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Hot Topics and Practical Tips in Estate Planning

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"HOT TOPICS AND PRACTICAL TIPS
IN
ESTATE PLANNING"

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I. INCOME TAXES

A. Code* § 1. Income Tax Rates.


On August 10, 1993, President Clinton signed into law the Revenue Reconciliation Act of 1993**, a comprehensive budget package that included various taxation provisions.

Under the Act, the income tax rates for estates and trusts are as follows:

- $0-1,500: 15% of taxable income
- $1,500-3,500: $225 plus 28% of the excess over $1,500
- $3,500-5,500: $785 plus 31% of the excess over $3,500
- $5,500-7,500: $1,405 plus 36% of the excess over $5,500
- Over $7,500: $2,125 plus 39.6% of the excess over $7,500 (after 10% surtax)

The Act retains the maximum statutory rate of 28% for net capital gains. The tax bracket thresholds will be indexed for inflation. The new rates are effective for taxable years beginning after 1992.

Under the Act, individuals (but not estates and trusts) may elect to pay additional 1993 taxes caused by the change in rates, without interest, over three years.

*All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

**All references to the "Act" are to the Revenue Reconciliation Act of 1993.
Note. The compressed rates for estates and trusts add another reason to consider making distributions to current income beneficiaries. Generally, individuals will not reach the 39.6% marginal bracket until their taxable income exceeds $250,000 whereas estates and trusts will be subjected to the surtax on all taxable income over $7,500.

B. Code § 55. Increased AMT Rates and Exemption Amount

The Act increases the AMT exemption for estates and trusts from $20,000 to $22,500. It also provides that the first $87,500 of alternative minimum taxable income (AMTI) in excess of the exemption will be taxed at a rate of 26%. All AMTI which exceeds $87,500 plus the exemption will be taxed at a rate of 28%.

The new rates and exemption amount are effective for taxable years beginning after 1992.

C. Code § 67. 2% Floor on Miscellaneous Itemized Deductions.

Trustee's Investment Advisory Fees Deductible Without Regard to 2% Limitation.

O'Neill Irrevocable Trust v. Comm'r, 93-1 U.S.T.C. ¶ 50,332 (6th Cir. 6/1993), rev'g 98 T.C. No. 17 (1992). A grantor created an irrevocable trust for the benefit of certain family members. The trustees hired investment advisers and paid them $15,374 for advice on the management of $4,500,000 of assets. The trustees deducted the full amount paid, but the IRS said that the fees were deductible only to the extent that they exceeded 2% of
the trust's income, after deducting the distributions deduction. Reversing the Tax Court, the Sixth Circuit held for the taxpayer. The Court noted that applicable state law (Ohio) requires the trustees to invest the trust assets in the manner of a "prudent investor," and this obligated the trustees to hire professional advisers, if they were not themselves sufficiently expert in investment matters. Because state law obligated the trustees to employ investment advisers, the court held that the expense was one "which would not have been incurred if the property were not held in such trust."


1. Insurance-Holding Partnership Sustains Partnership Classification, Avoiding Transfer-for-Value Rule.

Ltr. Rul. 9309021. Three individuals signed a cross-purchase buy-sell agreement with respect to the stock of their closely-held corporation. The buy-out was funded with insurance held by a partnership formed exclusively to manage the life insurance policies. The IRS said that the entity was a partnership for tax purposes, because it lacked the corporate characteristics of centralized management and limited liability. Further, the transfer-for-value rule would not apply with respect to exchanges of the policies under the partnership agreement because the insureds were partners in the partnership. The life insurance proceeds received by a partner as a result of the death of the other partner increased the receiving partner's distributive share as tax-exempt income and increased his basis in his partnership

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interest. Accordingly, the life insurance proceeds received by a partner would not be taxable to the extent that such proceeds did not exceed his adjusted basis in his partnership interest immediately before the distribution.

Note. The use of a partnership for this purpose has become more common. Of course, the estate of the first partner/stockholder to die includes the value of his or her partnership interest, including a proportionate share of the proceeds on his or her own life.


1. Act provides Permanent AMT Relief for Charitable Contributions of Appreciated Property.

Recently, if appreciated property was contributed to charity, the appreciation was treated as an item of tax preference for purposes of the alternative minimum tax (AMT). The Act eliminates this preference treatment for contributions of tangible personal property made after June 30, 1992 and contributions of all other appreciated property made after 1992. However, the change does not apply to any carryover for contributions made before these effective dates.


