I am pleased to report that the work of the Section and Committees has continued unabated.

At the June quarterly meeting, the Education Committee, led by Aaron Fox, presented a PBI CLE program entitled *What Estate Planners Should Do or Un-Do in a Troubling Economy* to an audience of almost 150 members. The expert presenters, Thomas Hiscott, Rebecca Rosenberger Smolen, and David Weinreb, provided timely and specific techniques for these trying financial times, backed up by statistical data demonstrating the efficacy of these techniques. In addition, Don DiCarlo, Co-Chair of the Taxation Committee, updated Members on recent tax developments. To round out the day, attendees brought with them children’s books, which were donated to Philadelphia Family Court Master Christine Adair’s program to provide books to newly-adopted children in Philadelphia. Email me at mthompson@cozen.com, if you would like to donate books to Master Adair’s program. The need continues!

The Elder Law Committee, led by Keelin Barry and Rise Newman, has been hard at work on a guardianship manual to guide practitioners and the public who serve as counsel or guardians for incapacitated persons. In addition, under the leadership of Gordon Wase, Section members are filling a great need, identified by the Philadelphia Orphans’ Court, for volunteers to serve as counsel to, or guardians for, alleged incapacitated persons. If you are not on the list, and wish to volunteer, contact Gordon Wase at gordon.wase@verizon.net. Elder Law Committee members are available to assist all volunteers, so you can sign up even if you are not experienced in this area of the law.

The Legislative Committee, led by Kathleen Stephenson, continues its review of pending and planned legislation, including the Uniform Prudent Management of Institutional Funds Act and the proposed Pennsylvania Assisted
Reproductive Technologies Act. In addition, with the assistance of Jay Foster (the Section’s Legislative Liaison), and the Legislative and Elder Law Committees, the Section co-sponsored a Philadelphia Bar Association Resolution, opposing a Pennsylvania bill that would allow the Department of Public Welfare to reach the non-probate assets of deceased medical assistance recipients.

The Orphans’ Court Litigation & Dispute Resolution Committee, led by Tim Holman, has examined a number of timely issues, including ethical issues for fiduciary litigators and metadata in E-discovery. Look for this Committee to provide reports on their work in upcoming newsletters.

The Publications Committee, led by David Ruben, has produced this second Newsletter of the year. I think you will agree that the articles are timely and important. Please let David (davidaruben@gmail.com) know if you have an idea for an article or would be willing to author an article yourself.

The Rules and Practice Committee, led by Bernice Koplin, recently completed a massive project examining the minors’ compromise procedures as set forth in the Philadelphia Orphans’ Court Rules and Civil Rules of Procedure. The Committee will be working with the Court on this project in the upcoming months. In addition, the Committee is assisting the Elder Law Committee by reviewing the draft guardianship manual for rule-related issues.

Since our last newsletter, the Tax Committee, led by Terry Kline and Don DiCarlo, has presented two timely programs. On May 5, Paula Jones was the presenter for a program on international estate planning issues. On June 2, Richard Nenno was the presenter for a program on trust decanting. Check out the Tax Committee page on the Philadelphia Bar Association/Probate Section Website for podcasts of these programs. Also mark your calendar for the Tax Committee’s October 6 program, which will be the annual Pennsylvania Inheritance Tax Update presented by Pennsylvania Department of Revenue officials.

As of this writing, Probate Section volunteers are manning the desks for the national service initiative, Get Help now PA!, in which attorneys and bankers help direct those in need in our community to service organizations that can assist them. The Philadelphia Bar Association asked each Section to sponsor a week, and our Section responded. We are very grateful to Section Members, Keelin Barry, Kara Chickson, Don DiCarlo, Mary Kenney, Dan Mandel, David Ruben, and Judy Stein, for their service and for representing the Section so ably.

The Section is only as good as its active Members, of which there are many. I invite every Member to participate in the work of the Section. Join a Committee (email me at mthompson@cozen.com), visit the Section page at the Philadelphia Bar Association website, www.philadephhiabar.org, and use the Section Listserv PROBATE_AND_TRUST_PBA@LISTSERVE.PHILABAR.ORG).

I hope that your summer was refreshing and provided an opportunity to spend time with family and friends. Best wishes for a busy and fulfilling fall.

**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:

David A. Ruben, Esquire
email: davidaruben@gmail.com
A GRAT Strategy for All Seasons

By DAVID WEINREB
BERNSTEIN GLOBAL WEALTH MANAGEMENT

When funded with publicly traded stocks, “rolling” short-term GRATs should outperform longer-term GRATs no matter the 7520 rate at inception.

As the Section 7520 rate dropped this year to record lows (2.0% in February 2009), some estate planners began recommending that clients create long-term grantor retained annuity trusts (“GRATs”) to “lock in” a low “hurdle rate.” Although this may seem like a sound strategy, our research shows that it is not the best approach. For GRATs funded with relatively volatile liquid assets, such as publicly traded stocks, a series of “zeroed out,” “rolling” short-term GRATs is a far more effective wealth transfer strategy, regardless of the 7520 rate at the strategy’s inception.

Capitalizing on Volatility

A series of rolling short-term GRATs is highly likely to outperform a single long-term GRAT for two main reasons:

First, the strategy keeps more of the funds committed to wealth transfer at work. In a single long-term GRAT, the funds committed to the strategy decline each year, as the annuity payments return assets in the GRAT to the grantor. By contrast, the rolling GRAT strategy maintains all of the original funds committed to the strategy that don’t pass to the beneficiaries in GRATs.

Second, the shorter two-year time horizon minimizes the chance that good investment performance in one year will be offset by poor investment performance in another year. Even if the compound annual return during a 10-year period is poor, there may be good two-year periods along the way that will successfully transfer wealth.

As an example, consider the decade that just ended: 1999 through 2008. During this period, the S&P 500 produced a compound annual return of negative 1.4%—the worst since the Great Depression. The 7520 rate at the start of this period was 5.6%. If one had created a 10-year zeroed out GRAT with $10 million on January 1, 1998, it would have failed to transfer any wealth to the remainder beneficiaries. However, if one had engaged in rolling two-year GRAT strategy, one would have seen five of those GRATs succeed, transferring $3.7 million. This example shows how the rolling GRAT strategy capitalizes on the short-term volatility of the stock market. (See “Capitalizing on Volatility,” below.)

An Historical Analysis

But what about other historical periods? How would term and rolling GRAT strategies compare across a span of “real life” conditions? We compared the results of the two strategies—rolling short-term versus simple 10-year term—assuming they had been launched every month from May 1941 through April 1998, for 684 trials in all. We assumed each GRAT began with $10 million invested in the S&P 500. And, since the 7520 rate has existed only since 1989, we created a proxy for earlier periods based on the IRS methodology. This 57-year span covers a wide range of interest rates and stock market returns, with the 7520 rate averaging 6.7 percent, but dipping as low as 1.2 percent.

The results were striking: The rolling short-term GRAT strategy beat the 10-year term GRAT in every period, and succeeded 100 percent of the time at transferring wealth to the next generation, while the long-term GRAT succeeded only 80 percent of the time.

Not only was the rate of success higher, but the amount of wealth transferred was much higher. Even when the 10-year term GRATs succeeded, the rolling GRAT strategy transferred nearly twice as much wealth in the median case: an inflation-adjusted transfer of $11.0 million compared with only $6.1 million for the 10-year GRAT.

We also compared term GRATs of less than 10 years, since it was clear that the 10-year term had

1 A GRAT is “zeroed out” if the value of its annuity payments, as determined under IRC Section 7520, equals the value of the property that the grantor transfers to the GRAT. “Rolling GRATs” refers to a strategy in which a grantor uses the annuity payment he receives each year from a GRAT to fund a new GRAT.

