the appraiser and their record keeping habits. The need for updated or improved photographs and additional details requested by the IRS will require additional time and money.

When deciding on an appraiser, consider the additional costs for comparables in support of a valuation. The appraiser should offer the ability to make comparables as part of the initial valuation or to be available in the future to provide comparable values. In either case, this effort will add cost to the appraisal.

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Estate Liability, continued

tinuing monthly gifts to be credits toward her pledge. The Court found this argument unpersuasive. More likely, the Court reasoned, "a person imbued with a generous attitude and affection toward an institution may make numerous gifts at different levels of giving, each intended to address a specific and timely need, and that such a pattern of giving is likely to continue even in the presence of a particularly large gift." Rejecting both of the executors' arguments, the Court held that the three legacies under the decedent's will and the inter vivos gifts and donations were intended by the decedent to be separate from the balance due under the letters of understanding and that the balance of the pledge agreement should be paid by the decedent's estate.❖

Revenue Ruling 2008-22: Power to Substitute Will Not Cause Estate Inclusion

By GIL A. NUSBAUM
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The use of grantor trusts is a popular estate planning tool because it allows a grantor to be treated as owner of trust assets for income tax purposes but not estate tax purposes. By reserving at least one of several powers enumerated in Code Sections 671 through 677, the grantor is taxed on trust income during his or her lifetime, but the value of the assets irrevocably transferred to the trust is removed from the grantor's gross estate as of the date of the transfer. In addition, since the trust receives the income generated by the trust assets but the tax on that income is paid by the grantor, the grantor is able to reduce his or her estate by the income tax he or she pays on behalf of the trust and essentially is able to make a nontaxable gift of that income to the trust beneficiaries.

A common method of creating a grantor trust is to give the grantor the power to substitute assets in the trust for assets of equal value. Code Section 675(4)(C) provides that the grantor of a trust is treated as the owner of any portion of the trust over which any person has the power, exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value. However, some commentators have questioned whether the retention of such a power by the grantor could cause inclusion of the trust assets subject to the power in the grantor's gross estate for federal estate tax purposes.

The IRS recently addressed this issue in Revenue Ruling 2008-22.[1] At issue in Revenue Ruling 2008-22 was whether the principal of an inter vivos trust is includible in the grantor's gross estate under Code Sections 2036 or 2038 if the grantor retains the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting property of equivalent value.

In the Ruling, the grantor established and funded an irrevocable trust for the benefit of his descendants in year 1. The trust instrument provided that the grantor was prohibited from serving as trustee. However, the grantor had the power, exercisable in a nonfiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. Furthermore, under local law, the trustee had a fiduciary obligation to ensure that properties exchanged are of equivalent value and a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. The grantor died in year 2.

Under Code Section 2036(a), the value of a decedent's gross estate includes "the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Under Code Section 2038(a)(1), the value of a decedent's gross estate includes

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[1] 2008-16 I.R.B. 796, 04/17/2008.

Art Appraisals, continued

It is a challenge to find an appraiser with sufficient general knowledge about a good variety of collectible art and antiques. Otherwise, you may find the need to engage multiple appraisers from a variety of disciplines. In some circumstances, it may be advisable to engage the services of an appraiser specifically dedicated to one area of expertise. This can occur with obscure or difficult to value items.

If the appraisal has been done properly, then supporting and justifying the initial findings should be a simple matter of providing the documentation used in the original valuation.❖

Revenue Ruling, continued

the value of all property "to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death."

The Ruling held that a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under Code Sections 2036 or 2038, provided that the trustee has a fiduciary obligation under local law or the trust instrument to ensure the grantor's compliance with the terms of the power by determining that the properties acquired and substituted by the grantor are in fact of equivalent value, and that the substitution power cannot be exercised to shift the benefits among the trust beneficiaries. The Ruling further explained that a substitution power cannot be exercised to shift benefits if "(a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income."

Revenue Ruling 2008-22 should quell the fear that the retention of a power of substitution by a grantor could cause inclusion of the trust assets subject to the power in the grantor's gross estate for federal estate tax purposes. The Ruling makes clear that the retention of such a power by a grantor will not, by itself, cause the value of the trust assets to be includible in the grantor's gross estate under Code Sections 2036 or 2038. Furthermore, under Pennsylvania law, a trustee has a duty to administer the trust solely in the interests of the beneficiaries.[2] Presumably, such a duty includes a fiduciary obligation to ensure that any property acquired and substituted by the grantor pursuant to the exercise of a power of substitution are in fact of equivalent value, as the Ruling requires. In order to ensure compliance with the second requirement that the substitution power cannot be exercised to shift the benefits among the trust beneficiaries, practitioners may wish to include limiting language to that effect in trust provisions granting a power of substitution.❖

[2] 20 Pa.C.S. § 7772(a).

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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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The Taxman Cometh

By JOHN E. CHAPOTON AND ALICE S. PAIK
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For taxable investors, the last five years have been as good as it gets. The 15% tax on long-term capital gains is the lowest since World War II, and dividends have received preferential tax treatment (also 15%) for the first time ever. We do not, however, expect these low rates to continue much longer.

Bush Tax Cuts and Sunsets - Current Legislation

	Rate Through 2010	Rate After 2010
Dividends	15%	Up to 39.6%
Long-term Capital Gains	15%	20%
Individual Income Tax Rates	10%	
	15%	15%
	25%	28%
	28%	31%
	33%	36%
	35%	39.6%
Estate Taxes	Top rate falls from current rate of 45% to 0% in 2010	55%
Gift Taxes	Top rate falls from current rate of 45% to 35% in 2010	55%

Our nation has a history of sporadic tax cuts, followed by slow but steady tax increases and ever-increasing government spending. Whatever the cause, the U.S. deficit is growing in absolute dollar terms, and the long-term budget outlook is troubled. To further complicate the mix, we face a highly unusual legislative conundrum related to the Tax Code: President Bush's tax cuts of 2001 and 2003, which amount to almost $200 billion per year in tax relief, are set to expire in 2010, followed by a reinstatement of the much higher rates that existed in 2000. Absent future legislation, long-term gains will be taxed at 20% and dividends will be taxed at the top rate of 39.6% beginning on January 1, 2011. Congress probably will enact tax legislation next year, but such legislation is unlikely to contain a wholesale extension of the Bush tax cuts. In the years since the tax cuts, the Republican Party — traditionally the champion of low taxes — has seen its political fortunes decline.

This strange tax scenario is a financial concern to be sure, but if you're a politician, the choices are career-threatening. Politicians go to great lengths to avoid association with tax increases, but the cruel reality of the numbers will not go away. The Alternative Minimum Tax (AMT) is affecting millions of additional taxpayers each year, but repealing this hidden tax would reduce Treasury revenues by almost

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The Taxman Cometh, continued

$1 trillion over the next 10 years. Failing to extend the Bush tax cuts permanently will impose a tax increase on millions of taxpayers, yet extending these lower rates leaves little room to protect those becoming ensnarled by the AMT. Our next President — regardless of party affiliation — and the newly-elected Congress will face an ugly fiscal plight. To state the obvious, the fall elections will have a lot to do with where taxes are headed, and the outcome is, of course, unknown. Nevertheless, here are some thoughts on what changes might be in store and when they could become effective.

INCOME TAX CHANGES

Long Term Capital Gains

From 1978 until 2003 the tax on long-term capital gains generally alternated between 20% and 28%. Our best guess is that the tax rate on gains will return to the 20-28% range by 2010. Although the 15% rate has been popular, it seems unlikely to survive given the deficit and spending picture, as well as a strong probability of continued Democratic control of Congress.

We believe that no change to the tax on long-term gains will occur before the next President is inaugurated in January 2009. A new President and Congress probably could not enact such a change before May 2009. It would be unusual (but not unprecedented) for such a tax increase to be made retroactive to the beginning of 2009. A mid-year effective date, however, seems much more likely, and an effective date of January 1, 2010 seems quite plausible.

Dividends

We approach with more trepidation the challenge of predicting the future tax rate on dividends. Until 2003, dividends always had been taxed as ordinary income, and that rule is slated to return in 2010.

The arguments with respect to timing of the long-term capital gains tax increases also apply to the anticipated change in the tax on dividends, with one caveat. A retroactive tax increase seems a little more likely for dividends than for long-term gains. A retroactive change to the capital gains tax rate seems unfair because it deprives an investor of the ability to make an informed investment decision on an after-tax basis at the time of the sale. The receipt of dividends, however, is an involuntary act, and it might be argued that a retroactive tax increase on dividends would not deprive investors of the opportunity to make an informed decision.