The Act requires a taxpayer claiming any charitable contribution deduction of $250 or more to obtain a contemporaneous written acknowledgement of the donation from the charity. The acknowledgement should include a recitation of the amount of cash
contributed as well as description (but not a valuation) of all noncash contributions plus a description (and good faith estimate of value) of any goods or services provided as consideration for the contribution.

The Act requires charities to inform donors of such so-called quid pro quo contributions (in excess of $75) (other than intangible religious benefits) of the amount of the contribution that is deductible. Failure to make the disclosure is penalized by $10 per contribution fines, up to $5,000 for a particular fund-raising event or contribution.

These provisions apply to contributions made after 1993.


Krapf v. U.S., 1992-2 U.S.T.C. ¶ 50,537 (Fed. Cir. 10/1992). The founder of a corporation gave some of his shares in the company to a university. The taxpayer valued the stock at $10.00 per share, based on the amounts paid to two employees when the corporation repurchased their shares a year earlier. Three years later, the stock was sold for $0.40 per share in two transactions, including one sale by the university of the contributed shares. The following year, however, the stock was again sold for $10.00 per share. The IRS said that the stock was worthless when contributed, and the Claims Court found that it had a value of $4.34 per share. The Federal Circuit reversed and remanded the case, finding that the post-gift events were properly considered, but incorrectly evaluated by the trial court.

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F. Code § 408. IRA Roll-Overs.

IRA Received Through Estate and Inter Vivos Power of Appointment Trust Could Be Rolled-Over.

Ltr. Rul. 9235058. A decedent's IRA was made payable to his estate. The beneficiary of the estate was an irrevocable trust that, on the decedent's death, divided into marital and nonmarital shares. The IRA was allocated to a marital trust, which was revocable by the decedent's widow. The widow then terminated the trust, distributed the assets to herself, and rolled them into an IRA, within 60 days of the distribution from the IRA. The IRS held that the widow's right to revoke the trust made her the trust's owner, and that the payment would be treated as having been made to the widow.

Note. Consider a marital power of appointment trust when there is a significant IRA balance. Alternatively, the IRA can be made payable outright to the surviving spouse, with the trust as the alternate beneficiary, permitting a disclaimer if the trust format is preferable at the time.

G. Code § 453B. Disposition of Installment Obligations. Automatic Termination of SCIN is a Disposition.

Estate of Frane v. Comm'r, 93-2 U.S.T.C. ¶ 50,386 (8th Cir. 7/1993), aff'g in part, rev'g in part 98 T.C. 341 (1992). The decedent sold his wholly-owned corporation to his four children in exchange for four 20 year self-canceling installment notes
The decedent's life expectancy exceeded the term of the notes, but the decedent died two years after the sale.

The Tax Court held that the death of the obligee amounted to a disposition under Code § 453B(f), and that the untaxed capital gain was income to the decedent's estate. The Tax Court said that the termination of the note was a disposition, even though it did not involve an actual transfer or specific release by the will. Because it was income to the estate on account of the seller's death, the Court reasoned the gain was not IRD. This decision was reviewed by the entire court.

The Eighth Circuit affirmed in part and reversed in part, holding that the gain had to be recognized by the decedent's estate, rather than on the decedent's final income tax return. The Court refused to treat the cancellation of a SCIN differently from any other form of cancellation of an installment obligation merely because there was no independent act of cancellation. The Court also held that the basis of the obligors in the assets exchanged for the obligation reflected the full value of the note instead of the value actually paid.


Discretionary Trust Can Be Beneficiary of Charitable Remainder Trust.

Ltr. Rul. 9328041. A decedent's will created three trusts, a 5-year and a 10-year charitable annuity trust and a 20-year charitable unitrust. The noncharitable beneficiary of each trust was one of several discretionary trusts created for the
benefit of members of the decedent's family. The remainder of each trust was a charitable organization. The IRS ruled that the trusts were qualified charitable remainder trusts, noting that as long as the term of the noncharitable interest is a number of years, rather than someone's lifetime, the beneficiary can be another trust, rather than one or more individuals.


