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Estate Planning Topics

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HOT TOPICS IN ESTATE PLANNING

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I. ANNUAL EXCLUSION GIFTS

A. Hackl v. Commissioner, No. 02-3093 (7th Cir. 2003). Affirming the lower court and holding that gift transfers made by the taxpayer to his children and their spouses of restricted shares in a limited liability company were future interest and not present interest gifts, the court determined that the gifts were not eligible for the gift tax annual exclusion under section 2503. The case involved gifts of ownership units in a family LLC organized to hold and operate timberland. Under the terms of the operating agreement the donees did not receive any present economic benefit because the agreement did not confer upon the donees any use, possession, or enjoyment of property within the meaning of section 2503(b). The operating agreement did not mandate distributions of income and contained various transfer restrictions. The primary business purpose was to acquire and manage timberland for long-term income and appreciation "and not to produce immediate income."

B. TAM 200341002. In technical advice, the Internal Revenue Service ruled that (1) no gift tax charitable deduction is allowed under section 2522 for transfers made to an irrevocable *Crummey* insurance trust subject to withdrawal powers given to four charitable organizations, (2) the gift tax annual exclusion is not allowable under section 2503(b) for those transfers, and (3) because the transfers do not qualify for the annual exclusion, each such transfer is includible in the computation of adjusted taxable gifts. There were issued regarding the adequacy and consistency of the *Crummey* notices.

II. MARITAL DEDUCTION

A. Davis v. Commissioner, T.C. Memo. 2003-55. Interest received by the decedent's surviving spouse in the decedent's testamentary trust did not qualify for the marital deduction under section 2056 because the decedent did not intend to grant the surviving spouse the entire income interest for life and because the power of appointment given to the surviving spouse was not a general power of appointment in that it was limited by an ascertainable standard.

B. Aronson v. Commissioner, T.C. Memo. 2003-189. The Tax Court found that the trust did not qualify as a QTIP. The estate contended that the language of the will was ambiguous and had obtained a decree from the Surrogate's Court to satisfy the QTIP requirements. The Tax Court disagreed and said that even if it looked at extrinsic evidence, the extrinsic evidence did not support the estate's contention that the decedent intended (1) to leave his wife all the income from the trust, (2) to enable the estate to qualify for the marital deduction under the terms of the 1993 will, or (3) to minimize the estate's tax liability.

C. Brown v. United States, No. 02-55254 (9th Cir. 2003). Marital deduction was reduced for allowed administration expenses and interest on estate taxes. In this case the husband gave money to his wife to allow her to create an irrevocable life insurance trust and subsequently gave her funds to pay the resulting gift taxes, after which the husband died. The Internal Revenue Service took the position that the gift taxes should have been included in the husband's estate and argued that because those funds were not transferred to the wife as part of the marital bequest under the will, no marital deduction was allowed. The administration expenses included legal fees and mediation expenses involved in contesting these matters and the interest expense was for interest paid on the estate tax deficiency after the courts found that the husband in substance had paid the gift taxes.

D. Regulations – Marital Deduction Property Transfers – T.D. 9077. These final regulations provide that the amount of property transferred from a donee spouse to a recipient is reduced by the amount of recoverable gift tax on the transaction under section 2207A. The rules relate both to the amount treated as a transfer under section 2519 when there is a right to recover gift tax under section 2207A(b) and to the related gift and estate tax consequences if the right to recover the gift tax is not exercised. The regulations describe the interrelation of sections 2207A and 7872 by providing that a delay in the exercise of the right of recovery would be treated as a below-market loan if the loan does not provide for the payment of sufficient interest. But, depending on the facts and circumstances, a loan arising from the delay could be a loan exempt from the application of section 7872 because it is a loan for which the interest arrangements do not have a significant effect on any federal tax liability of the lender or the borrower. The final rules provide that the transferor may waive the right of recovery, thus causing the gift from the transferor to the donee to be complete upon the later of the date of the waiver or the date of the payment of the federal gift tax.