2 We assumed that each 10-year GRAT had annuity payments that increased by 20% each year and that each two-year GRAT had level annuity payments.
A GRAT Strategy, continued

significant weaknesses. The results were comparable: Running the same historical analysis using four-year term GRATs versus four years of rolling two-year GRATs, the rolling strategy succeeded 96% of the time after only four years, compared with 74% for the four-year term GRATs. And out of the 756 periods, the four-year term GRAT transferred more wealth than the rolling strategy only 18 times, or in 2.4 percent of the trials.

A Timeless Strategy

Based on our research, there should be no doubt that a series of rolling short-term GRATs is a better way to transfer publicly traded stocks than a long-term GRAT, regardless of 7520 rates. Further, the rolling short-term GRAT strategy provides the added benefit of flexibility: If for some reason the grantor wishes to stop the strategy, he or she can simply stop the “rolling” process.

One of the well-worn maxims of investment management is that it doesn’t pay to time the market. We might add that trying to “time” a GRAT strategy—or estate planning in general—is equally misguided. Smart estate planning is timeless: One can shield wealth from gift and estate taxes in any interest rate environment. And a series of rolling short-term GRATs funded with publicly traded stocks is a simple and effective wealth transfer strategy at any time.

Ed. Note: Bernstein Global Wealth Management is a unit of Alliance Bernstein L.P. Bernstein does not offer tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

Role with the Changes

By DAVID M. WEISS
SAMUEL T. FREEMAN & CO.

Auctioneers have been characterized with many labels: from estimable art experts, to market prognosticators, to frustrated actors (for those who also sell property on the rostrum), to less flattering names. In the modern era, auctioneers’ day to day duties necessitate a broad variety of skill sets in which the worlds of connoisseurship and commerce intersect. As connoisseurs, fine art and antiques auctioneers are often judged by the degree to which they possess a so-called ‘good eye,’ or, simply stated, having the knowledge, experience and visual acumen to discern the quality, age and authenticity of an object—i.e. its ‘rightness,’ to paraphrase from The Expert versus the Object, Judging Fakes and False Attributions in the Visual Arts (Ronald D. Spencer, editor, 2004), whether for purposes of providing formal written verbal evaluations or condition reports before an auction. As agents of commerce, auctioneers seek to procure consignments, which typically necessitates being skilled in the areas of communication, negotiation and salesmanship. As the economy at large, and the art and antiques market – a trailing indicator of the former’s health – has softened, being good listeners and expressing empathy for consignors and bidders who have suffered financially in the downturn and/or are uncertain about selling/buying, are skills requisite in any industry involving sellers, buyers and commodities. Possessing such interpersonal skills in big doses, at the risk of playing the role of a hand holding armchair psychologist, has of late, become as integral to being a good auctioneer as it is to being a successful stockbroker or realtor.

On an institutional level, auction houses have experienced seismic changes since Sotheby’s and Christie’s set up shop in 18th century Britain. The modern auction house ‘version 2.0’ has come a long way in shedding its earlier identity as a more perceptibly clubby, dealer-driven institution. An unabashed democratization of the auction/‘what is it worth’ process, in part demystified by the success of eBay and other online commerce hubs, along with the popularity of television programs featuring experts engaged in educating and appraising, is clearly evident (full disclosure: the author participates as an appraiser on one such program). Auctions have, in the modern era, gained a much broader following among large sectors of the populace, not only as a venue of choice to buy and sell goods, and for many an interesting and sometimes newsworthy spectator sport. There has also been substantial growth in the sheer number of auction houses (notwithstanding, as in any industry, some examples of consolidation amongst houses), whether national/international, or regional/local in size and scope, with offerings ranging from the generic and more moderately priced to high end art and antiques offered in single genre, or sometimes single owner sales.

One need only compare a typical auction catalogue of earlier generations - many with printed descriptions devoid of any accompanying illustrations, or at best poorly reproduced black and white illustrations - with the modern auction catalogue produced by most auction continued on Page 5
Role with the Changes, continued

houses. The latter is typically replete with color illustrations, and in most cases, well-researched, scholarly entries. At the top end, the catalogues themselves have become indispensable learning tools for the collector and appraiser alike, with some, created to advertise world-class collections, dressed up with hard bound cloth covers and highlighted with the occasional priciest lots with no accompanying pre-sale estimates, but instead given the marquee designation of ‘estimate upon request’ or ‘refer to department’ - the absence of a published estimate being indicative of an item’s quality, pedigree and worth. Quite apart from the objects they describe and promote, many catalogues in the modern era have themselves become collector’s items, suitable for display on any art and antique lover’s coffee table. The next wave of catalogue production points to, well, an end to catalogues and the dead-wood era they represent. In their place, some auctioneers are turning up with the regularity to which many auctioneers, sellers and buyers are accustomed.

Stated differently, Frederic Edwin Church is not painting any more landscapes, Thomas Chippendale is not constructing any more cabinets and Johannes Gutenberg is not printing any more bibles. In short, across many categories, there is a dwindling supply of the top goods, a fact that is in part the culprit for noticeably thinner auction catalogues in many sales rooms. This dearth of high end material seems to be an omnipresent story, providing sufficient ink for nearly every art market publication over the last year or two. With many sellers’ current reticence to part with their goods in a topsy-turvy environment, while looming in the background, industry pundits attempt to read the tea leaves to see if the market has bottomed (“Has the market finally bottomed out?” asks the lead story headline in the July-August edition of ‘The Art Newspaper’) it is fair to say that not since around 1991, the time of which the last major, recognized downturn, have auctioneers faced such a challenging environment.

Evolving markets and ever changing fortunes notwithstanding, one constant of the auction industry is the role of the auctioneer – whether of the traditional brick and mortar or internet-based type: to serve as the seller’s agent. While representing the seller, auctioneers, by operational necessity, seek to win consignments. Many consignments are procured by an auction house because a seller is loyal to one of its appraisers or to a particular firm(s) based on its reputation in the market place. Some of the more lucrative consignments that include property that will give an auction house valuable market share in a specific category(ies) are secured only after a prospective seller accepts an auctioneer’s proposal, often one of many from rival houses that he/she will entertain. While auctioneers strive to be accurate and reasonable in both setting auction estimates and proposing consignment terms, ‘Company A’ may determine it necessary to tweak proposed prices upward or slightly reduce the seller’s commission should there be indications that ‘Company B’ has offered slightly higher estimates and more favorable consignment terms, but that all things being equal, the client prefers to sell with ‘Company A.’ To be clear, this author is neither implying that in every instance an auctioneer must compete head-to-head for the privilege of selling better goods, nor that estimates are randomly adjusted to win business. Further, consignment terms are generally not adjusted to such a degree in favor of the seller that it results in the auctioneers’ financial detriment.

Still, to what lengths should auctioneers have to go as business winners? Well, according to the latest Antiques Trade Gazette (July 11, 2009)...“sourcing top-end material at the right price has proved harder than ever.” Auctioneers may wag a cautionary finger at overzealous sellers, advising them that if reserves (minimum prices beneath which continued on Page 6
Role with the Changes, continued

Lots cannot be sold generally set by auction specialists with the seller’s approval) are excessive, even sought after items may not sell. To cite a colorful old industry adage that describes sellers perceived as potentially overly greedy, ‘pigs get fat, but hogs get slaughtered.’ Still, there are generally more buyers with cash than there are sellers with valuable goods. So, based on this supply/demand paradigm, sellers of desirable property are courted by auctioneers like the most popular girl in school at prom time. The decline in seller’s premiums at the top end, culminating at times, in zero commission charge, and the coterminal slow ratcheting up of buyer’s premiums in recent years to bridge the gap in lost revenues, is one way auctioneers hope to put smiles on the faces of potential sellers and thereby win consignments.

In the modern era, auctioneers, while never to be confused with performing functions associated with banking, do provide services that are not entirely dissimilar to those offered by financial firms. These include monetary advances for consignors against future sales; ‘enhanced hammer’s (see Art & Auction, June 2009, p. 26); the house refunds to the seller a negotiated portion of the hammer price, normally in conjunction with waiving the seller’s commission; auction house guarantees: the house guarantees the seller that she/he will receive an agreed upon price. If this price is not realized in the actual course of bidding, the house will pay the seller for the item. As a result, at least one major house, as of this writing, discontinued offering such guarantees when the market began to cool last fall (www.theartnewspaper.com/January 2009).