Estate and Gift Taxes

Full repeal of the estate tax — the cherished dream of an intense and decade-long lobbying effort — is almost certainly dead. However, in its place is likely to be a very significant reduction in estate taxes. The exemption is likely to be higher, and the tax rates lower. We believe a compromise will be achieved in Congress that will settle on an exemption in the $4-5 million range (per individual) with a top rate as low as 35% (versus the current rate of 45%).

Gift tax rates are likely to follow the same rate schedule, but it is impossible to predict whether the lifetime gift tax exclusion will be re-coupled with the estate tax exclusion (as it was prior to 2001) or remain at a lower level ($1 million today).

The timing of these changes is critical, of course. No one knows when Congress may agree on a compromise — the political stars must align properly — but it is increasingly clear that regardless of when the legislative debate is settled, the changes will not be effective until January 1, 2010. Meanwhile, there seems to be no inclination to upset the schedule adopted in 2001. So we are stuck with existing law until that date — a $2 million estate tax exemption, growing to $3.5 million in 2009; a $1 million gift tax exemption; and a maximum 45% tax rate on both estates and gifts — even though we think it is safe to assume a new set of rules will be in place for 2010. With widely differing policies emerging from the campaign trail and the exact make-up of the legislature unknown, there is a fair amount of political uncertainty regarding the details of the next estate tax regime, except that a full repeal probably is not plausible.

MARKET IMPACT OF TAX INCREASES

The prospect of an increase in the long-term capital gains tax will certainly induce taxable investors to sell some appreciated assets before the advent of the higher tax. Will this have a significant adverse impact on the market? While the approach of a tax increase could create some downward pressure on certain stocks or even on the market, we expect that such pressure would be both temporary and minor relative to the traditional drivers of the market.

Although every sale has at least some theoretical impact on the market, tax-sensitive investors make up a relatively small percentage of the trading volume on the equity markets. Institutional investors (pen-

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The Taxman Cometh, continued

sion funds, mutual funds, insurance companies, foundations and institutional trustees) hold almost 70% of the outstanding shares of the 1,000 largest U.S. corporations. With the exception of mutual funds and institutional trustees, these investors would be indifferent to a change in the 15% tax rate. As for the other 30% of the market, hedge funds, which are notoriously tax-insensitive, make up the lion's share, at least by volume. Individuals who have invested in mutual funds surely care about the 15% rate, but most mutual funds managers seem to pay little attention to taxes. Morningstar, the mutual fund research firm, reports the median annual turnover (percentage of investments that are sold in a given year) for U.S. stock funds is 70%. By comparison, tax-sensitive investors will generally have an average turnover of about 30%. Even if selling by taxable investors is sufficient to drive down particular stocks, we would expect other investors to eventually step in to snap up bargains.

Consider Sales of Concentrated Positions

Investors with large, low-cost stock positions are among those with the most to lose if the tax rate on long-term gains is raised. Since we expect this increase, are we advising our clients to sell now? It depends. Incurring a tax sooner to take advantage of a lower rate generally makes sense if the tax would have been incurred in the near future anyway. Given sufficient time to defer the tax, however, the benefits of deferring the tax can exceed the benefit of the lower tax rate. There are a number of unknowable variables in this calculation, including the rate of return, the magnitude of the tax increase and the length of deferral. Thus, this decision involves as much art as science. In general, where a diversification program already exists for a concentrated position, we are accelerating that program somewhat in 2008, and where a program is not yet in place, we are discussing the possibility with our clients.

Perhaps viewed as a thin silver lining, one positive side of an increased tax rate (aside from hopefully improving the fiscal balance of government revenues and spending) is the increased value of a charitable deduction. Since current income tax laws allow those who itemize their deductions to reduce their taxable income by the value of their charitable contributions (within limits), offsetting income that would be taxed at a higher rate would make some sense. While we are not advocating that a regular charitable giving plan be altered, it is worth considering the impact of deferring a large one-time contribution.

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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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The Montgomery County Orphans' Court Dismisses Petitions to Reopen its December 14, 2004 Barnes Foundation Decision For Lack of Standing

By DAVID A. RUBEN
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In a December 14, 2004 opinion (Barnes Foundation, 25 Fiduc. Rep.2d 39), the Montgomery County Orphans' Court ruled that the trustees of The Barnes Foundation (the "Foundation") were permitted to relocate the Foundation's $6 billion art collection from Lower Merion to Philadelphia.

On August 27, 2007, the Friends of the Barnes Foundation and several individuals (referred to collectively herein as "the Friends") filed a petition to reopen the proceeding.

The Friends alleged that during the prior proceeding the Foundation's trustees concealed the fact that a state budget bill, passed in 2002, contained a line item for approximately one hundred million dollars for the construction of a Philadelphia facility to house the art collection. Subsequently, Montgomery County filed its own petition to reopen the proceeding. Montgomery County argued that a recent proposal by its Commissioners to purchase the Foundation's land and buildings and lease the property back to the Foundation would breathe new life into the financially struggling organization.

The trustees, joined by the Office of the Attorney General, filed preliminary objections raising the issue of standing. Citing Milton Hersey School, 590 Pa. 35 (2006), the Orphans' Court held that the Friends did not have standing in this matter as they lacked an "actual interest," or an interest beyond that of the general public. Citing Philadelphia Health Care Trust, 872 A.2d 258 (Cmwlth. 2005), the Orphans' Court held that Montgomery County lacked any "special interest," since protecting historical resources or nurturing economic welfare are matters within the purview of the Attorney General's office. Therefore, the Orphans' Court dismissed the petitions to reopen the proceeding for lack of standing.❖

ETHICS COLUMN

By PAUL C. HEINTZ
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My client, the administratrix of an estate, took possession in my presence of some bearer bonds of significant value. She has ignored my directions to redeem the bonds and deposit the proceeds in the estate account and I am growing concerned she has absconded with, or intends to abscond with, the bonds. What are my ethical duties under these circumstances as attorney for the administratrix?

Pennsylvania's Rules of Professional Conduct, and the rules of many other States, now permit revealing, under these circumstances, information that normally would be considered confidential. Specifically, Pennsylvania Rule 1.6 permits an attorney to reveal information the attorney "…reasonably believes necessary…to prevent the client from committing a criminal act that

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Ethics Column, continued

the lawyer believes is likely to result in…substantial injury to the financial interests or property of another. See Rule 1.6(c)(2). The Rule also permits revealing confidential information when necessary "to prevent, mitigate or rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services are being or had been used". See Rule 1.6 (c)(3). Clearly, in Pennsylvania the attorney has the ability to take action without violating the Rules.

This is a departure, and many believe a welcome departure, from what long has been the "majority rule" that would not allow an attorney to reveal the fiduciary-client's behavior.

A 1995 Montgomery County Orphans' Court decision issued by Judges Ott and Taxis appears to require that an attorney take that action. In that case, the court held that although an attorney representing a fiduciary should not consider the beneficiaries of a will or trust to be his or her client, that attorney still has a duty of care toward those beneficiaries similar to that of the fiduciary he or she represents. The opinion explains that these duties owed by the attorney to the non-client beneficiaries are "joint", "derivative" or "secondary" duties. The Judges held that if the attorney does not take appropriate action to stop the fiduciary from breaching his or her duty or curing its consequences, including reporting to the beneficiaries, the beneficiaries may have a cause of action against the attorney. *Pew Trust*, 16 Fiduc. Rep. 2d 73 (Montg. 1995).

Depending on the status of the estate administration, the attorney may also be obligated to notify the Register of Wills and Orphans' Court. That arises from the attorney's obligation of candor toward tribunals set forth in Rule 3.3. Both the Register of Wills and Orphans' Court are deemed tribunals.

If an inventory has been filed with the Register of Wills or if a status report has been filed noting the estate has been closed, the attorney may have an obligation to notify the Register of the changed estate value and reopened status of the estate.

If an account or any other document relating to the estate size and composition has been filed with the Orphans' Court, the attorney has a duty to file an amended account or otherwise advise the court of the receipt of additional assets.

In summary, it is the attorney's obligation, first, to remonstrate with the client to make certain that the client deposits into an estate account as promptly as possible the assets she received in the attorney's presence. As part of that communication, the attorney should advise the client that if she fails to do so, the attorney is under an obligation to report the existence of the assets to the beneficiaries and, where appropriate, to the Register of Wills and Orphans' Court and, thereafter, to withdraw as her counsel. If the client does not follow the attorney's advice, then the attorney should notify the beneficiaries, Register of Wills and Orphans' Court of the existence of the estate asset and, because the attorney's position will have become adverse to the client, then he or she must withdraw as counsel for the client.