E. PLR 200323010. In this case, a QTIP election was made for both the QTIP trust and the credit shelter trust. Pursuant to Rev. Proc. 2001-38, the QTIP election with respect to Trust C, the credit shelter trust, will be treated as a nullity for federal estate, gift, and generation-skipping transfer tax purposes. However, because Trust B meets the requirements for qualified terminable interest property and the election under section 2056(b)(7)(B)(v) was made on a timely filed estate tax return, the QTIP election for the property passing to Trust B, the marital trust, is valid and irrevocable. Also, as a result of a miscalculation, the value of the property that passed to Trust B was reported incorrectly on Schedule M and as a result of this miscalculation, the marital deduction claimed for Trust B was less than the amount that should have been claimed, resulting in an estate tax liability. The ruling holds that the description of the QTIP property on Schedule M does not invalidate the QTIP election for the property passing to Trust B and that the miscalculation of the value of the property passing to Trust B does not preclude a marital deduction for the full value of the property which will actually fund Trust B under the terms of the governing instrument.

III. GROSS ESTATE INCLUSION AND VALUATION ISSUES

A. Kimbell v. U.S., 244 F. Supp. 2d 700 (N.D. Tex. 2003). The court applied section 2036 to impose an estate tax on the full value of assets transferred to a family partnership shortly before the decedent's death. The decedent retained a 99 percent interest in the partnership, as well as a 50 percent interest in the general partner, through which she was able to remove the general partner and control the income stream from the partnership. The court found no arm's length transaction because the decedent "stood on both sides of the transaction," and "it would be an oxymoron to say that one can engage in an arm's length transaction with oneself." The court found no adequate consideration because the decedent received no consideration other than her interest in the partnership. The decedent merely changed the form in which she held the transferred property – in essence a "recycling" of value. The court found that the decedent, if she had become the general partner, would have had no fiduciary duty to the partnership that would have prevented her from exercising that right. Incredibly, the partnership agreement recited that the general partner would have no fiduciary duty to the partnership.

B. Strangi v. Commissioner, T.C. Memo. 2003-145. On remand from the Fifth Circuit, the Tax Court holds that section 2036(a) applies to the family limited partnership and found that the full value of the assets the decedent transferred to the partnership were includible in the estate. The court ruled that the full date-of-death value of the assets Mr. Strangi had transferred to the partnership before his death was included in his gross estate for estate tax purposes under section 2036 and thus subject to estate tax upon his death.

C. Stone v. Commissioner, T.C. Memo. 2003-309. None of the assets owned by any of the five family limited partnerships at issue were includible in the decedent's gross estate under section 2036(a)(1). Unlike the transfers involved in *Kimbell, Harper, Thompson,* and other cases, the transfers at issue here did not constitute a "circuitous 'recycling' of value" but instead were for adequate and full consideration in money or money's worth and fell under the exception in section 2036(a)(1).

D. McCord v. Commissioner, 120 T.C. No. 13. This long-awaited gift tax decision involves taxpayers who assigned their interests in a family partnership as gifts to their children and certain charitable organizations without admitting the assignees as partners. The value of the assigned interests was determined for purposes of the gift tax after taking into account the partnership's net asset value and discounts for lack of control and marketability. The majority ignored the defined value clause but seemed to endorse an approach similar, but not exactly like, what the courts rejected in *Proctor* and *Ward*. The court ultimately allowed a 32 percent discount.

E. Lappo v. Commissioner, T.C. Memo. 2003-258. Gifts of interests in a family real estate/marketable securities limited partnership were valued for gift tax purposes by the Tax Court after considering the testimony of the valuation experts involved.

F. Peracchio v. Commissioner, T.C. Memo. 2003-280. Fair market value of limited partner interests in a family limited partnership transferred by taxpayer to a family trust in two separate transactions was determined for gift tax purposes.

IV. OTHER VALUATION ISSUES

A. Dailey v. Commissioner, T.C. Memo 2002-301. In a decision that some say may signal an end to the Internal Revenue Service's attempts to disregard validly formed limited partnerships, the Tax Court awarded an estate $42,700 in litigation costs against the government because its position that the partnership should be disregarded was not "substantially justified." However, the court refused to award litigation costs against the government for contesting the issue of valuation because the government's expert was qualified, and valuation issues are inherently difficult.

B. TAM 200303010. In determining the fair market value of Series E United States savings bonds for estate tax purposes, the estate is not entitled to a lack of marketability discount for the income taxes due on the interest that accrued on the bonds from the date of purchase to the date of maturity. The TAM notes that although the only willing seller is the decedent or decedent's estate and the only willing buyer is the United States government by contractual arrangement, the bonds will be redeemed by the United States Treasury at the redemption price, citing the *Cartwright* case decided by the Supreme Court in 1973 holding that mutual fund redemption arrangements are similar to closely held buy-sell agreements and fix the value for estate tax purposes.