Despite a few raised eye-brows and assertions in some quarters of proverbial smell tests being flunked, the world’s two largest auctioneers offer variations concerning guarantees. They are: third party guarantees and ‘irrevocable bids’ (the latter introduced solely, apparently by Sotheby’s, in October 2008) (www.theartnewspaper.com, online article published March 11, 2008). These contractual provisions essentially insure that a lot is pre-sold prior to the auction, but not, however, by the auction house, whose role is no longer to serve as the consignor’s direct guarantor of top end lots. Instead, these guarantees are made by a third party. According to the terms of the former provision the third party is not permitted to bid at the auction, whereas according to the terms of the latter provision, the third party is permitted to bid at the auction. Should the irrevocable bidder be the successful bidder, he/she…“will be required to pay the full Buyer’s Premium and will not otherwise be compensated.” Should that bidder not be the successful bidder, he/she…“will be compensated based on the hammer price…” (Reference: Sotheby’s). The compensation is based on the difference between the unsuccessful placed bid and the hammer price (www.ar tmarketblog.com 2008/11/12 www.theartnewspaper.com (bid)).

Do these bidding arrangements represent a progressive twist in the auctioneer’s role while remaining the champion of the consignor’s cause? Clearly yes, because they enable the auctioneer to limit his own financial risk while reducing the chances that an important picture or object be ‘bought-in’ (go unsold). Indeed, for an auctioneer to find a potential buyer for an unsold, well publicized lot – one that is thus said to be ‘burned’ or ‘shopped’ - whether in a future sale or in another venue, it is a redoubtable task.

Interestingly, at least one writer has suggested the irrevocable bid is indicative of a shift from a seller’s to a buyer’s market (www.artmarketblog.com, November 11, 2008), alluding to the potential payday that should result if the irrevocable bidder does not capture the lot.

Another writer notes that a bidder’s choosing to place such a bid may be a “gambler's option” (www.saatchigallery.co.uk/blogon/2008) that can result in a generous payday. Whether this form of bidding is an overt nod to the seller or to the irrevocable bidder is debatable. However, as some would-be consignors remain on the sidelines, auctioneers are sometimes finding themselves going to great lengths to find reliable buyers. For now, auctioneers are contending with a softened market and skittish sellers, a combination that begets smaller, more select sales frequented by circumspect buyers whose pockets may not be as deep as in the pre-September 2008 salad days.

If one of the auctioneer’s roles in the current environment is to expend more effort in securing deep-pocketed buyers, an ancillary role is to extend, at times, albeit in very limited instances, more favorable payment terms to the purchaser. This, however, is not actually noted by auctioneers as a publicized service offered in their ‘terms and conditions of sale.’ There are a handful of recent well-publicized cases in which buyers have refused to honor their purchases (including buyers reneging on successful bids as a form of political protest or contending that an auctioneer failed to disclose its financial interest in a lot www.aris-corporation.com online article published March 3, 2009, and www.ft.com online article published March 14, 2009). According to the above cited article in The Financial Times …“Buyers not paying for their purchases are one of the little secrets of the art market – one that auction houses and dealers...
Role with the Changes, continued

are generally reluctant to discuss.”

Regulations governing payment and the removal of property are strictly stipulated by auction houses, and a sensationalist case or two does not a trend make. Buyers are not simply defaulting on auction house purchases en masse, even those with acute cases of that old chestnut, post-sale remorse. It is true, though, that in many cases waning liquidity and smaller coffers have made for more challenging times in many an auction house collections department. The same may be said for a number of dealers who patiently watch the post for the ‘check in the mail.’

As the economy takes its toll on (some) budgets and buying habits – even if some bidder behavior in the post-September 2008 art world is less a consequence of financial hardship and more symptomatic of following the herd to see if it’s safe to venture back into the market, auctioneers, and to a lesser degree, dealers, have adjusted their own expectations and encouraged their clients to ‘be realistic’ about valuations. Auctioneers will continue to navigate changing markets knowing ultimately the ‘three Ds’: death, divorce and debt – will keep them afloat.
The following chart summarizes some of the proposed legislative presently pending before the House and Senate which would impact on federal estate, gift and generation skipping tax.

<table>
<thead>
<tr>
<th>Proposal or Bill Name and Number</th>
<th>Estate Tax Exemption</th>
<th>Gift Tax Exemption</th>
<th>Rate</th>
<th>Spousal Unused Exemption Amount (summarized below)</th>
<th>Inherited Property Basis Rules</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>President Obama’s Budget Proposal</td>
<td>$3.5M (may index after 2010)</td>
<td>$1.0M</td>
<td>Top rate of 45% for estates and gifts over $1.5M</td>
<td>None</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule</td>
<td></td>
</tr>
</tbody>
</table>

1 Under IRC § 2631(c), the generation skipping tax exemption is the same as the applicable exclusion.
2 Source: www.govtrack.us/congress/bill

continued on Page 9
### Changes to Transfer Taxes, continued

<table>
<thead>
<tr>
<th>Bill Name and Number</th>
<th>Estate Tax Exemption</th>
<th>Gift Tax Exemption</th>
<th>Rate</th>
<th>Spousal Unused Exemption Amount (summarized below)</th>
<th>Inherited Property Basis Rules</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>H. R. 2023</td>
<td>$2M</td>
<td>Same as Estate Tax Exemption - Reunification</td>
<td>$555,800 on first $1.5M; 45% up to $5M; 50% up to $10M; 55% over $10M (inflation adjusted in increments of $10,000)</td>
<td>Unused exemption of first spouse to die added to exemption of surviving spouse</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule</td>
<td>Restore state death tax credit</td>
</tr>
<tr>
<td>H.R. 436</td>
<td>$3.5M</td>
<td>$1.0M</td>
<td>$555,800 on first $1.5M; 45% on excess of $1.5M; 5% surtax on excess over $10M not to exceed $1.575M</td>
<td>Unused exemption of first spouse to die added to exemption of surviving spouse</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule</td>
<td>In case of transfer of interest in entity (i.e. FLP) nonbusiness assets deemed transferred directly; exception for certain passive assets and working capital; no discount allowed for lack of control on transfers to family members</td>
</tr>
</tbody>
</table>

Changes to Transfer Taxes, continued
### Changes to Transfer Taxes, continued

<table>
<thead>
<tr>
<th>Bill Name and Number</th>
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<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>H. Con. Res. 85, 111th Cong., 1st Sess. (passed House 04-02-2009)</td>
<td>$3.5M (may be indexed to inflation after 2010)</td>
<td>$1M – No reunification</td>
<td>Top rate of 45% for estates and gifts over $1.5M</td>
<td>None</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule.</td>
<td></td>
</tr>
<tr>
<td>S. Con. Res. 13, 111th Cong., 1st Sess. (passed House and Senate, April, 2009)</td>
<td>$5.0M (indexed to inflation)</td>
<td>$3.5M (indexed to inflation)</td>
<td>Top rate of 35% for estates</td>
<td>Unused exemption of first spouse to die added to exemption of surviving spouse</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule.</td>
<td></td>
</tr>
<tr>
<td>S. 722 “Taxpayer Certainty and Relief Act of 2009” (as of 08-29-2009, referred to committee)</td>
<td>$3.5M (inflation adjusted in increments of $10,000)</td>
<td>Same as Estate Tax Exemption - Reunification</td>
<td>$555,800 on first $1.5M; 45% on excess of $1.5M</td>
<td>Unused exemption of first spouse to die added to exemption of surviving spouse</td>
<td>IRC Section 1014 continues to apply. No carryover basis rule. Permanent alternative minimum tax relief; middle class income tax relief; special use valuation maximum reduction increased from $750,000 to $3.5M; qualified family-owned business exclusion statute (§ 2057) repealed</td>
<td></td>
</tr>
</tbody>
</table>
Changes to Transfer Taxes, continued

The Spousal Unused Exemption applies as follows:

1. Applicable Exclusion Amount is the sum of:
   a. Basic exclusion amount, and
   b. In the case of a surviving spouse, the aggregate “deceased spousal unused exclusion amount”

2. Aggregate Deceased Spousal Unused Exclusion Amount equals lesser of:
   a. Basic exclusion amount
   b. Sum of the deceased spousal unused exclusion amounts computed with respect to each deceased spouse of the surviving spouse

3. Deceased Spousal Unused Exclusion Amount is, with respect to the surviving spouse of any deceased spouse dying after December 31, 2009, the excess of:
   a. The basic exclusion amount of the deceased spouse, over
   b. The amount with respect to which the tentative tax was determined in the estate of the deceased spouse

4. Election by Personal Representative of Deceased Spouse Required

A deceased spousal unused exclusion amount may not be taken into account unless the personal representative of the deceased spouse’s estate files an estate tax return on which such amount is computed and makes an election on such return for such amount to be taken into account. Such an election, once made, is irrevocable. No election may be made if the federal estate tax return in the estate of the deceased spouse is filed late.