Also, see Opinion 2008-9 issued by the Philadelphia Bar Association's Professional Guidance Committee.❖

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

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TAX UPDATE

By JOAN AGRAN
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I. TREASURY REGULATIONS

Proposed Regs Provide Guidance to Obtain Time to Make GST Elections

In REG-147775-06, 73 Fed. Reg. 20870 (4/17/08), the Service has issued new proposed regs which provide guidance on requests for extensions of time under Code Sec. 2642(g)(1) to make various GST tax elections. Notice 2001-50, 2001-2 CB 189, provided interim guidance under the rules of Reg. §301.9100-3. The new proposed regs are intended to replace Reg. §301.9100-3 with regard to relief under Code Sec. 2642(g)(1).

The proposed regs apply to a request for an extension of time to (i) allocate GST exemption to a transfer, (ii) elect under Code Sec. 2632(b)(3) not to have the deemed allocation of GST exemption apply to a direct skip, (iii) elect under Code Sec. 2632(c)(5)(A)(i) not to have the deemed allocation of GST exemption apply to an indirect skip or transfers made to a particular trust, and (iv) elect under Code Sec. 2632(c)(5)(A)(ii) to treat a trust as a GST trust for purposes of Code Sec. 2632(c).

Requests for relief under Code Sec. 2642(g)(1) will be through a request for a letter ruling and will be granted when the taxpayer establishes to the Service's satisfaction that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. Prop Regs. §26.2642-7(d)(2) and (d)(3) include a nonexclusive list of factors the Service will consider in determining whether the standards of reasonableness, good faith, and lack of prejudice to the interests of the government are met. Prop Reg. §26.2642-7(e) provides illustrations of situations where this standard would not be treated as met.

Reg. §301.9100-3 will be amended to provide that relief under Code Sec. 2642(g)(1) could not be obtained through the provisions of Reg. §301.9100-1 and Reg. §301.9100-3 after the proposed regs are finalized. However, automatic 6-month extension relief under Reg. §301.9100-2(b) would continue to be available to transferors or transferors' estates qualifying for that relief.

Proposed Regs Clarify Availability of Code Sec. 2032 Alternate Valuation

In REG-112196-07, 73 Fed. Reg. 22300 (4/25/08), the Service has issued Prop. Regs §20.2032–1, clarifying that the Code Sec. 2032 alternate valuation election is available to estates where a decrease in value of the gross estate after decedent's death is due to market conditions, but not other post-death events. Any interest or estate which is affected by the mere lapse of time is included at its value as of the time of death (instead of the later date), with adjustment for any difference in its value as of the later date that is not due to the mere lapse of time. The proposed regs would define "market conditions" as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued.

Reg. §20.2032-1(f)(1) provides examples that illustrates this rule. One example, with facts similar to those in *Kohler v. Comr.*, T.C. Memo 2006-152, nonacq., 2008-9 I.R.B., concludes that a reduction in the value of stock as a result of a corporate reorganization within the six-month period does not qualify for Code Sec. 2032 treatment.

Proposed Regs Address Procedure for Declaratory Judgments on Gift Tax Values

In REG-143716-04, 73 Fed. Reg. 32503 (6/9/08), the Service has issued proposed regs under Code Sec. 7477 that would provide a procedure for filing petitions with the Tax Court for declaratory judgments on gift tax values. The regs would apply to Tax Court petitions filed on or after the date the regs are finalized.

The proposed regs would provide a procedure for pursuing a declaratory judgment in the Tax Court under Code Sec. 7477 in those situations where an adjustment by the Service does not result in a gift tax deficiency or refund. In the absence of Code Sec. 7477, without an actual gift tax deficiency, a taxpayer would be unable to petition the Tax Court to contest the determination or, without an overpayment of tax, file a claim for refund or bring suit for refund in federal court. In situations where the adjustment results in a proposed tax deficiency or a po-

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tential refund, taxpayers must follow the current procedures to dispute a deficiency or claim a refund.

To qualify for this procedure (i) the transfer must be shown or disclosed on a federal gift tax return, or on a statement attached to the return, and (ii) the Service must first make a determination regarding the gift tax treatment of the transfer that results in an actual controversy in a situation where the adjustments do not result in a gift tax deficiency or refund.

Tax Court Rule 211(d) requires that the petition must contain a statement that the petitioner has exhausted all administrative remedies within the Service. The proposed regs not only set forth the administrative remedies available to the donor but also provide that the Service will not contest the donor's allegation that the donor's administrative remedies have been exhausted if (i) the donor requests Appeals consideration in writing within 30 calendar days after the mailing date of a notice of preliminary determination of value from the Service, or by such later date for responding to the notice as determined under IRS procedures; (ii) the donor participates fully in the Appeals consideration process; and (iii) the Service mails to the donor a Letter 3569, which will notify the donor of the proposed adjustments and of his right to contest the determination by filing a petition for declaratory judgment with the Tax Court before the 91st day after the date of mailing the Letter 3569.

Because the donor will also receive a Letter 3569 where the donor does not respond to the notice of preliminary determination, or expressly declines to participate in the Appeals process, the proposed regs provide that in those situations the Service would consider the donor to have failed to exhaust administrative remedies, and the Service could challenge any allegation in the donor's petition that he has exhausted all administrative remedies.

Proposed Regs Clarify Rules on Estate and Trust Payments to Charitable Beneficiaries

In REG-101258-08, 73 Fed. Reg. 34670 (6/18/08), the Service has issued proposed regs clarifying that estate and trust provisions which specify the source from which income amounts must be paid to charities must have economic effect independent of income tax consequences to be effective. The proposed regs would clarify the existing regs under Reg. §1.642(c)-3(b) and Reg. §1.643(a)-5(b). The regs would apply to trusts and estates for tax years beginning after the date they are finalized.

Under the proposed regs, a provision in a governing instrument or local law that specifically provides the source from which amounts are to be paid, permanently set aside, or used for a purpose specified in Code Sec. 642(c), would have to have economic effect independent of income tax consequences in order to be respected for federal tax purposes. If the economic effect rule isn't met, income distributed for a purpose specified in Code Sec. 642(c) would consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes.

Prop Reg § 1.642(c)-3(b)(2) contains an illustration of payments to a charity under a charitable lead annuity trust containing an ordering provision which does not have economic effect independent of tax consequences, because the amount to be paid to charity is not dependent upon the type of income from which it is to be paid.

Final Regs Subject Charitable Remainder Trusts with UBTI to Excise Tax

In TD 9403, 73 FR 35583 – 35585, 06/19/2008; Reg. §1.664-1, the Service has issued final regulations under Code Sec. 664(c), effective for taxable years beginning after December 31, 2006, which reflect a change made by the Tax Relief and Health Care Act of 2006.

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

In order to determine the character of the distribution made to the beneficiary, the income that is UBTI is considered income of the trust. The trust's income is allocated among Reg. §1.664-1(d)(1) trust income categories (ordinary income, capital gains, or other income) without regard to whether any part of it is UBTI. The final regs clarify that, consistent with Reg. §1.664-1(d)(1) and Reg. §1.664-1(d)(2), the excise tax imposed on a charitable remainder trust with UBTI is treated as

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paid from corpus, and the trust income that is UBTI is income of the trust for purposes of determining the character of the distribution made to the beneficiary. The final regs contain examples illustrating the tax effects of UBTI on a charitable remainder trust for taxable years beginning after December 31, 2006.

Final Regs Address Portion of Grantor Retained Interest Trust Subject to Estate Tax

In TD 9414, 73 FR 40173-40179, 07/11/2008, the Service has issued final regs, effective for estates of decedents dying after July 13, 2008, which provide a method for determining the extent to which a trust in which the grantor has retained an interest for any period not ascertainable without reference to his death, or for a period that does not in fact end before his death, is includible in his gross estate under Code Sec. 2036. The final regs adopt proposed regs issued last summer with numerous modifications and clarifications. The regs clarify that while Code Sec. 2039 also could apply in some situations, these interests will be taxed under the rules of Code Sec. 2036 and not under Code Sec. 2039.

The final regs provide rules for determining the extent to which a grantor retained annuity trust, a grantor retained income trust, a grantor retained unitrust, a charitable remainder annuity trust and a charitable remainder unitrust is includible under Code Sec. 2036 where the grantor retains an interest for himself and dies before the end of the trust term.