C. Gribauskas v. Commissioner, No. 01-4189 (2d Cir. 2003). Remaining installments of a state lottery prize that are subject to transferability restrictions are to be valued in the estate of a deceased winner without regard to the actuarial tables for valuation of annuities, if the restrictions in fact result in a lower market value. The court agreed with the holding in *Shackleford v. United States*, 262 F.3d 1028 (9th Cir. 2001), that the governing principle is that a departure from the section 7520 tables is allowed if the tables produce a substantially unrealistic and unreasonable result.

D. Cook v. Commissioner, No. 02-61011 (5th Cir. 2003). Decedent's right through a partnership to receive the remaining installments of a lottery prize for the next 19 years was a private annuity that must be valued under the section 7520 annuity tables. The decedent's executor had valued the partnership's right to lottery payments using a discounted cash flow method and including a discount for nonmarketability. The parties stipulated that, because of the prohibition on transfer of the lottery prize, no market for the right to lottery payments existed at the time of the decedent's death.

E. Rev. Rul. 2003-122. The applicable federal interest rates (AFR) for December 2003. The annual short-term rate is 1.68 percent (up from 1.50 percent for November), the annual mid-term rate is 3.55 percent (up from 3.32 percent for November, and the annual long-term rate is 5.12 percent (up from 4.99 percent for November). The AFR under section 7520 for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 4.2 percent (4.0 for November, 4.4 for October, 4.2 for September, and 3.2 for August). Remember that **HIGHER** 7520 RATES are *GOOD* for QPRTs, CRATs, and CGAs and *BAD* for GRATs, CLATs, and private annuities; **LOWER** 7520 RATES are *GOOD* for GRATs, CLATs, and private annuities and *BAD* for QPRTs, CRATs, and CGAs.

V. MISCELLANEOUS

A. Regulations – Split-Dollar Insurance – T.D. 9092. These final regulations create two tax treatment regimes for split-dollar life insurance arrangements entered into or materially modified after September 17, 2003 and make obsolete previous rulings on the tax treatment of split-dollar arrangements. Which regime applies to an arrangement depends solely upon which party owns (or is deemed to own) the underlying policy. The first new regime (endorsement method) requires that the economic benefit rules of sections 61 and 83 apply to any arrangement in which the employer is formally designated as the owner of the contract. The second tax regime (collateral assignment method) applies if the employee is formally designated as the owner of the life insurance contract. Under this structure, the premiums paid by the employer are treated as a series of loans to the employee. These loans are in turn subject to section 7872 or sections 1271-1275.

B. Notice 2002-8. This notice contains the various grandfather and transitional rules for equity split-dollar arrangements in existence before September 18, 2003, the effective date of the final regulations. December 31, 2003 is the deadline for converting or terminating such an arrangement in order to take advantage of the safe harbor to avoid income tax on the equity in the policy.

C. Costanza v. Commissioner, No. 01-2207 (6th Cir. 2003). Sale by the decedent to his son in return for the son's execution of an installment note containing a cancellation-upon-death provision was a bona fide transaction, not a gift, but the case was remanded for consideration of commissioner's alternative argument that the SCIN constituted a bargain sale that subjects the estate to gift taxation under section 2512.

D. Rev. Proc. 2003-42. This provides a sample declaration of trust that will meet the requirements of section 2702(a)(3)(A) and the regulations thereunder for a qualified personal residence trust (QPRT) with one term holder. Alternate provisions deal with additions to the trust to purchase a personal residence and the disposition of the trust's assets when the trust ceases to meet the requirements for a qualified personal residence trust.

E. Rev. Proc. 2003-53. In this and seven other Revenue Procedures issued the same day, the Internal Revenue Service provides updated sample declaration of trust instruments for certain types of charitable remainder annuity trusts (CRATs) and issues new samples for additional types of CRATs. Altogether, eight samples are provided, both inter vivos and testamentary versions of CRATs, providing for annuity payments for one measuring life, for a term of years, consecutively for two measuring lives, and concurrently and consecutively for two measuring lives.

F. Notice 2003-39. The Internal Revenue Service intends to publish sample forms for charitable lead trusts and requests comments and suggestions regarding the creation of these sample forms, including comments on the type of format to be used, the substantive provisions to be included, and the various types of charitable lead trusts for which samples would be most helpful.