The IRS may re-exam the federal estate tax return of the deceased spouse for purposes of determining the unused exclusion amount even if the statute of limitation has otherwise run.

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In addition, the Obama Administration has made several revenue proposals for fiscal year 2010 that would impact on transfer taxes. They are as follows:

- Treasury proposes that basis of assets received from an estate or by gift would have to be the same in the hands of the recipient as in the hands of the donor or personal representative, even if the recipient disagrees with the value reported by the donor or estate. The IRS would issue regulations that would require that the recipient and the IRS be notified of the recipient’s basis, even where a federal estate tax return or gift tax return is not required.

- Treasury proposes creating a category under IRC § 2704(b) called “disregarded restrictions” that would be ignored in valuing an interest in a family controlled business which is transferred to a family member if after the transfer the restriction will lapse or may be removed. Disregarded restrictions would be ignored without regard to whether they are more restrictive than applicable state law provides.

- Treasury proposes requiring that the minimum term for a grantor retained annuity trust (“GRAT”) be ten (10) years. This change would not eliminate the ability to zero-out a GRAT but would increase the risk to the donor of death prior to the expiration of the GRAT Term.
The PEPC invites the Philadelphia Bar Association Probate and Trust Law Section to join our Council for membership and programming!

**October Breakfast Program**  
October 20, 2009  
7:45 - 8:15 a.m. Registration  
8:15 - 8:45 a.m. Breakfast  
8:45 - 10:00 a.m. Program  
Union League, 140 S. Broad Street, Philadelphia, PA  
Topic: “The Year in Review: An Estate Planner’s Perspective on Recent Tax Developments”  
Speaker: Howard Zaritsky, Esq.

**November Luncheon Program**  
November 17, 2009  
11:45 - 12:15 pm Registration  
12:15 - 12:45 pm Lunch  
12:45 - 2:00 pm Program  
Union League, 140 S. Broad Street, Philadelphia, PA  
Topic: “Asset Protection: Avoiding the Landmines”  
Speaker: Jay Adkisson, Esq.

**January Luncheon Program**  
January 19, 2010  
11:45 - 12:15 pm Registration  
12:15 - 12:45 pm Lunch  
12:45 - 2:00 pm Program  
Union League, 140 S. Broad Street, Philadelphia, PA  
Topic: “Alternatives to Alternatives: How to Invest Going Forward”  
Speaker: Landis Zimmerman

For more information on joining the Philadelphia Estate Planning Council or to register for any upcoming programs, please visit [www.philaepc.org](http://www.philaepc.org).
Pending Proposals that Affect Planning with FLPs/GRATs/IDGTs

By ALPA D. PANCHAL
DIRECTOR, CREDIT SUISSE, PRIVATE BANKING USA

Overview

The Obama Administration and Congress have provided some insight regarding pending proposals that may significantly affect popular estate planning techniques. On May 11, 2009, the Obama Administration released through the Treasury Department its “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals”, also referred to as the “Green Book.” These proposals complement the Obama Administration’s budget proposals that were released at the end of February, and are consistent with bills under consideration in Congress. If enacted by Congress, these revenue-raising proposals would reduce some of the estate planning advantages of using Family Limited Partnerships (FLPs) and Grantor Retained Annuity Trusts (GRATs).

Proposals

There are two estate planning proposals outlined in the Green Book. The first proposal, the partnership proposal, would eliminate valuation discounts associated with the transfer of partnership/LLC interests in family controlled entities. This proposal provides that valuation discounts would be substantially reduced or eliminated when an interest in a partnership/LLC is transferred to another member of a family. Partnership/LLC interests are often transferred to GRATs and Intentionally Defective Grantor Trusts (IDGTs), therefore the proposal regarding partnerships may have an affect on GRAT and IDGT planning. The new rules would apply to transfers after the date of enactment, although this is dependent upon how Congress ultimately drafts the legislation.

The second proposal regarding GRATs would impose a minimum required term of ten years. If enacted, this would highlight the mortality risk of a GRAT transaction. One of the requirements in order for a GRAT to be effective in transferring wealth at a reduced gift tax cost is that the grantor must survive the trust term. With a longer term GRAT, there is a greater possibility that the grantor may not survive, in which case the technique fails. A second result of the proposal is that longer terms prevent the use of short-term GRATs to capture short-term fluctuations in asset returns. When a short-term GRAT is used, the funds or assets distributed from the GRAT are typically reinvested in a new GRAT, often referred to as a “rolling GRAT” strategy. As with the partnership proposal, the Treasury recommends an effective date after the enactment of the legislation.

Planning Opportunities

Given that Congress is considering various proposals to reduce or eliminate many traditional wealth transfer planning techniques, investors should take the time now to speak with their tax or legal advisors about various planning strategies. Initiating planning discussions today is particularly important in light of historically low interest rates and asset valuations. Following is a discussion and comparison of two popular wealth transfer planning techniques that would be impacted by proposed legislation.

The Grantor Retained Annuity Trust (GRAT)

A GRAT is an irrevocable trust whereby a grantor transfers property/assets that have a likelihood of appreciating over the IRS “hurdle rate” (i.e., 3.4% in July 2009), while at the same time retaining the right to receive annual annuity payments for a specified term of years. The GRAT is treated as a “grantor trust” for federal income tax purposes and, during the term of the GRAT, the grantor is taxed on the income generated by the property contributed. The property remaining in the GRAT when the trust terminates (the remainder interest) passes to designated beneficiaries or to trusts for their benefit, assuming the grantor survives the trust term. The annuity payment received by the Grantor can be used to fund a new GRAT so that any further appreciation of the assets over the then applicable hurdle rate passes to younger generations. This technique is often referred to as a “Rolling GRAT.”

When a GRAT is created, the grantor is treated as having made a taxable gift equal to the present value of the remainder interest. Currently, it is still possible to create a GRAT that will not have any gift tax consequences to the grantor as long as the present value of the annuity payment equals the amount contributed to the GRAT.

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It is recommended that the grantor make a taxable gift to fund the trust in an amount equal to at least 10% of the value of the property sold to the IDGT. This gift is to accomplish a generally accepted 10% capitalization or seed money funding benchmark. No gift tax need be paid on the gift amount if it falls within the grantor's remaining lifetime gift exclusion amount, which is $1,000,000 in 2009.

The note can provide for interest-only payments during the term, with a balloon payment of principal at the end of the term. The property remaining in the IDGT, after the interest and the balloon payment has been made, is distributed to the beneficiaries under the terms of the trust.

The law on the treatment of the promissory note on death is somewhat unsettled. From an estate tax perspective, the unpaid balance of the note would be included in the grantor's estate, with the possibility of a discount for the note depending on the situation. From an income tax perspective, many practitioners believe that the grantor recognizes gain when the trust ceases to be a grantor trust (i.e., at the grantor's death). Some potential solutions may be to pay off the loan before death or have the trust procure life insurance on the grantor to provide proceeds in the event of death.