The final regs amend Reg. §20.2036-1 to incorporate the guidance provided in Rev Rul 76-273, 1976-2 CB 268 , and Rev Rul 82-105, 1982-1 CB 133, dealing with CRUTs and CRATs and apply it to other types of trusts in which the grantor has retained an interest. Specifically, the final regs provides that if a decedent transfers property during life to a trust and retains the right to an annuity, unitrust, or other income payment from, or retains the use of an asset in, the trust for life, a period that does not in fact end before his death, or a period not ascertainable without reference to his death, he has retained the right to income from all or a specific portion of the property transferred as described in Code Sec. 2036. The portion of the trust corpus includible in the decedent's gross estate is that portion of the trust corpus, valued as of the decedent's death (or the alternate valuation date, if applicable) necessary to yield the annual annuity, unitrust or other payment without reducing or invading principal, applying the Code Sec. 7520 interest rate in effect on the date of the decedent's death (or on the alternate valuation date, if applicable). The portion of the trust corpus that is includible in the decedent's gross estate under Code Sec. 2036 may not exceed the fair market value of the trust corpus on the date of the decedent's death.

Final Regs on Additional GST Trust Severance Issued

In T.D. 9421, 73 FR 44649-44653, 07/30/2008, the Service has issued final regs providing guidance regarding the GST tax consequences of the severance of a trust effective under state law, but that doesn't meet the requirements of a qualified severance under Code Sec. 2642(a)(3). The regs also provide guidance on the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts, and special funding rules applicable to the non-pro rata division of certain assets between or among resulting trusts. The regulations apply to severances occurring on or after August 2, 2007, although certain provisions apply only to severances occurring on or after September 2, 2008.

II. COURT DECISIONS

No Recovery for Estate Taxes Paid to Eliminate Lien on Purchased Homes

In *First American Title Insurance Co., et al., v. U.S.*, (2008, CA9) 101 AFTR 2d 2008-622 decedent died in 1991, leaving an estate primarily consisting of three houses and stock in a drive-in restaurant in Tacoma, Washington. A court admitted decedent's Will to probate and gave decedent's daughter, as the estate's personal representative, the power to transfer the estate's real and personal property without further court order.

Daughter deeded the three houses to herself and her husband. She filed a federal estate tax return, paid part of the estate tax shown on the return, and made a Code Sec. 6166 election to pay the balance of the estate tax in installments. The houses were later sold to purchasers who obtained title insurance policies but the title insurance companies did not discover that the houses were encumbered by tax liens due to the unpaid estate taxes.

The Service audited the estate tax return, increasing the value of the restaurant. The estate consented to the assessment of additional estate taxes but daughter made only one installment payment. After the estate failed to make installment payments of the estate taxes owed, the Service sent letters to the purchasers of the three houses, threatening to seize and sell the houses unless they paid

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the remaining estate tax owed.

The homeowners made claims on the title companies, who paid about $189,372 in estate taxes under protest and then filed refund claims, which the Service denied. The title companies filed suit in district court under 28 USCS 1346 to recover federal estate tax erroneously or illegally assessed and collected.

Before the district court, the title Companies acknowledged that a special estate tax lien under Code Sec. 6324(a)(1) attached to decedent's gross estate at her death and that the estate's personal representative didn't obtain a discharge of liability under Code Sec. 2204 before selling the properties in question. The title companies contended however, that the proceeds from the sale of the three homes were used to pay encumbrances, taxes, title insurance premiums, real estate commissions and expenses of estate administration, thereby divesting the lien under Code Sec. 6324(a)(1). To prove that divestment occurred, the title companies had to show that (i) the sale proceeds satisfied charges against the estate or expenses of its administration; and (ii) a court with proper jurisdiction allowed the satisfaction. The court held that the tests had not been met.

On appeal, the Ninth Circuit first noted that Code Sec. 7426, not 28 USCS 1346, is the statute providing jurisdiction for suits by persons other than taxpayers. Code Sec. 7426(c), unlike 28 USCS 1346, does not permit the title companies to challenge the assessment of how much the restaurant was worth, and the assessment is what increased the taxes and is the basis for the refund claim. The Ninth Circuit stressed that there is no injustice in the Code Sec. 7426 limitation on challenges to assessments; had daughter paid the estate taxes when due, or paid the installments and not gone bankrupt, she could not have challenged the assessment, because she had agreed to it. The court acknowledged that the homeowners and the title insurers that stepped into their shoes did not have a chance to challenge the assessment but that was not their right. In this case, a third party that pays a tax to eliminate a tax lien on the third party's property is, under Code Sec. 7426(c), bound by the assessment on the property.

Fair Market Value of Partnership Interests Determined for Gift Tax Purposes

In *Astleford v. Comr.*, T.C. Memo 2008-128 (5/5/08), taxpayer's husband owned a 50% partnership interest in 'Pine Bend' general partnership which purchased 3,000 acres of land in Minnesota. In 1996, following her husband's death, taxpayer formed a family limited partnership, funding it with real estate interests. Taxpayer gave each of her children a 30% limited partnership interest in the partnership, retaining a 10% general partnership interest. In 1997, taxpayer transferred to the partnership her 50% Pine Bend interest and her interest in 14 other properties located in Minnesota. On that same day taxpayer gave each of her children additional limited partnership interests in the partnership, causing the ownership interests to return to the percentages they were following the first gifts in 1996.

The Service audited taxpayer's 1996 and 1997 gift tax returns, increasing the fair market values of a number of the properties that were transferred to the limited partnership. For 1996, taxpayer valued the taxable gifts at $277,441 while the Service valued the taxable gifts at $626,898. For 1997, taxpayer valued the taxable gifts at $3,954,506, while the Service valued the gifts at $10,937,268.

The Tax Court reviewed the fair market value of the properties and each of the three gifted 30% limited partnership interests. Regarding the Pine Bend properties, the court used the Service's expert's initial value, finding him more experienced and credible than the taxpayer's expert. However, disagreeing with the Service, the court allowed a market absorption discount due to the fact that a sale of a large parcel of real estate would flood the market and reduce the price at which real estate could be sold.

The court then held that the Pine Bend interest transferred to the limited partnership should be treated as a general partnership interest and not as an assignee interest, because taxpayer continued to control the management rights associated with the interest. Applying the substance over form doctrine, the court found that because taxpayer was the limited partnership's sole general partner, she was essentially in the same management position relative to the 50% Pine Bend interest both before and after the transfer. The court went through a detailed analysis to determine the lack of control and lack of marketability discounts of the 50% Pine Bend interest, concluding that a combined discount of 30% for lack of control and lack of marketability was appropriate.

Finally the court determined the value of the limited partnership interests gifted to the children, applying successive discounts of 16.17% for 1996 and 17.47% for 1997 for lack of control and 22% in

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both years for lack of marketability to the gifted interests in the limited partnership, for a combined discount of 33.97% in 1996 and 35.63% in 1997. This resulted in total taxable gifts in 1996 of $517,575 and total gifts in 1997 of $6,565,215.

Supreme Court Declines Review of Case of Nonapplication of GST Tax Grandfather Rule

The Supreme Court has declined to review the decision of the U.S. Court of Appeals for the Sixth Circuit in *Estate of Gerson v. Comm.* (2007, CA6) 507 F.3d 435 , 100 AFTR 2d 2007-6593 , cert denied (2008, S.Ct.) 2008 WL 447510, (listed as *Kleinman v. Comm*. under the name of the executor) which held that Reg. §26.2601-1(b)(1)(i) is valid. That reg provides that a "grandfather" exception to the GST tax doesn't apply to property transferred under the exercise, release, or lapse of a general power of appointment which is treated as a taxable transfer for federal estate or gift tax purposes.

In this case, decedent died in 2000, survived by four children and five grandchildren. Her Will exercised a general power of appointment in favor of her grandchildren over a marital trust created for her upon the death of her husband in 1973. The Service determined that the transfer to her grandchildren was subject to GST tax.

Although the GST tax does not apply to any generation-skipping transfer from a trust that was irrevocable on Sept. 25, 1985, under Reg. §26.2601-1(b)(1)(i), this does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer for estate tax or gift tax purposes. The estate argued that (i) the regulation is invalid, and (ii) the transfer qualifies for the grandfather exception. The Service disagreed, ruling that the disputed transfers in this case were not required under the trust, but were made at decedent's election and pursuant to the exercise of a general power of appointment; she was therefore deemed to be the owner of the property for purposes of the federal estate tax and the transfers were not eligible for exemption from the GST tax.

The Sixth Circuit affirmed the Tax Court, which had rejected the estate's arguments and agreed with the Service. The Sixth Circuit held that Reg. §26.2601-1(b)(1)(i) is a reasonable and valid interpretation of the 1986 statute's transitional rule because it harmonizes with the plain language of the statute, its origin, and its purpose and therefore decedent's transfer to her grandchildren was subject to GST tax.