G. PLR 200315040. Amendment and reformation of a trust to eliminate all noncharitable interests to qualify as a 501(c)(3) organization will not result in income to the trust. The IRS looked to the rationale of *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). It noted that the trust amendment is intended solely to qualify the trust as a section 501(c)(3) charity and that it will not result in a change in the trust's assets or a sale or disposition of property within the meaning of section 1001. The ruling holds that the trust will not realize gain or loss under section 61 or section 1001 as a result of the amendment.

H. PLR 200303022. Section 9100 relief was granted to make a late allocation of GST exemption for a gift in Year 1 even though the failure to make it was discovered by the drafting attorney in Year 2 and relief was not sought until after the Internal Revenue Service commenced an audit in Year 3 of the gift tax return and proposed an adjustment for the value of the closely held stock given to the trust.

I. PLRs 200328034 and 200328034. No sale or exchange will occur under section 1001 upon the rather unique partition of a jointly owned contiguous tract of property. The property is to partitioned in such a manner that certain co-tenants will continue to own one parcel jointly while another piece will be owned by one individual in his sole name and another piece will have two of the owners as life tenants with a trust (another co-owner) as the remainderman.

VI. YOUR ANNUAL ESTATE PLANNING EXAMINATION "WHAT'S NEW TO BE ADDED TO YOUR CHECKLIST"

A. Documents to Review Can Include:

Will
Revocable Trust
Power of Attorney
Advance Medical Directive
Operating Agreement of any Closely-Held Limited Liability Company
Split-Dollar Agreements
Charitable Remainder Trusts
Joint Accounts
POD (Pay-on-Death) Designations
TOD (Transfer-on-Death) Designations
Retirement Plan Beneficiary/IRA Beneficiary Designation
Irrevocable Life Insurance Trusts

B. Will and/or Revocable Trust Considerations.

1. Increasing Estate Tax Exemption/Potential repeal of Federal Estate Tax in 2010.

2. Change in step-up/step-down in basis rules at death if Estate Tax repeal occurs in 2010.

3. Drafting with greater flexibility. Use of special powers of appointment and springing general powers of appointment.

4. Phase out of credit of state death taxes; state death taxes become a deduction in 2005.

5. Impact of owning property in different states with different state death tax regimes.

6. Drafting to use conservation easements created by Executor.

7. Minimum Distribution Rules impact on naming a trust as a beneficiary; use of conduit provision.

8. Rule of Perpetuities - §55-12.1 (partial repeal).

9. Use of "Letter Instructions" as authorized by §64.1-45.2, giving a Trustee private guidance on discretionary distribution authority.

10. Death Tax Clause -- "Off the Top" vs. "Apportionment". Which beneficiaries share the burden of death taxes?

11. Titling residence in Revocable Trusts of husband and wife (½ interest each) and preserving the "tenants by the entirety with right of survivorship" creditor protection under §55-20.1.

12. Impact of Virginia Income/Principal Act on trust distribution language.

13. Authorization to move trust situs to another state.

14. Do not condition disclaimer on being qualified under Federal tax law.

15. Drafting to avoid conservator's control of a Revocable Trust under §37.1-137.5.

C. Powers of Attorney.

1. HIPAA "privacy" language.

2. Drafting for recognition in other states.

3. Authorization to transfer an IRA account to a Qualified Plan and authority/direction to make beneficiary designations.

D. Advance Medical Directive. HIPAA "privacy" language.

E. Operating Agreements of LLCs, Etc.

1. Drafting vs. Behavior to avoid impact of *Hackl* decision on annual exclusion gifts.

2. Drafting vs. Behavior to avoid impact of *Strangi II* decision on estate tax inclusion under Code Section 2036(a).

F. Irrevocable Life Insurance Trust. "Amending" an Irrevocable Trust - Letter Ruling 200228019 (existence of grantor trust status from an income tax point of view).

G. IRAs, Etc.

1. Careful if you name a Trust.

2. Ability to now name a charity for a portion of IRA without adversely impacting Minimum Distribution Rules.

H. Checklist Reminders That Should Always Be Reviewed.

1. Clear differences in life expectancy of either spouse.

2. Maximizing benefit of "Property-Previously Taxed Credit".

3. Review use of disclaimers.

4. Survivorship conditions and/or presumptions.

5. Selection of Executors, Trustees, Attorneys-in-Fact, Guardians for minor child(ren), Trust Advisor(s), and Trust Protector(s).

6. Identify need for Trusts to be able to own "S" stock.