1. Right to Add Descendants Creates Grantor Trust Status for S Corporation Trust.

Ltr. Rul. 9304017. A decedent created a trust to hold S corporation stock. The decedent gave a nonadverse (but not necessarily independent) trustee a broad power to pay income and principal among the decedent's children, in such shares as the trustee deemed appropriate. The trustee also was granted the power to add and remove as beneficiaries any of the decedent's descendants, and the right to renounce this power at any time. At the death of both the decedent and the decedent's spouse, the trust would divide into separate shares for each of the decedent's then-living children who then are beneficiaries of the trust. The IRS ruled that the trust was a grantor trust under Code § 674, owned entirely by the decedent. At the decedent's death, the trust would create separate QSSTs for the decedent's children.


Ltr. Rul. 9247024. An individual created a charitable lead unitrust which, to secure an accelerated income tax deduction,
needed to be a grantor trust. Code § 170(f)(2)(B). To make the unitrust a grantor trust, the individual granted a related party the nonfiduciary right to substitute assets of equivalent value for any assets held by the trust, giving the trustee the independent right to verify the equivalency of values. The IRS said that the trust would be a grantor trust under § 675(4), and no portion of it would be included in the grantor's gross estate under §§ 2036, 2037, 2038, 2041, or 2042, on account of the power to substitute assets.

Note. This creates an unusual trust that qualifies for the gift tax charitable deduction as a gift of a guaranteed unitrust interest, but also provides an accelerated income tax deduction.


1. Proceeds of Sale of Real Estate Pursuant to Option Agreement Were Not IRD.

Ltr. Rul. 9325029. A decedent died owning certain real estate subject to an option agreement granted by the decedent prior to the decedent's death and exercisable only after the decedent's death. After the decedent's death, the real estate was sold pursuant to the option. The IRS ruled that the gain was not IRD, because at decedent's death, the decedent was not unconditionally entitled to the proceeds of the sale. The IRS also noted that the real estate could not be conveyed unless the option holders first executed a sales contract after exercising the option.
Note. The IRS also noted that the basis of the real estate in the hands of the estate was its fair market value on the date of death, taking into account the existence of the option.

2. Disclaimed Retirement Benefits Taxable to the Recipient, not Disclaimant.

Ltr. Rul. 9319029. A widow disclaimed a portion of her deceased husband's profit-sharing plan by a disclaimer that was qualified under state law and § 2518. The IRS said that the disclaimed benefits were IRD, and taxable to the ultimate recipient, not the disclaimant. If the estate of a decedent transmits the right to IRD to another person who would be required to include that income when received in his or her gross income, only the transferee must include that amount in gross income. The widow's disclaimer satisfied this requirement because it was a transfer at death to persons pursuant to their right to receive it by reason of the death of the decedent or by bequest, devise or inheritance of the decedent.

3. Appreciation in Value of Both Series E and Series H Savings Bonds is IRD, Accelerated on Funding Pecuniary Share.

Ltr. Rul. 9315016. A decedent funded a revocable trust with both Series E U.S. Savings Bonds and Series H bonds, acquired in an exchange for Series E bonds. When the decedent died, the value of the bonds exceeded the decedent's purchase price, and the bonds were distributed to satisfy a pecuniary charitable bequest to a private foundation. The IRS ruled that the appreciation in value of the bonds represented accrued interest and was, therefore, IRD, and that the distribution of the bonds in satisfaction of a
pecuniary legacy, even to a charity, caused the trust to recognize
the previously-untaxed income. Citing Rev. Rul. 67-74, 1967-1 C.B.
194; and Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940).

K. Code § 1001-1035. Recognition of Gain and Amount of
Gain.

1. Exchanges of Life Insurance Contracts Were Tax Free
Despite Differing Nationalities of Insurers.

Ltr. Rul. 9319024. A U.S. citizen exchanged a
nonvariable deferred annuity contract issued by a U.S. insurer for
a nonvariable deferred annuity contract issued by a foreign
insurer. The U.S. annuity was to begin on September 1, 2033, and
the foreign annuity was to begin on September 20, 2002. Both
policies are annuities under Code § 1035(b)(2). The IRS ruled that
the exchange is tax-free under § 1035 because the legislative
history indicates that a contract is life insurance without regard
to the nationality of the issuer.

2. Swap of Joint and Survivor Life Insurance Policy for
Single Life Policy is Tax-Deferred, When One Insured
Is Already Deceased.

Ltr. Rul. 9248013. An individual created an irrevocable
life insurance trust to buy a joint and survivor (or "last to die")
insurance policy on his life and the life of his spouse. The
spouse died first, causing the policy cash value to grow signifi-
cantly. The trustee wanted to exchange the policy for a universal
life policy on the life of the widower alone. The IRS held that
such an exchange would be tax-deferred under Code § 1035, in part
because the spouse's death meant that there would be no change in the insureds.