Contribution of Stock to Family Limited Partnership not Indirect Gift

In *Holman v. Comr.*, 130 T.C. No. 12 (5/27/08), taxpayer held a substantial amount of company stock that he had acquired as a company employee by the exercise of stock options and by purchase. Taxpayer established UTMA accounts for each of his children, to which he transferred some of the stock.

In 1999, on the advice of an attorney, taxpayer created a family trust for the benefit of his children, funding it with cash and a small amount of company stock. Taxpayer and his wife then established a family limited partnership, to which they transferred a substantial amount of stock in exchange for general and limited partnership interests. The family trust transferred its company stock to the partnership in exchange for a limited partnership interest. The partnership contained a number of restrictions on transfers of partnership interests.

A week after creating the partnership, taxpayer and his wife transferred most of their limited partnership interests to the family trust and to an UTMA account for their youngest child. As a result of this transfer, the trust held a 70% interest in the partnership and the youngest child a 14% interest. Taxpayer and his wife made additional gifts of partnership interests in 2000 and 2001.

On audit of the gift tax returns, the Service asserted deficiencies, asserting that the 1999 gift should be treated as an indirect gift of the stock shares and not as a direct gift of partnership units, and that under Code Sec. 2703(a)(2), the valuation of all the gifts should ignore the restrictions contained in the partnership agreement.

On the basis of these facts, the Tax Court held that the 1999 gift was a direct gift of partnership units and not an indirect gift of stock. On the day the family limited partnership was formed, taxpayer and the trustee contributed shares of stock and received partnership interests proportional to the number of shares each transferred to the partnership. Taxpayer did not first transfer partnership units to the trustee and then transfer stock to the partnership, nor did taxpayer simultaneously transfer stock to the partnership and partnership units to the trustee.

The court found in this case that the creation of the partnership and the 1999 gift were not interdependent transactions that must

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be treated as a single transaction under the step transaction doctrine; even though at the time the partnership was created taxpayer intended to transfer the stock to his children, taxpayer bore a real economic risk of a change in value of the partnership for the six days that separated the transfer of stock to the partnership and the date of the 1999 gift.

The court also held that under Code Sec. 2703(a)(2), the restrictions on transferability found in the partnership agreement must be ignored for purposes of the gift tax valuation of the gifts of partnership units. The court found no business purpose for the restriction because the partnership carried on little activity other than holding shares of stock and because the stated purpose of the trust was to manage family assets and protect them from dissipation by the children. In addition, the gifts of the partnership units were gifts to members of taxpayer's family, and the restrictions on transferability were a device for making gifts to such family members. The court declined to decide whether the restrictions were comparable to arms length transactions, because it had already decided the restrictions on transferability must be ignored for valuation purposes.

The court then provided a detailed analysis of its determination of the gifts' value, explaining that where it is publicly traded stock, if there is a market for the stock, its valuation is equal to the mean between the high and low price quoted for the day. The court then applied minority interest discounts and marketability discounts that were substantially smaller than taxpayer's proposed discounts to arrive at the fair market value of the gifted units.

Supreme Court Declines Review of Holding that Court Not Bound by Estate's Valuation

In *Estate of Josephine T. Thompson*, (CA2 2007) 100 AFTR 2d 2007-5208, cert den. (2008, S.Ct.) 2008 WL 436949, the Supreme Court has declined to review a Second Circuit decision holding that a shift of the burden of proof to the Service didn't require the Tax Court to adopt the estate's valuation method.

As reported previously, the Tax Court valued 20% of a closely held company at $13.5 million, higher than the $1.75 million valuation claimed by the estate but below the $32 million valuation claimed by the Service. The Tax Court found that the estate's valuation method exaggerated the risks associated with technological change, while the Service's methodology was generally deficient.

The estate argued that because the parties agreed that the estate introduced credible evidence on the valuation issue, under Code Sec. 7491 the burden of proof shifted to the Service and the Tax Court was obligated to adopt the estate's valuation once it rejected that of the Service.

Although the Second Circuit agreed that under Code Sec. 7491 the burden of proof on a particular factual issue shifts to the Service if the taxpayer introduces "credible evidence" and meets requirements relating to substantiation, recordkeeping, and cooperation with reasonable requests by the Service for information, this does not require the Tax Court to adopt the taxpayer's valuation whenever it rejects the Service's proposed value. The burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation.

In this case, the Service cited evidence on the record to rebut the estate's valuation, including the facts that the estate: (i) was overly pessimistic in its profit projections; (ii) failed to properly account for non-operating assets; and (iii) made assumptions that were inconsistent with the company's investments. The Second Circuit concluded that, notwithstanding Code Sec. 7491, the Tax Court is not bound by formulas or opinions of expert witnesses but may reach a determination of value based upon its own analysis of all the evidence in the record. The court affirmed the Tax Court's valuation, with the exception, agreed to by the parties, that the Tax Court made an error in calculation, which the Second Circuit directed it to correct in further proceedings.

Charitable Deduction Denied

In *Daniel Gomez et ux. v. Commissioner*; T.C. Summ. Op. 2008-93: No. 13167-07S (30 Jul 2008), taxpayers were members of the Apostolic Assembly, a church body. During 2005, they gave the Assembly $6,548.27. The Service, auditing their 2005 income tax return, found that, while they had checks to prove the gifts, they did not have the required receipts. They received a letter dated January 2008 from Apostolic Assembly indicating gifts that totaled $6,552. The Service denied the deductions because the letter was too late.

On the basis of these facts, the court found that, although there was no doubt that (i) gifts had been given, (ii) the church was a qualified charity, and (iii) the January 2008 letter substantiated the gifts, the statute required the letter to have been received by the due date of the income tax return on April 17,

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2006. Therefore, the Court denied the charitable deduction. Deductions under Code Secs. 170(a) and 170(c) require that for gifts of $250 or more, there must be “contemporaneous written acknowledgement from the donor organization.” The contemporaneous acknowledgement must be obtained on the earlier of the date the taxpayer files the return or the due date (including extensions) for this filing.

III. IRS REVENUE RULINGS, REVENUE PROCEDURES & NOTICES

Power to Substitute Trust Property Does not Result in Estate Inclusion (See earlier article)

In Rev Rul 2008-22, 2008-16 IRB 796, the Service makes it clear that the corpus of an irrevocable trust that a grantor created during life is not includible in his gross estate under Code Sec. 2036 or Code Sec. 2038 on account of the grantor having retained the power, exercisable in a nonfiduciary capacity, to acquire property held by the trust by substituting other property of equivalent value.

Taxpayer, a U.S. citizen, established and funded an irrevocable trust for the benefit of his descendants. The trust instrument provides that (i) taxpayer is barred from serving as trustee, (ii) taxpayer has the power, exercisable at any time, to acquire any property held in the trust by substituting other property of equivalent value, and further the power is exercisable by taxpayer in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity, and (iii) to exercise the power of substitution, he must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value.

Under local law, the trustee (i) has a fiduciary obligation to ensure that the properties being exchanged are of equivalent value, (ii) must act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries, and (iii) has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

The Service, noting that, under the facts as presented, taxpayer cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase his net worth, held that taxpayer’s retained power will not cause the value of the trust corpus to be included in his gross estate under Code Sec. 2036 or Code Sec. 2038.

Guidance on Estate and Gift Tax Value of Restrictive Management Accounts

In Rev. Rul. 2008-35, 2008-29 I.R.B. 116, the Service has ruled that the estate and gift tax valuation of restrictive management accounts is determined based on the value of the underlying assets, with no discount for account restrictions.

Taxpayer deposited marketable securities and cash into a five-year restrictive management account at a certain bank on the understanding that the restrictive management account will enhance the investment performance of taxpayer’s portfolio by allowing the investment advisor appointed by the bank to invest the portfolio without the risk that taxpayer will withdraw the assets before the end of the stated term. In exchange, the bank charges reduced management fees because the bank is guaranteed fees over the stated term.

During the restrictive management account’s term, the bank has full investment discretion and all dividends, interest, and other income earned are retained in the account and reinvested. Taxpayer may nominate an investment advisor for the account but the bank has the power to select and replace the advisor. At the end of the term, the bank will pay the account assets to taxpayer or, if he is not living, to his legal representative. The bank issues Forms 1099 to taxpayer for income generated by the account.

With the bank’s consent, taxpayer may extend the term and/or transfer or assign all or part of the account to taxpayer’s spouse, parents, and/or descendants or to a trust for any of them. If taxpayer makes a partial transfer, the bank will create a separate restricted management account for that portion and select the assets to be transferred. The transferee will be the “depositor” for the new account, which will be subject to the same terms as the original restricted management account. The new account’s terms will bind the transferee and his or her heirs, successors, transferees, executors, and administrators.