Comparison: Long and Short Term GRATs and an Installment Sale to an IDGT

Assumptions
- Initial transfer to the GRAT/IDGT: $1,000,000
- July 2009 hurdle rates utilized for initial GRAT and for IDGT
- Successive GRATs use a 3-year historical average IRS hurdle rate(1)
- 10% annual appreciation of the assets
- 120% increase in annuity payments for GRAT illustrations

Note that for purposes of this illustration a 3-year historical average has been used for the IRS hurdle rate throughout the analysis. However, for rolling GRATs, the IRS hurdle rate then in effect would be the correct factor in determining the actual amount passing to remainder beneficiaries.
As the hypothetical illustration above indicates, an installment sale to an IDGT offers greater leverage than a GRAT, largely as a result of the lower hurdle rate and the ability to defer the repayment of the grantor’s “retained” interest in the transferred asset to the end of the relevant period. Additionally, an advantage of an IDGT over a GRAT is that the IDGT can be structured as a Generation-Skipping Transfer ("GST") tax exempt trust and GST exemption allocated at the beginning of the trust. If a GRAT is used for this purpose, the GST tax exemption may not be allocated until the end of the initial term of the trust.

Note that an installment sale is not ideal for assets that are difficult to value because there may be a risk in the event the IRS challenges the valuation of those assets and determines that there was a part gift/part sale. Although subject to debate, there may be price adjustment or formula clauses that may be included in the sale agreement or trust to avoid this result. This concern does not apply to a GRAT because an upward adjustment by the IRS to the value of the asset contributed to the GRAT would simply increase the annuity amount and would not create a gift.

Internal Revenue Code ("Code") section 2702, and the regulations thereunder, provides specific statutory authority and detailed guidance on structuring a GRAT. Conversely, there is no precise Code section or definitive pronouncement from the IRS on the use of the IDGT technique. As a result, the effectiveness of this technique in transferring wealth is less certain than with a GRAT due to lack of direct statutory guidance by the IRS. Use of either of these techniques should be considered only after consultation with competent tax and legal counsel.

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I. FEDERAL COURT DECISIONS

1. Alan Baer Revocable Trust
No. 8: 06CV774 (D. Neb. 5/18/09).

The decedent’s trust provided that 23 monetary bequests totaling $1.3M be made to non-family members, provided that decedent’s stock in a closely held corporation was sold at a profit before the death of decedent’s surviving spouse. The rest of decedent’s estate passed to the surviving spouse, mostly through a QTIP trust. In this action, the estate is claiming a refund of the income taxes assessed by the IRS and paid by the estate.

The estate had filed an estate tax return that listed the bequests as gifts to “contingent beneficiaries” with a value of $1.3M. The valuation was discounted to reflect the delay of six years that was estimated to be required to fund the gifts. The estate tax return noted that the bequests might never be paid (apparently due to the speculative nature of the closely held corporation). Although the contingent bequests were not claimed as marital deduction property on the estate tax return, the IRS determined that the marital deduction should be reduced by excluding the value of the contingent gifts and that the taxable estate should be increased.

On a motion for summary judgment, the government claimed that the date of death value of the stock was irrelevant and that the true issue in the case was whether the contingent bequests qualify for the marital deduction. The government argued that the interests passing to the spouse were terminable, because it was possible that the contingent bequests would be funded and paid to beneficiaries other than the surviving spouse. The Court disagreed, explaining that the estate was not claiming that the contingent bequests were included in the marital deduction.

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The estate contended, and the Court agreed, that the date of death value of the stock presented a factual issue that was relevant to the case, and that the estate had presented evidence showing that the estate was not claiming that the contingent bequests were included in the marital deduction. The estate contended, and the Court agreed, that the date of death value of the stock presented a factual issue that was relevant to the case, and that the estate had presented evidence showing that the estate was not claiming that the contingent bequests were included in the marital deduction.
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the value of the stock could not be ascertained with fair certainty. If the stock could not be sold at a profit, the bequests would lapse. The Court pointed out that even the IRS had acknowledged that the estate’s appraisal of the stock was incomprehensible in its complexity, and that the IRS examiner had also taken issue with other appraisals provided by the estate.


Two issues were presented to the Tax Court. One issue was whether assets transferred to the decedent’s family limited partnership (MFLP) in April 2002 and May 2003 were entitled to a discount, or whether the gross estate must include the total value of those assets. The other issue was whether decedent’s husband’s estate made a valid QTIP election at his death in 2000, regardless of whether decedent needed or actually received any income from the QTIP trust.

Decedent died on May 28, 2003. For many years before her death, she had assisted her husband as he invested in stocks using a specific methodology that he also taught to his son, Virgil G. One year after her husband’s death in 2000, decedent, at the age of 86, formed MFLP, which was funded in 2002. Virgil G. was named general partner and received both general partner and limited partner units, whereas the decedent’s other children received limited partner units. Virgil G. managed the FLP according to his father’s investing philosophy. Decedent’s revocable trust was the sole funding source of MFLP: the trust transferred $3.8 million to the partnership in 2002 (about 77% of its net assets) and $880,000 in 2003 (the remainder of its assets). The trust received shares in MFLP in exchange for the assets transferred in 2002 but no shares for the assets transferred in 2003. Most of the 2003 transfers were made in May, the same month that decedent’s health declined precipitously and she died. Because the 2003 transfer left no assets in the decedent’s possession to pay taxes on her estate, MFLP had to make a cash distribution to the partners, a large portion of which was used to pay the estate tax liability.

The decedent’s estate tax return did not include the value of the securities used to fund her QTIP trust. A 35% discount was taken on the shares transferred to MFLP.

The Tax Court made the following rulings:

- The assets transferred to MFLP in 2002 were transferred for a legitimate and significant nontax reason, i.e. the creation of the MFLP, which was to be actively managed by Virgil G. according to his father’s investment practices. These transfers were therefore not includible in the decedent’s estate because they satisfied the exception under Estate of Bongard v. Comm’r, 124 T.C. 95 (2005) for bona fide sales for adequate and full consideration for money or money’s worth. Also, the decedent retained enough assets outside of MFLP to pay for her living expenses.

- In contrast, under IRC §2036, the decedent’s gross estate must include the portion of the securities she transferred to MFLP in 2003, valued at their fair market value. The 2003 transfers were not made for a legitimate and significant nontax purpose, but rather were precipitated by the decedent’s failing health in order to reduce her taxable estate. Because the decedent retained the economic benefit of the transferred assets as set forth in Estate of Jorgensen v. Comm’r, T.C. Memo. 2009-66, her estate was not entitled to a discount.

- The assets in the QTIP trust as of the decedent’s date of death were includible in the decedent’s estate under the express provisions of IRC §2044. Whether or not the decedent needed or actually received any income was irrelevant.


The District Court affirmed a Bankruptcy Court summary judgment ruling against the executor of an estate, holding that unpaid estate taxes owed by the executor were not dischargeable in bankruptcy. Decedent died in 1998, leaving his three children (two brothers and a sister) as executors of his estate. In 1999, the estate had sufficient assets to pay the estate tax debt. The estate made regular installment payments to satisfy the $2.5M estate tax debt until 2004, but stopped making payments after only $1.2M of the debt was paid. Between 1998 and continued on Page 19
Willis Barnett died on October 13, 2003. His son, Elton R. Barnett, the administrator of his estate, filed an estate tax return reporting a total estate of $1,341M and a taxable estate of $1,235M and paid a total of $72,752.00 in estate taxes. The IRS increased the taxable estate by $268,042 and added $340,000 back into the estate as an adjusted taxable gift. The IRS sought summary judgment in the case brought by the administrator, who claimed a refund of the additional estate taxes assessed by the IRS.

There were two issues in this case: the first was whether a series of $11,000 checks issued by Elton R. Barnett as agent under decedent’s Power of Attorney were gifts; the second was whether a $350,000 check from the decedent to Elton R. Barnett in 2001 was to be treated as a gift or as repayment of a loan.