Note. If both insureds were still alive when the exchange occurred, the exchange should not qualify under §1035, because there would no longer be an identity of insureds.


1. Even a Remote Possibility of Improper Distribution Disqualified Separate Share Trust as QSST.

Rev. Rul. 93-31, 1993-17 I.R.B., p. 5 (4/1993). A decedent created a trust to hold stock of an S corporation. The trust provided for income to be paid to A and B in equal shares, but there was a remote possibility that one of the beneficiaries would receive more than its proportionate share of trust corpus. The possibility was so remote as not to prevent application of the separate share rule under Code §§ 663(c) and 1361(d)(3). However, the IRS said that the requirements of §1361(d)(3)(A)(ii) must be met for a trust to be a QSST, and even a remote possibility that the corpus allocated to the separate share of one beneficiary could be allocated to the other was sufficient to disqualify the trust. Thus, the IRS ruled that the trust terms must provide that any corpus distributed during the life of the current income beneficiary be distributed only to that beneficiary.

Note. The IRS also noted that if the application of this ruling caused an inadvertent termination of an S-corporation election, relief could be requested under §1362(f).
2. Income Beneficiary Taxed on Gain From Sale of S Corporation Stock by QSST.

Rev. Rul. 92-84, 1992-40 I.R.B., p. 24 (10/1992). A QSST sold all or part of its S corporation stock. Local trust law requires that the gain or loss on the sale of capital assets be allocated to corpus, rather than income. The IRS said that, as the income beneficiary is treated as the owner of the portion of the trust consisting of the S-corporation stock under Code § 678, the income beneficiary must take into income any item of gain or loss directly related to the stock. The IRS said that the gain or loss on the stock sale was directly related to the stock and therefore clearly taxable to the income beneficiary.

Note. The IRS did not discuss what happens when the sale is on the installment basis and the trust ceases to be a QSST. It is far less clear that the income beneficiary is taxable on the gains recognized in the year after the trust no longer owns any S corporation stock.


Rev. Rul. 92-73, 1992-37 I.R.B., p. 7 (9/1992). An individual owned stock of an S corporation, and assigned it to a trust that constituted an Individual Retirement Account, under Code § 408(a). The IRS ruled that a trust that is used as an IRA cannot be an eligible S corporation shareholder. The IRS noted that the trust cannot be a QSST because the beneficiary of a QSST must elect to have the trust treated as a beneficiary-controlled trust under § 678, so that the beneficiary is taxed on all trust income cur-
rently. § 1361(c) (2)(A)(i). Alternatively, were the trust a grantor trust under § 671, the participant would be the grantor and taxed on all trust income currently. IRAs, on the other hand, are taxed differently under § 408. The beneficiary of an IRA is taxable only when distributions are made, and then under the rules of § 72. Thus, the rules for taxation of IRAs are inconsistent with those for S corporation trusts.

4. **Crummey Demand Power Creates an Eligible S Corporation Trust Via Code § 678.**

**Ltr. Rul. 9311021.** An individual created a trust with separate shares for each of the individual's three children. The trustee had discretion to pay income and principal to each child under an ascertainable standard. When each child reaches 40, the trust funds will be paid to him or her outright. If the child dies before 40, his or her share will be held for that child's descendants. Each child is given a Crummey demand power over all gifts to the trust. The grantor represented that no gifts would be made in excess of the quantitative limitations on the Crummey power. The IRS ruled that the demand power made the child the trust's owner under Code § 678(a), and that the child was the owner of the trust under §§ 677 and 678(a)(2). Furthermore, each child was given a nonfiduciary power to remove and replace assets, causing grantor trust status under § 675(4). Because the child owned the entire trust under these sections, the trust was an eligible S corporation stockholder under § 1361(c)(2)(A)(i).

Note. If gifts may exceed $5,000 per year, it is also a good idea to give each child a limited testamentary power of
appointment over the remainder interest. This would avoid causing a taxable gift by the child when his or her demand power lapses unexercised. This appears not to have been done or ruled upon here.

Further Note. This is an excellent alternative to the QSST, since the trustee need not be required to distribute income or principal currently. Furthermore, if the beneficiary is given a general testamentary power of appointment over the entire trust fund, the trust will qualify for the annual exclusion under both the gift and generation-skipping transfer tax rules.