In the second year, when the value of the account assets have grown, taxpayer assigns 1/6 of the account to his child. The bank selects and transfers 1/6 of the assets to a new account with child as depositor. In the third year, taxpayer extends the restricted management account’s term for two years (for a total of seven years), with the bank’s consent. Taxpayer dies in the fourth year.

On the basis of these facts, the Service ruled that the fair market value of the restrictive manage-

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ment account for gift and estate tax purposes is determined based on the fair market value of the account's assets with no reduction or discount to reflect transfer or use restrictions. Therefore, (i) taxpayer's gift to his child is valued at the full value of the account assets at the time of the transfer to child's restrictive management account, and (ii) the value of the restrictive management account included in taxpayer's estate for estate tax purposes is the fair market value of the account at his date of death.

The Service observed that (i) taxpayer retains a property interest in the restrictive management account assets at all times, (ii) the bank does not have a property interest in the assets, (iii) taxpayer remains the sole and outright owner of the assets and income therefrom despite the account restrictions on withdrawal, termination, and transfer, and (iv) the restrictive management account does not change the nature of taxpayer's property. The restrictive management account agreement is a management contract and any restrictions imposed relate mainly to the performance of the management contract rather than to substantive restrictions on the underlying assets. The account restrictions do not impact the price at which those assets would change hands between a willing buyer and seller and, therefore, do not affect the value of the assets, in much the same way as a retirement fund or individual retirement account, or rental real estate managed by a property manager.

No Adverse Tax Consequences on Division of Charitable Remainder Trust

In Rev Rul 2008-41, 2008-30 IRB 170, the Service has ruled that a charitable remainder trust, meeting the requirements of Code Sec. 664, can be divided into two or more separate trusts with no adverse tax consequences. The ruling sets forth two fact situations.

In the first situation, the trust, a qualified CRAT or CRUT under Code Sec. 664, provides that two or more individuals are entitled to an equal share of the annuity or unitrust amount, payable annually, during the individual's lifetime, and upon the death of one individual, each surviving individual becomes entitled for life to an equal share of the deceased individual's annuity or unitrust amount. The last surviving individual becomes entitled to the entire annuity or unitrust amount for his life. Upon the death of the last surviving individual, the trust assets are to be distributed to one or more Code Sec. 170(c) qualified charitable organizations.

The state court having jurisdiction over the trust has approved a pro rata division of the trust into separate and equal trusts for each beneficiary living at the time of the division, with each asset of the trust divided equally among the separate trusts. The individual beneficiaries pay all the costs associated with the division.

Each of the separate trusts has the same provisions as the original trust, except that: (i) each separate trust is administered and invested independently, (ii) upon the death of the beneficiary, each asset of that beneficiary's separate trust is to be divided on a pro rata basis and transferred to the separate trusts of the surviving beneficiary(ies), with the annuity or unitrust amount payable to the beneficiary of each such separate trust increased by an equal share of the deceased beneficiary's annuity or unitrust amount (in the case of unitrust, the requirements of Reg. §1.664-3(b) with respect to the subsequent computation of the unitrust amount are incorporated into the separate trusts), and (iii) upon the death of the last surviving beneficiary, that beneficiary's separate trust terminates, and the assets are distributed to the remainder charitable beneficiaries. The remainder beneficiaries of the original trust are the remainder beneficiaries of each of the separate trusts and are entitled to the same total remainder interest after the division.

The facts of the second situation are similar to the above facts, except that the beneficiaries are a divorcing couple, and on the death of the first to die, the remainder of that separate trust will pass directly to the charities rather than to the separate trust of the survivor beneficiary. In this case, it is possible that the charities will receive more than under the original trust, but no increased charitable deduction is allowed.

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

1. The pro rata division of a trust that qualifies as a charitable remainder trust under Code Sec. 664(d) into two or more separate trusts does not cause the trust or any of the separate trusts to fail to qualify as a charitable remainder trust under Code Sec. 664(d).

2. The division is not a sale, exchange, or other disposition producing gain or loss, the basis under Code Sec. 1015 of each separate trust's share of each asset is the same share of the basis of that asset in the hands of the trust immediately

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before the division of the trust, and, under Code Sec. 1223, each separate trust's holding period for an asset transferred to it by the original trust includes the holding period of the asset as held by the original trust immediately before the division.

3. The division does not terminate the trust's status under the private foundation provisions of Code Sec. 4947(a)(2), and does not result in the imposition of an excise tax under Code Sec. 507(c), nor does the division constitute an act of self-dealing under Code Sec. 4941 or a taxable expenditure under Code Sec. 4945.

Proposed Revenue Ruling Approves Use of Private Trust Companies

In Notice 2008-63, 2008-31 IRB, the Service has issued a proposed revenue ruling permitting families to use private trust companies without adverse income, estate, gift or generation-skipping transfer tax consequences for the trust creators or beneficiaries in certain defined situations.

The proposed ruling covers two specific fact situations. A married couple established separate irrevocable trusts for each of their three children, all of whom are married and have their own children. The trustee of each trust has discretionary authority to distribute income and/or principal to the primary beneficiary during his lifetime and the primary beneficiary has a testamentary power to appoint the trust corpus to or for the benefit of one or more family members and/or charities. Each trust also provides that the grantor, or the primary beneficiary if the grantor is not living, may appoint a successor trustee other than himself or herself if the current trustee can no longer serve for any reason.

In the first situation, the trust is governed by the laws of a state that has enacted a private trust company statute which provides that any private trust company formed under the statute must create a discretionary distribution committee and delegate to the committee the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as trustee. The statute provides that no member of the committee may participate in the activities of the committee with regard to any trust of which that committee member or his or her spouse is a grantor, a beneficiary, or with respect to any trust with a beneficiary to whom that committee member or his or her spouse owes a legal obligation of support.

In 2008, the couple and their children formed a private trust company with governing documents creating a discretionary distribution committee that will make all decisions with respect to discretionary distributions from all trusts for which it serves as trustee, consistent with the statute. There is detailed information concerning the discretionary distribution committee's powers and restrictions on who may serve as committee members. Members of the family own all of the stock in the private trust company, either outright or through trusts and/or other entities. The private trust company, established for the specific purpose of acting as the trustee for various trusts established by members of the family, is appointed trustee of the above trusts and additional family trusts.

The facts of the second situation are the same except that the private trust company is formed in a state that has not enacted a statute governing the formation or operation of a private trust company.

On the basis of these facts, the Service in the proposed revenue ruling concludes that neither the appointment nor the service of the private trust company as trustee of a family trust described in each situation will by itself (i) cause the value of the trust assets to be included in a grantor's gross estate under Code Sec. 2036(a) or Code Sec. 2038(a), (ii) cause the value of the trust assets to be included in a beneficiary's estate under Code Sec. 2041, (iii) affect the exempt status of that trust if the trust is otherwise exempt from the GST tax under the grandfather exception in Reg. §26.2601-1(b)(1)(i), or change the inclusion ratio of a trust, or (iv) cause any grantor or beneficiary of that trust to be treated as the owner of that trust or any portion thereof under Code Secs. 673, 676, 677, or 678. Whether any grantor is treated as an owner of the trust or any portion of it under Code Sec. 675 is a question of fact. Whether any grantor is treated as an owner of the trust or any portion thereof under Code Sec. 674 will depend upon the particular powers of the trustee and may depend upon the proportion of the members of the discretionary distribution committee with authority to act with regard to that trust who are related or subordinate to the grantor.

Last, the proposed revenue ruling concludes that neither the appointment nor the service of a private trust company as the trustee of the trusts in which the trustee has the discretionary power to distribute income and/or principal to the grant-

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or's child or descendants in either situation above will by itself cause the grantor's transfer to that trust to be deemed to be an incomplete gift under Code Sec. 2511, or any distribution from the trust to be a gift by any committee member.

Service Provides Sample Inter Vivos Charitable Lead Unitrust Forms

In Rev Proc 2008-45, 2008-30 IRB 224, the Service has provided sample trusts and alternate provisions that meet the requirements for an inter vivos charitable lead unitrust.