In considering the first issue, the court acknowledged the undisputed fact that the decedent’s Power of Attorney did not contain language authorizing gifting. However, Elton R. Barnett claimed that the decedent orally “ratified” his decision to distribute the gift checks. The court looked to Pennsylvania law, which provides that any authorization to make gifts under a power of attorney must be specifically stated in the power of attorney. 20 Pa. C.S.A. §5601.2(b)-(c). The court found that the agent under the decedent’s power of attorney was not empowered to make gifts because of the principal of strict construction of powers of attorney. None of the gifts, therefore, could be considered a valid gift for gift tax purposes.

In finding for the administrator on the second issue, the court determined that the evidence offered by the administrator was sufficient to raise a genuine issue of material fact concerning whether the total of $312,000.00 transferred over a nine-year period from Elton R. Barnett to the decedent was a loan which the decedent had intended to repay. Probative evidence of the decedent’s intent to repay included the creation of an amortization schedule applying an interest rate of 7%, the notation of the loan on the books of the decedent’s corporation as a “note payable,” the testimony of the corporation’s accountant and Elton R. Barnett’s testimony that he expected the loan to be repaid in full. The government argued that the lack of many of the indicia of loans -- such as a note, a maturity date, a payment schedule, security, and a demand for payment – was evidence that the decedent did not have an unconditional duty to repay the loan. The court found this reasoning unpersuasive, especially since intrafamily loans often sidestep many such indicia.


The U.S. District Court for the Western District of Washington granted the government’s motion for summary judgment where William and Stacy Linton (“William” and “Stacy”), a married couple, sought a partial refund of 2003 gift taxes assessed and paid on LLC interests they had given to irrevocable trusts for each of their four children. On January 22, 2003, William transferred to Stacy half of his interest in an LLC he had previously formed. William and Stacy then set up irrevocable trusts for each of their four children, each parent transferring an 11.25% interest in the LLC to each child. After the gifts were made, William
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and Stacy each owned 5% of the Trust. The documents contributing property to the LLC, creating trusts for each child, and funding the trusts were all signed on the same day. In computing the gift taxes payable on these gifts, the Lintons applied a 47% discount for lack of control and lack of marketability. The IRS refused to recognize the discounts.

The couple’s parol evidence was ruled ineffective in their effort to reform the documents to establish that the trusts were created and funded on January 31, 2003. The court held that the transfers to the children constituted indirect gifts because the funding and the gifting took place simultaneously and thus lacked the proper sequence of transactions.

The court also held that the indirect gifts to the children’s trusts satisfied the step transaction doctrine. The court defined three separate tests for indirect gifts: (i) the “binding commitment” test; (ii) the “end result” test; and (iii) the “interdependence” test. The binding commitment test, which is the most narrow test, states that an indirect gift has occurred “if, at the time the first step is entered into, there was a binding commitment to undertake the later step.” (C08-0227-TSZ (Dkt. No. 44 at 16).) The end result test, which is the most flexible test, inquires whether the “series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result.” Id. The interdependence test, which focuses on the relationship between each step, asks whether “on a reasonable interpretation of objective facts,” the steps were “so independent that the legal relations created by one transaction would have been fruitless without a completion of the series” of transactions. Id.


The court held that a married couple who, in a step transaction, made indirect gifts of cash to their children’s trusts, was not entitled to a refund of federal gift tax. Following the advice of their professional advisors, the couple first invested cash in their wholly-owned limited liability company, then transferred minority shares of the limited liability company to their children’s trusts.

In 2001, the couple established trusts for their children, appointing the brother of the husband and the sister-in-law of the wife as trustees. The same day, they set up three LLCs (an LLC to hold real estate, an LLC to hold investments and an umbrella LLC to hold the other two), transferring a beach house and mutual funds in subsequent months from their personal accounts to the LLCs. On January 11, 2002, the same day that the mutual funds were transferred to the investments LLC, a certain number of LLC units were assigned to each of the children’s trusts and the children’s trusts were admitted as Members to one of the LLCs. Each of the children’s trusts owned a minority interest of just fewer than 50% in the umbrella LLC. The Heckermans’ gift tax return for that year reflected a 58% lack of marketability discount for the gifts of the LLC units to the children’s trusts. In an audit of the gift tax returns, the IRS determined that the level of funding of the LLCs on the basis of the gift tax advantage they would gain from the lack of marketability discount. The Heckermans determined the level of funding of the LLCs in the same district (see the article on this case elsewhere in this “Tax Update”) and concludes that both the “end result” and the “interdependence” tests are met here. The “end result” test is met because there is incontrovertible evidence that the Heckermans, with the help of their financial advisors, deliberately designed a scheme intended to convey property to their children while minimizing their tax liability. The “interdependence” test is met because the record shows that the Heckermans determined the level of funding of the LLCs on the basis of the gift tax advantage they would gain from the lack of marketability discount. The Heckermans would not have transferred their mutual funds to the LLCs if they had not anticipated claiming the lack of marketability discount in their gift taxes.


The government argued, and the court agreed, that the transfer of the mutual funds to the LLC should be considered indirect gifts to the children’s trusts, because the Heckermans did not present evidence sufficient to prove that they contributed the assets to the LLC before they transferred the LLC units to the children.

The court also held that the transfer of the mutual funds to the LLC and the gifting of the LLC units to the children’s trusts were integrated and simultaneous events, thus meeting the definition of a step transaction and constituting an indirect gifts to the trusts. These actions had no independent purpose or effect beyond the evasion of taxes. The opinion cites the discussion of the three tests for indirect gifts in Linton v. United States, Cpi-0227-TSZ, a tax case in the same district (see the article on this case elsewhere in this “Tax Update”) and concludes that both the “end result” and the “interdependence” tests are met here. The “end result” test is met because there is incontrovertible evidence that the Heckermans, with the help of their financial advisors, deliberately designed a scheme intended to convey property to their children while minimizing their tax liability. The “interdependence” test is met because the record shows that the Heckermans determined the level of funding of the LLCs on the basis of the gift tax advantage they would gain from the lack of marketability discount. The Heckermans would not have transferred their mutual funds to the LLCs if they had not anticipated claiming the lack of marketability discount in their gift taxes.
The Estate of Kwang Lee (the “Estate”) appealed the Tax Court’s assessment of a $255,032 penalty under § 6651(a)(1) for untimely filing, and a $204,026 accuracy-related penalty under § 6662(a) for negligence or disregard of rules or regulations, or alternatively, for a substantial understatement of income tax. The penalties were assessed by the court because, in the underlying case, Estate of Kwang Lee v. Commissioner, T.C. Memo. 2007-371, the Estate had erroneously claimed an estate tax marital deduction on the advice of an attorney. The attorney had advised the Estate that language in the wills of the decedent and his wife operated to reverse the order of their respective deaths. Each spouse’s will stated “For purposes of this Will, any person who shall die within six (6) months after my death shall be deemed to have predeceased me.” Although decedent’s wife had predeceased decedent by 46 days, decedent’s estate was administered as if his wife had survived him (thus permitting the use of her estate tax exemption). A credit shelter trust was set up, and the residue of decedent’s estate was transferred into his wife’s name as if she were still alive. The court ruled that no marital deduction is allowed under IRC §2056 because decedent’s wife cannot be considered a “surviving spouse.”

The court held that the estate was not liable for either the accuracy-related penalty, because the executor acted reasonably and in good faith in relying on the advice of the attorney. The executor, who was himself an attorney and a longtime judge, evaluated the professional credentials of the Estate’s attorney, reviewed the tax returns she prepared, and questioned her specifically about the deemed survivorship clause in the will. The court also held that the Estate was not liable for the penalty for untimely filing, because the executor reasonably relied on the attorney’s erroneous advice that a second six-month extension for filing the federal estate tax return was available.