M. Income Tax Liens.


The Act simplifies the safe harbor for avoiding a penalty on underpayment of estimated tax based on the prior year's tax by submitting a provision that if the prior year's adjusted gross income exceeds $150,000, then a penalty may be avoided by paying 110% of the prior year's tax rather than 100%. The Act retains the safe harbor that a penalty may be avoided by paying 90% of the current year's tax.

The new provision is effective for estimated tax payments applicable to taxable years beginning after 1993.
II. ESTATE TAXES


1. Act Makes 55% Rate Permanent.

The Act makes permanent the 55% top estate, gift, and generation-skipping transfer tax rate. The rates are effective for decedent's dying, gifts made and generation-skipping transfers made after 1992.

2. Fourth Circuit Agrees That IRS Can Revalue Gifts After Death.

_Levin v. Comm'r_, 93-1 U.S.T.C. ¶ 60,128 (4th Cir. 3/1993), aff'g sub nom. _Estate of Prince v. Comm'r_, T.C. Memo. 1991-208 (1991). A decedent gave bonds issued under the 1937 Housing Act to her children, filing gift tax returns and reporting the transfers as exempt from gift tax. The 3-year period for assessing gift taxes expired before the decedent died. The IRS said that the bonds had a substantial value for gift tax purposes, and revalued them for purposes of setting the estate tax rate under Code § 2001. The Fourth Circuit, affirming the Tax Court, said that the amount of the decedent's "adjusted taxable gifts" could be revalued despite the expiration of the statute of limitations on the gift tax. The statute of limitations on the gift tax does not extend to the revaluation of gifts for estate tax purposes.


1. CPA's Marketability and Minority Discounts Rejected.

_Estate of Berg v. Comm'r_, 976 F.2d 1163 (8th Cir. 10/1992), aff'g in part and rev'g in part 26.92% interest in a
closely-held real estate holding and management company. The value of the company's underlying assets was approximately $4,000,000, so the value of the decedent's stock, before discounts, was $1,000,000. The estate claimed a 60% discount for lack of control and lack of marketability. The estate tax return included an explanation of the discount, but not an appraisal. Rather, the estate merely said that it was relying on earlier Tax Court decisions sustaining a 60% discount for the stock of a real estate holding company. The Tax Court rejected the estate appraisals in favor of the IRS approach, which looked at comparable publicly traded real estate investment trusts and which concluded that a 30% discount (20% lack of control; 10% lack of marketability) was appropriate. The Eighth Circuit agreed with the Tax Court, noting that the estate had failed to prove that the Tax Court's determination was "clearly erroneous." The Eighth Circuit said that the Tax Court's opinion showed a careful weighing of the substance of the appraisers' reports and the backgrounds of those who gave the expert testimony.

Note. The Eighth Circuit reversed the Tax Court in part, finding that the estate was not liable for an addition to tax for understating its tax liability because it had reasonably relied on its accountant's valuation of the stock.

2. Buy-Sell Agreement Price Did Not Fix Estate Tax Values Because It Was Adopted Primarily For Testamentary Purposes.

Corporation, the holding corporation for Estee Lauder, Inc., an internationally-known fragrance manufacturer. In 1974, at the suggestion of one of the decedent's sons, the stockholders entered into a cross-purchase buy-sell agreement. The purchase price was set by formula based on the book value of the stock, excluding the value of intangible assets. The date of death value of the decedent's stock under the agreement was $4,111 per share, and the value listed on the estate tax return was $4,300 per share. The IRS asserted that the stock was worth $13,250 per share, and assessed a deficiency of $42,702,597. The Tax Court held that the agreement did not fix estate tax values, because it was used as a device to shift the value of the business to the children at a bargain price. The court noted that the decedent was in his 70's when the agreement was signed (although he lived another 9 years); no appraisal was used to set the formula; the parties did not attempt to negotiate the formula at all; and the formula excluded intangibles, even though the intangible assets of the corporation were immensely valuable.