Sections 4., 5. and 6. provide a sample declaration of trust for a nongrantor charitable lead unitrust with a term of years unitrust period with annotations and samples of alternate provisions. If a trust (i) is substantially similar to the sample trust or properly integrates one or more alternate provisions into a substantially similar trust, (ii) is a valid trust under applicable local law, and operates in a manner consistent with the terms of the instrument, and (iii) if all other deductibility requirements are satisfied, the value of the charitable lead interest will be deductible under Code Sec. 2522(c)(2)(B) and/or Code Sec. 2055(e)(2)(B), and payments of the unitrust amount to the charitable lead beneficiary will be deductible from the gross income of the trust to the extent provided by Code Sec. 642(c)(1). A nongrantor charitable lead unitrust will also qualify for this safe harbor if the trust satisfies all of the above requirements, except that it defines the unitrust amount as a varying percentage amount for which the value is ascertainable at the creation of the trust and/or provides for a different disposition of trust assets upon the termination of the unitrust period.

Sections 7., 8. and 9. provide a sample declaration of trust for a grantor charitable lead unitrust with annotations and samples of alternate provisions. If a trust (i) is substantially similar to the sample trust or properly integrates one or more alternate provisions into a substantially similar trust, (ii) is a valid trust under applicable local law, and operates in a manner consistent with the terms of the instrument, and (iii) if all other deductibility requirements are satisfied, the value of the charitable lead interest will be deductible under Code Sec. 170(a), Code Sec. 2522(c)(2)(B), and/or Code Sec. 2055(e)(2)(B). A grantor charitable lead unitrust will also qualify for this safe harbor if the trust satisfies all of the above requirements except that it (i) contains a different power or provision sufficient to make the donor the owner of the entire charitable lead unitrust under the grantor trust provisions, (ii) defines the unitrust amount as a varying percentage amount for which the value is ascertainable at the creation of the trust; and/or (iii) provides for a different disposition of trust assets upon the termination of the unitrust period.

Service Provides Sample Testamentary Charitable Lead Unitrust Form

In Rev Proc 2008-46, 2008-30 IRB 238, has provided a sample form, annotations, and alternate provisions for a testamentary charitable lead unitrust. If a trust (i) is substantially similar to the sample trust or properly integrates one or more alternate provisions into a substantially similar trust, (ii) is a valid trust under applicable local law, and operates in a manner consistent with the terms of the instrument, and (iii) if all other deductibility requirements are satisfied, the value of the charitable lead interest will be deductible by the decedent's estate under Code Sec. 2055(e)(2)(B), and payments of the unitrust amount to the charitable lead beneficiary will be deductible from the gross income of the trust to the extent provided by Code Sec. 642(c)(1). A testamentary charitable lead unitrust will also qualify for the safe harbor if the trust satisfies all of the above requirements, except that it defines the unitrust amount as a varying percentage amount for which the value is ascertainable at the creation of the trust and/or provides for a different disposition of trust assets upon the termination of the unitrust period.

IV. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Power Over Trust not a General Power of Appointment

In PLR 200812022, grantor created a trust for his spouse and descendants which became irrevocable before October 21, 1942. Following the deaths of grantor, his spouse and child, grantor's grandchild became the sole income beneficiary of the trust. Before November 1, 1951, when grandchild was 19, grandchild partially released and renounced her testamentary power of appointment over the trust, retaining only a limited testamentary power to appoint to and among certain parties, not including herself, her estate, her creditors, or the creditors of her estate.

Governing state law specifically allows power of appointment holders to partially or wholly release such powers. Although state law provides that the age of majority is 21, the trust, which does not prohibit releases of powers of appointment, expressly allowed grandchild to exercise her power of appointment once she reached age 18. Grand-

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child plans to exercise her testamentary power to appoint the remainder of the trust to her issue per stirpes at her death. No one has made any additions to the trust, or amended or reformed the trust, since September 25, 1985.

On the basis of these facts, the Service ruled that (i) grandchild's limited power to appoint the trust assets is not a general power of appointment, and (ii) grandchild's planned exercise of her power of appointment in favor of her issue per stirpes will not be deemed a constructive addition to the trust for GST tax purposes.

Code Sec. 2041(a)(1) includes in the gross estate general powers of appointment created on or before October 21, 1942 to the extent exercised but provides that the failure to exercise, or the complete release of, such a power is not deemed an exercise of the power. Where a general power of appointment created on or before October 21, 1942 is partially released before November 1, 1951 so that it is no longer a general power, an exercise of the power is not deemed to be the exercise of a general power of appointment. Citing Regs. §20.2041-2(e), the Service assumed that all general powers are releasable unless local law provides otherwise and that the release method used is effective unless the method is not in accordance with local law.

Regarding the GST tax issue, the trust is exempt from the GST tax because the GST tax does not apply to a generation-skipping transfer under a trust that was irrevocable on September 25, 1985 to the extent the transfer is not made out of corpus added to the trust after that date (or income on such additional corpus. Because grandchild partially released her general power of appointment before September 25, 1985, the partial release was not taxable for gift or estate tax purposes. Citing Regs. §26.2601-1(b)(1)(v)(B), grandchild's proposed exercise of her limited power of appointment will not constitute an addition to the trust because the exercise of a limited power is not treated as a trust addition for GST tax purposes if (i) the power of appointment was created in a trust that is not subject to the GST tax because the trust was irrevocable on September 25, 1985, and (i) the exercise does not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for any period, measured from the trust's creation date, extending beyond any life in being at the trust's creation date plus 21 years.

Charitable Remainder Trust not Disqualified

In PLR 200813006 and PLR 200813023, a trust intended to qualify as a charitable remainder unitrust under Code Sec. 664(d)(2) provides that the trustee must pay a certain portion of the unitrust to grantor for life and also provides that the trustee has discretion to allocate payments of the remaining portion of the unitrust amount among the grantor and the charitable beneficiaries. The trust agreement lists, in order, the names of possible successor special trustees. The grantor retains the power to appoint a successor special trustee included in the list. The trust agreement provides that in no event may the grantor or any party that is related or subordinate to the grantor act as special trustee. The trust agreement also provides that the grantor retains the power to replace the charitable remainder beneficiary with one or more charitable organizations.

On the basis of these facts, the Service sanctioned a power in the special trustee to allocate payments of a portion of the unitrust among grantor and the charitable beneficiaries. Granting the independent trustee power to allocate payments is not inconsistent with the provisions of the Code and regulations governing charitable remainder trusts, provided that the governing instrument requires that a portion of the unitrust must be allocated and paid to the noncharitable beneficiaries each year and provided that the portion of the unitrust amount so paid is not de minimis. The grantor's retained power to remove and replace the trustee will not cause any person to be treated as the owner of the trust because the terms of the trust agreement prevent grantor from substituting a trustee that is subordinate to grantor.

The Service further ruled that because grantor retains the right to designate the charitable remainder beneficiary or beneficiaries of the trust, grantor will not make a completed gift of the remainder when the trust is created; however, retention of this power will not disqualify an otherwise qualifying charitable remainder trust.

The trust agreement in PLR 200813006 was created by two grantors, husband and wife. In addition to the provisions discussed above, the trust provides for the unitrust amount to be paid for the joint lives of husband and wife; upon the death of the first spouse, the unitrust amount will be paid to the surviving spouse for life, and the surviving spouse becomes the only noncharitable beneficiary of the trust. Because, upon creation of the trust, husband and wife are each treated as making a gift to the other of a successive unitrust interest for life in the one-half portion of the trust property each contributes, and because the donee

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spouse is the only noncharitable beneficiary other than the donor spouse, neither husband nor wife is subject to gift tax upon creation of the trust. Finally, the Service ruled that, upon the death of the first spouse, the unitrust interest passing from the predeceasing spouse to the surviving spouse will qualify for the marital deduction under Code Sec. 2056(b)(8), as long as the trust satisfies the requirements of Code Sec. 664. The surviving spouse will be the only noncharitable beneficiary of the trust and therefore, the interest passing from the decedent spouse to the surviving spouse will not breach the terminable interest rule and will qualify for the marital deduction.

No Addition Made to Trust for GST Tax Purposes or Gift Tax Purposes

In PLR 200816008, the Will of a decedent who died before September 25, 1985 established a trust for decedent's granddaughter funded with estate assets, including mineral interests. Granddaughter is to receive the trust's net income each year during her life. At her death, the remainder of the trust is to pass to her descendants or to charity.

State law provides that if a trust receives proceeds from an interest in minerals, 27.5% of the gross proceeds is to be allocated to principal and the balance to income. Pursuant to this rule, the trustee, has allocated 27.5% of the trust's mineral receipts to principal. However, for several years, the Schedules K1 prepared by trustee reported that all mineral receipts were allocated to income and distributed to granddaughter, and granddaughter included all of the trust's mineral revenues in calculating her personal income tax liability each year.

The error was discovered and amended trust returns were filed. Granddaughter asserted her right of recovery for reimbursement against the trust for the excess income taxes she paid and the trustee, pursuant to its power under state law, has agreed to reimburse granddaughter from trust principal for this amount plus interest at the applicable Code Sec. 7520 rate.