II. TREASURY REGULATIONS

1. T.D. 9448, 05/01/2009; Reg. § 1.170A-12T; Reg. §1.642(c)-6T; Reg. § 1.664-4%; Reg. § 20.2031-7T; Reg. § 20.2032A-1T; Reg. § 20.2056A-4T; Reg. § 25.2512-5T; Reg. § 25.2522(c)-3; Reg. § 1.7520-1T; Reg. § 20.7520-1T; Reg. § 25. 7520-1T; www.irs.gov (Corrections published in 74 FR 27079, dated 6/8/2009). Section 7520 Mortality Component Tables

Regulations revising the Section 7520 mortality component tables for valuing remainder and reversionary interests, annuities, and interests for life or terms of years were issued on May 1, 2009. Section 7520 provides that the valuations of remainder and reversionary interests, annuities, and interests for life or terms of years are determined by a combination of the Section 7520 interest rate and a mortality component that comes from the tables published in the Treasury Regulation. The revised mortality component data comes from the 2000 census as set forth in Table 20000 CM. The IRS must update the mortality component tables at least once every ten years under IRC Section 7520(c)(3).

Transitional rules are provided to “alleviate any adverse consequences” that may result from the changes. If the transfer (for gift tax purposes) or the date of death (for estate tax purposes) took place on or after 5/1/2009 but before 7/1/2009, either the old or the new tables can be used for the valuation of any interest and/or applicable charitable deductions. The Section 7520 rate that is used is the one for the month in which the valuation date occurs.

However, for charitable deductions whose valuation date was on or after 5/1/2009 but before 7/1/2009,

- If the Section 7520 rate for March or April, 2009 is used, the old mortality tables must be used;
- If the Section 7520 rate for May or June, 2009 is used, either the old or the new mortality tables may be used; and
- If the valuation date was 7/1/2009 or later, the new mortality tables must be used, even if the donor or executor elects to use the 7520 rate from a prior month.

Various minor corrections to these regulations were published in 74 FR 27079, dated 6/8/2009.


The IRS issued proposed regulations to address certain comments received in response to NPRM REG-119097-05, which was adopted by the IRS in T.D. 9414 on July 14, 2008. The proposed regulations would apply to the estates of decedents whose date of death was on or after 5/1/2009 but before 7/1/2009, and were published in 74 FR 27079, dated 6/8/2009.
death is on or after the date on which the final regulations are published. The proposed regulations provide a methodology for calculating the portion of a trust, specifically a GRT or a CRT, or any other property includible in the grantor’s gross estate under IRC § 2036, if the grantor holds a graduated retained interest in the trust or property. A graduated retained interest is an annuity or other interest that increases by a specified percentage (no more than 20%) each year of the term of the trust.

As proposed, the amount includible in the grantor’s gross estate would be the sum of the following amounts:

1. For the trust year in which the decedent’s death occurred, the amount of corpus it would take to generate enough income to pay the grantor’s retained annuity, unitrust, or other annual payment, using the 7520 rate in effect as of the grantor’s date of death as the rate at which income is generated; and

2. For each succeeding year of the trust, the amount of corpus it would take to generate enough income to pay the increase (if any) in the annuity, unitrust, or other annual payment, using the 7520 rate in effect as of the grantor’s date of death as the rate at which income is generated, deferred until the beginning date of such increase.

III. PRIVATE LETTER RULINGS


The payment of premiums by married settlors for a second-to-die life insurance policy owned by a trust pursuant to the terms of a described agreement will not result in a gift by either settlor under Code Sec. 2511 provided that amounts paid by the trust for life insurance benefits received by the trust under the agreement are at least equal to amounts prescribed in the tables under Notice 2001-10 2001-1 CB 459. Also, the proceeds of policy payable to trust will not be included in gross estate of surviving spouse under Code Sec. 2042(2).

2. PLRs 200922013 through 200922027. Partial Termination of CRTs. June 1, 2009.

In fifteen identical PLRs, the IRS ruled that no adverse GST or income tax consequences would be incurred by the partial termination of a charitable remainder annuity trust (the “Trust”) and the early distribution of its corpus to its charitable remaindermen. The Trust was established before the effective date of the Tax Reform Act of 1969, which required that the annual payout of a charitable trust be at least 5% of its initial fair market value. The Trust was being terminated in order to accelerate the distribution of the remainder interests to charities.

The estimated termination date of the Trust is 2051. Because two of the beneficiaries died without surviving issue, leaving only three of the five original non-charitable beneficiaries, the corpus of the CRATs had grown far larger than the amount necessary to fund the annuity payments to the beneficiaries. The total currently payable annuity is only .1% of the value of the corpus of the trust, while the trustee fees are three times the amount of the annuities distributed.

Under a state statute allowing for a court to reform continued on Page 23
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of an irrevocable trust with the consent of all of its beneficiaries, the parties drew up an agreement that the Trust should be terminated and the corpus distributed to the six charitable remaindermen, except to the extent of the amount (about 4%) needed to fund the annuity payments for the duration of the Trust (the “Agreement”). The charitable remaindermen were also required to purchase commercial annuities for the benefit of each of the non-charitable beneficiaries such that annuities would be paid to each annuitant family for a term identical to the term of the Trust.

The IRS ruled that the transaction would not cause the Trust to lose its “grandfathered” status under § 1433(b)(2)(A) of the 1988 Tax Reform Act or Reg. Sec. 26.2601-1(b)(4)(i), under which it is exempt from GST taxation. Its rationale was that the implementation of the Agreement would not shift any beneficial interest in the Trust to a beneficiary who occupies a lower generation than the beneficiaries who hold the beneficial interests prior to the modification of the Trust. Furthermore, the Agreement would not necessitate an extension of the time for vesting of any beneficial interests in the Trust beyond the period provided for in the Trust.

The IRS also ruled that the modification of the Trust and the purchase of the commercial annuities would not result in any gain or loss under § 1001, and the purchase of the annuities by the charitable remaindermen for the benefit of the annuitant beneficiaries would not result in the immediate realization by the annuitant beneficiaries of capital gain, capital loss or taxable income.


A married couple established and funded T, an irrevocable trust, for the benefit of their issue. Neither the husband nor the wife was a trustee of T. The same couple wished to create a QPRT qualified under Reg. § 25.2702-5(c), with husband as trustee, to hold non-commercial property improved by a residence (the “Property”). Under the terms of the QPRT, the couple would be allowed to reside in the Property until the death of the survivor of the husband and wife. At that time, the remaining assets of the QPRT would be transferred to T. The expenses of the QPRT would be paid in the same manner as expenses are paid by the holders of legal life estates and remainder interests under state law. The husband and wife would be the only holders of term interests in the QPRT. Neither the husband, who was older than the wife, nor the wife suffered from a medical condition that would make it more than 50% probable that he or she would die within one year.

T would transfer to the couple cash and marketable securities whose value was determined by an independent appraiser to equal the fair market value, using the § 7520 tables, of the remainder interest in the QPRT.

The couple sought the following rulings, which the IRS granted: (a) the property constituted a “personal residence” under § 2702(a)(3)(A)(ii) and § 25.2702-5(c)(2), because its size was comparable to that of properties in its vicinity; (b) the sale of the remainder interest to the Trust qualified for the QPRT exception to the special valuation rule under § 2702(a)(2), and the remainder interest was properly valued under the §7520 tables; (c) the couple’s sale to T of the remainder interest in the QPRT was deemed to constitute a sale for adequate and full consideration for money or money’s worth and therefore was not a gift for federal gift tax purposes; and (d) the husband would not be treated as making a gift to the wife, assuming that she transferred to him consideration equal to the actuarial difference in value between their contingent life estates.

The IRS expressed no opinion on the issues concerning (a) whether the proposed QPRT qualified as a QPRT under § 25.2702-5(c), (b) whether the corpse of the QPRT would be includible in either the husband’s or the wife’s gross estate under §2036, or (c) the fair market value of the Property on the date it was transferred to the QPRT.


The IRS ruled that a grantor Charitable Lead Annuity Trust (CLAT) must recognize gain when it pays an annuity to a private foundation with appreciated property. The Grantor wished to transfer appreciated securities to a charitable organization by creating a CLAT to hold a partial interest in a family LLC. The CLAT was a grantor trust that provided for twenty annual payments to a private foundation of a percentage of the fair market value of the initial interest. The payments were to be made in equal annual installments, first from income and, to the extent that income is not sufficient, from principal.

The IRS distinguished...
Tax Update, continued

payments from a CLAT from payments of a pledge agreement under Revenue Ruling 55-410 (satisfaction of a charitable pledge with appreciated or depreciated property does not give rise to taxable gain or deductible loss), stating that Revenue Ruling 55-410 is not applicable in cases such as this, where a private foundation has a claim against CLAT assets. Also, under IRC §170(f)(2)(B), a CLAT can take a charitable deduction for the present value of future payments of the gifted annuity interest, whereas no income tax deduction is allowable to a charitable pledge until the pledge is satisfied.

IV. OTHER IRS GUIDANCE

SBSE-04-0509-009 Tax Preparer Penalties

Interim guidance in a memo published by the IRS Small Business/Self-Employed Division on June 3, 2009, by the IRS Small Business/Self-Employed Division, instructs IRS exam agents to consider whether the preparers of every tax return they are examining may be liable for penalties for the understatement of estate and gift tax liabilities. The memo details the procedures that IRS agents must use to verify that §6694 and §6695 are properly followed and the procedures for IRS estate tax attorneys to follow in asserting penalties under §6694 and §6695. Estate and gift tax examinations are to be settled at the group level, separately from return preparer penalty examinations.

V. EXEMPT ORGANIZATIONS


This is a new IRS publication. It specifies which exempt organizations must notify the IRS upon terminating or merging with another organization and how the notification must be disclosed.

For organizations other than private foundations, a final form – either the e-Postcard, Form 990, or Form 990-EZ – must be filed within four and one half months from the date of the termination or merger. The kind of form and type of attachments that are necessary depend on the size of the organization’s gross receipts.

A private foundation must file a final Form 990-PF, with accompanying explanation of the reason for its dissolution or merger and the destination of its assets, for the short tax year in which it is liquidated or merged. It is also subject to the provisions of IRC § 507, which states the four ways in which a private foundation can be terminated.

2. PLR 200905027. Extension to make election under Section 642(c) to claim a deduction in the trust’s first taxable year for distributions made in the trust’s second taxable year. The trustee must file an amended income tax return for the first taxable year.

VI. STATE ESTATE AND INHERITANCE TAXES

DELAWARE

HB 291. Delaware Estate Tax Reinstated.

Delaware HB 291, amending Titles 3, 12 and 30 of the Delaware Code, decouples the Delaware estate tax on the estates of residents and non-residents from any repeal of the federal estate tax and reinstates the Delaware estate tax. It also reinstates the estate tax exemption for farm land included in the Delaware Agricultural Lands Preservation Act program. The tax applies to estates with values in excess of $3,500,000. For decedents dying after June 30, 2009, the amount of tax is determined using the credit allowable in IRC §2011 as it was in effect on January 1, 2001. The tax on the estates of nonresidents who own real estate or tangible personal property located in Delaware will be calculated as the ratio of Delaware taxable assets over total taxable assets. Returns are due within nine months after the decedent’s date of death.

NEW YORK


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Cynthia Wu died, leaving her brother Harry, who had served as a witness to her will, the proceeds of two insurance policies on her life valued at $3.3M. The decedent’s will provided that all taxes, whether or not they arose from her will, were to be paid by her estate and not apportioned to her beneficiaries. Her husband, the executor of her estate, sought a court order mandating that Harry pay a ratable share of the taxes resulting from her death. The court decided in favor of the executor, citing the New York law that provides that a necessary witness to a will is unable to be the recipient of a “beneficial disposition” under the will. EPTL 3-3.2(a)(1). The court reasoned that if Harry were relieved of his portion of the applicable taxes, he would be receiving an impermissible “beneficial disposition” under the will.

The Court admitted that this decision could seem harsh, especially since Harry testified that he was not aware of the contents of his sister’s will. But the Court pointed out that the tax clause would have no effect on a non-interested witness or a witness who was not named the beneficiary of non-probate assets until after the execution of the will. The Court warned drafters of non-apportionment clauses that they should “be fully informed of the testator’s non-probate assets to avoid unintended consequences, some of which may have even greater potential for frustrating the testator’s intent.”

PENNSYLVANIA

1. No. INH-04-002. Property Held by Decedent as Trustee of Trust for Ex-Wife Not Subject to Pennsylvania Inheritance Tax, March 26, 2004; Reissued March 27, 2009.

After his divorce, three years before his death, decedent maintained control of an interest in commercial property as trustee of a trust conveyed to his ex-wife under their property settlement agreement. The decedent paid his monthly income from the commercial property to the ex-wife, and she reported this income on her federal and state income tax returns. The Office of Chief Counsel held that the property should not be subject to inheritance tax at decedent’s death because decedent did not retain ownership of the property at his death. At the time of the property settlement agreement, he had transferred the property to his ex-wife for “valuable and adequate consideration in money or money’s worth.” Moreover, the control he maintained over the property was nominal, because he could not change his ex-wife’s rights to the property without her consent.


Common-law marriages contracted under Pennsylvania law before January 1, 2005, are valid for Pennsylvania inheritance tax purposes. The validity of a common-law marriage can be proven either by an exchange of words spoken with the intent of establishing a legal marital relationship or by circumstantial evidence such as cohabitation, both members of the couple holding themselves out to the public as husband and wife, and establishing the reputation of being married.


No interest and penalties accrue on Pennsylvania Inheritance Tax resulting from guaranteed lump sum payments of $750,000.00 which an insolvent estate is due to receive in the years 2016 and 2017. The delay in the receipt of payments is unavoidable because they are being made by the California State Workers Compensation Insurance Fund, which prohibits premature distribution of the payments. No interest is accrued on the lump sum payments prior to their distribution. Under 72 P.S. §2143, interest for a period during which estate property is held by a fiduciary earns little or no income, and inheritance tax is not paid because of “unavoidable delay” is calculated at the rate of the net income produced by the property. Interest will begin to accrue after each lump sum distribution is made to the estate.

1 The author wishes to extend her thanks to Joan Agran for her expert guidance and advice.
Because of technological changes over the past years, an increasingly frequent problem when probating a Will at the Register of Wills is whether or not the document being offered for probate is a copy rather than the original. For example, a copy of a document on red-lined paper will show black lines. Even if a Will contains original signatures by testator, witnesses and notary but was executed on what appears to be a fax (date and telephone numbers across the top or bottom) or the black lined version of will paper (photocopy of red-lined paper), the Register’s Office will consider it a photocopy and will require the document to be processed in accordance with its procedure for probating a photocopy. This could prove embarrassing should the attorney take the client to probate with the client having the expectation that he or she will receive a short certificate and proceed on to the bank from there.

Instead, when a photocopy is to be probated, a hearing must be held with notice to all intestate heirs or their joinder in the petition. Some intestate heirs may not cooperate and in any event the probate process will be complicated and extended. Attorneys should review a Will ahead of the appearance for probate for such issues. Those who note a problem are advised to address the problem with the Register’s office ahead of the appearance for probate. In order to avoid a more formal hearing, you may be required to provide a letter or affidavit of explanation describing why an original document looks like a copy but may not be, a proposed decree, and the joinder of all of the intestate heirs. If a more formal hearing is required, you may wish to consult with John Ramondi, Esquire (the Deputy for Litigation) for his requirements regarding specific issues or problems ahead of the hearing or appearance to probate.

Another common problem at probate is alternate names for the deceased (a/k/a’s), and it is the experience of the Register’s office that it processes a significant volume of petitions to amend or add a/k/a’s to the Letters and to the record. As many a/k/a’s as are known at the time of probate should be included in the Petition for Letters.