On the basis of these facts, the Service, citing Regs. §26.2601-1(b)(1)(v)(C), ruled that no addition to the trust occurred for GST tax purposes nor did granddaughter make a gift to the trust as a result of granddaughter's erroneous payment of additional income tax because she timely enforced her right of recovery and she will be reimbursed from trust principal.

Lifetime Payouts to Nonspouse IRA Beneficiary Approved

In PLR 200811028, child of decedent who died in 2002 at age 66 was named as the sole beneficiary of decedent's two IRAs. Following decedent's death the IRAs were retitled in the name of decedent, also naming child as beneficiary.

Both IRAs provide that where a required distribution has not commenced before the owner's death, the owner's nonspouse designated beneficiary may choose to have the balance of the IRA distributed to over his or her life expectancy starting by December 31 of the year following the year of the IRA owner's death or, alternatively, in accordance with the five-year rule.

Child failed to start taking required minimum distributions for 2003 (the year after her father died), and for 2004. The required minimum distributions for 2003, 2004, and 2005 were taken in the aggregate in 2005, based on child's life expectancy for each year. In 2007, child paid the Code Sec. 4974(a) penalty tax for her failure to timely receive required minimum distributions for 2003 and 2004. Child represented, and evidence submitted in conjunction with the ruling request supported the representation, that she had not elected the 5 year distribution rule for either IRA.

On the basis of these facts, the Service concluded that child could take required minimum distributions from the two IRAs over her life expectancy. Because both IRAs provide that where an IRA owner dies before his RMD, distributions to a beneficiary are to be made under the life-expectancy rule unless the designated beneficiary chooses otherwise, the Service found that the "default" required distribution rule for both IRAs is the life-expectancy rule and not the five-year rule. Child had not elected the five-year rule for either IRA and paid the 50% excise tax on the distributions she should have but didn't receive in 2003 and 2004. Therefore, the Service concluded that "the life-expectancy rule of Code Sec. 401(a)(9)(B)(iii) applies to distributions from both IRAs.

Reformation of NIMCRUT not Self-Dealing and Will not Violate Code Sec. 664

In PLR 200818002, taxpayer created a NIMCRUT with a foundation as the trustee and remainder beneficiary of the trust. An officer at the foundation discovered that, although the trust instrument, which was drafted by counsel for the foundation, created a NIMCRUT, the trust had been treated as a standard payment unitrust since its inception. The foundation's counsel

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advised the foundation it would have to recapture the excess payments to the taxpayer in order to keep the trust in compliance with the requirements of Code Sec. 664 but taxpayer refused to repay the excess distributions because taxpayer had intended to create a CRUT rather than a NIMCRUT. In order to avoid litigation, the taxpayer and the foundation entered into a settlement agreement in which they agreed to seek judicial reformation of the NIMCRUT into a standard CRUT.

The attorney general waived any objection to the trust reformation, and the state court approved the requested reformation based on a mistake in the original trust document because it did not reflect taxpayer's intent to create a CRUT. The court's order was contingent on a private letter ruling that the trust will retain its qualification under Code Sec. 664(d) following the reformation.

On the basis of these facts, the Service ruled that the contemplated reformation is consistent with state law and therefore does not violate Code Sec. 664 and will not adversely affect the trust's qualification as a valid CRUT. Although under Regs. §1.664-3(a)(4), a charitable remainder trust may not be subject to a power to alter or amend for the beneficial use of a person other than the charitable organization, a reformation of a charitable remainder trust does not violate Code Sec. 664 if the reformation is necessary to conform the trust instrument to the grantor's intent.

The Service further ruled that, based on the state court's finding of mistake in the original draft of the trust documents and the state attorney general's waiver of any objection to the reformation, the judicial reformation of the trust does not result in an act of self-dealing under Code Sec. 4941.

Judicially Reformed Trust Does not Qualify as Valid CRUT Under Code Sec. 2055

In PLR 200818003, in 1954 decedent created an inter vivos trust directing the Trustee to make payments to decedent's wife during her life; following her death to make monthly payments to decedent's two children during their respective lives, and following the death of each child, to make monthly payments to each child's children. Upon the death of the last to die of decedent's wife, children and grandchildren, the principal and income were to be retained by the trustee, to distribute the net trust income to whomever trustee may select for the purpose of the correction or betterment of crippled or underprivileged children.

After the death of wife and children, the trustee petitioned the court to reform the trust to establish a charitable remainder trust within the meaning of Rev. Proc. 2005-55, 2005-2 C.B. 367, and Code Sec. 664(d)(2). The reformed trust provides that in each taxable year the trustee shall pay to decedent's three grandchildren a unitrust amount equal to 5% of the net fair market value of the assets of the trust valued as of the first day of each taxable year of the trust.

On the basis of these facts, the Service ruled that the trust, as reformed, does not qualify as a valid charitable remainder trust under Code Sec. 664(d). When a trust has not functioned exclusively as a charitable remainder trust since its inception, only in limited circumstances may it be reformed to qualify as a charitable remainder trust. The reformation provision that allows a remainder interest in a split-interest trust to qualify for the gift tax charitable deduction applies only to transfers made after 1969; because the transfer of Decedent's trust took place in 1954, the Service concluded that the trust did not qualify as a valid charitable remainder trust under Code Sec. 664(d).

Reformation of Trust to Authorize Reimbursement of Grantor's Income Tax Liability Will not Cause Estate Inclusion

In PLR 200822008, grantor executed an irrevocable trust, designating his spouse as trustee. Under the trust provisions, grantor will be treated as the owner of the trust under Code Sec. 671 and will be required to include the trust income in determining his individual income tax liability. The trust prohibits spouse from reimbursing grantor for any income tax and grantor expressly waived any right to receive a reimbursement. Spouse proposes to petition the court seeking a judgment to modify the trust and authorize, but not direct, spouse with the approval of a reimbursement committee and at least one child beneficiary of majority age who qualifies as a Code Sec. 672(c) adverse party, to reimburse grantor for any federal, state, or local income tax liability attributable to the trust's taxable income.

On the basis of these facts, the Service ruled that the reformation of a trust to authorize the reimbursement of a grantor's tax liability will not, on its own, (i) cause the inclusion of the trust assets in the grantor's gross estate, or (ii) affect the status of the trust as a grantor trust.

The Service examined Rev. Rul. 2004-64, 2004-2 C.B. 7, to de-

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termine whether any income tax reimbursement would cause the value of the trust's assets to be included in grantor's gross estate. Because any distribution must be approved by the reimbursement committee, consisting of an individual or individuals who are not related or subordinate to grantor within the meaning of Code Sec. 672(c), and assuming there is no understanding, express or implied, between grantor, the reimbursement committee, and spouse regarding spouse's exercise of discretion, spouse's discretion to reimburse grantor would not cause the inclusion of the trust in grantor's gross estate.

Lastly, the Service ruled that, because (i) the reformation is valid under applicable state law, (ii) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person(s) who held the beneficial interest prior to the modification, and (iii) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust, the proposed modification meets the requirements of Regs. §26.2601-1(b)(4)(i)(D), and will not affect the inclusion ratio of the exempt trust for GST purposes.

Transfer of IRA to Minor's Trust not Taxable Disposition Under Code Sec. 691

In PLR 200826008, decedent's minor child was one of the designated beneficiaries of his IRA and his share was set aside in a separate IRA of which he is the sole beneficiary. The minor's conservator proposes to petition the state court to authorize the creation of a trust for the minor's benefit to which the IRA will be transferred. The terms of the trust will provide that the minor is the sole beneficiary of the trust during his lifetime; upon his death, he will have a general power of appointment.

On the basis of these facts, the Service ruled that the trust will be a grantor trust owned by the minor under Code Secs. 671 and 677(a) because the trust income, without the consent of an adverse party, may be distributed to the minor or held or accumulated for the minor; therefore the transfer of the minor's share of the IRA to the trust is not a transfer for purposes of Code Sec. 691(a)(2). Code Sec. 691(a)(1) provides that the amount of all items of gross income in respect of a decedent that are not includible in the taxable period which includes the decedent's date of death is included in gross income, for the taxable year when received, of either the decedent's estate or the person who acquires the right to receive the amount because of the decedent's death. Under Code Sec. 691(a)(2), if a person who receives this right transfers the right, the fair market value of such right at the time of the transfer plus the amount by which any consideration for the transfer exceeds such fair market value is includible in gross income. The term "transfer" does not include transmission at death to the decedent's estate or a transfer to a person pursuant to the right of such person to receive such amount by reason of the decedent's death.❖