3. Fractional Interest in Real Estate Given Only Small Discount.

Ltr. Rul. 9336002. A decedent died owning an undivided one-half interest in a ranch valued at $1,311,845. The decedent's appraisers claimed a 30 percent discount against the proportionate value of the whole property. The IRS noted that a buyer could sue to partition the property with relative ease, and therefore said that if the discount were allowable at all, it must be limited to

Note. This position is inconsistent with numerous opinions that have granted significant discounts for partial interests in real estate. The discounts are always based on comparable sales of partial interests, and the fact that most buyers do not want to sue for partition, and many properties are difficult, if not impossible, to partition. In such cases, the buyer of a partial interest really only acquires the right to force a sale to a third party and a right to a share of the proceeds.

C. Code § 2035. Transfers Within Three Years of Death.

Life Insurance Policy Purchased Through Re-executed Contract Excluded From Gross Estate.

Ltr. Rul. 9323002. The decedent initially applied for two life insurance policies, listing herself as "proposed insured" and naming her estate as the beneficiary of the policies. The space for "owner other than the insured" was left blank. The application stated that it would "take effect only if the first full premium is paid and [the] policy issued and delivered to the owner." Later that same year, but before any premium had been paid, the decedent decided that the policies should be owned by her two sons, and she filed a supplementary application under which the sons were named owners and beneficiaries. No premium was paid with the supplementary application. Thereafter, a premium was paid and the policies were issued to the two sons. The IRS ruled that the decedent never held any economic ownership or contractual rights
in the policies, and that the three-year rule of Code § 2035(d) was never triggered. The IRS noted that applicable state law (Texas) did not give the decedent any rights over the policy until it is issued. The IRS noted that an insurance policy application is merely an offer to buy insurance, and that the application is not enough to convey incidents of ownership until it is accepted. The IRS noted also that premium rates had increased since the decedent had filed the original application, but that the insurance company agreed to use the more favorable rates with respect to the supplementary application. However, the transfer of this favorable premium rate from the decedent to the policy owners did not constitute the transfer of an incident of ownership in the policy itself.


1. Gift-Leaseback Recharacterized as a Retained Life Estate.

_Estate of Maxwell v. Comm'r, 93-2 U.S.T.C. ¶ 60,145 (2d Cir. 8/1993)._ A decedent sold her personal residence to her only child and the child's spouse for $270,000. Decedent forgave the $20,000 down payment and took back a $250,000 mortgage. Decedent then leased the house back for five years for an amount that was approximately equal to the mortgage payments. Decedent was then 82 years of age and suffering from cancer, such that she was unlikely to live for five years. Decedent forgave each principal installment as they became due, and in her will, the decedent forgave the outstanding debt. The Second Circuit, affirming a
decision of the Tax Court, found that there was an understanding between parent and child that the parent would be allowed to live in the house for the rest of her life, and that no payments would have to be made on the notes. The court recharacterized the transaction as a gift with a retained life estate, noting that no payments were made on the debt, that the child never occupied the house, and that the debt amortization and rental payments were substantially the same.


Estate of Ridenour v. Comm'r, T.C. Memo. 1993-41 (2/1993). An individual executed a durable general power of attorney that did not specifically grant or deny the authority to make gifts. The attorney-in-fact made gifts on the individual's behalf, consistent with a pattern of prior gifts. The IRS, citing Estate of Casey v. Comm'r, 948 F.2d 895 (4th Cir. 1991), viewed the gifts as unauthorized and voidable, and included them in the decedent's gross estate under Code § 2038(a). The Tax Court, however, said that Va. Code § 11-9.5 (Michie Supp. 1992), passed by the General Assembly and signed by the Governor March 30, 1992, had validated the gifts retroactively. The court noted that the Virginia General Assembly provided that this portion of the legislation was "declaratory of existing law." 1992 Va. Acts ch. 544. The court focused on what the Virginia Supreme Court would conclude on the issue. See Comm'r v. Bosch, 387 U.S. 456, 465 (1967). The
court indicated that Virginia law permits the General Assembly to enact retroactive laws.

3. **Retention of General Partnership Interest in Family Limited Partnership is Not a Retained Interest Under Code § 2036(a).**

**Ltr. Rul. 9310039.** Husband and Wife created a family limited partnership, to which the husband contributed $990,000 in cash for a 1% general partnership interest and a 98% limited partnership interest, and the wife contributed $10,000 in cash for a 1% limited partnership interest. The partnership holds stocks and securities and was not required to distribute income or principal except in the discretion of the general partner, the husband, or at termination. All distributions will, however, be made to the partners in proportion to their partnership interests. Husband gave his limited partnership interests to the wife. The IRS ruled that the limited partnership interests are not includible in husband's gross estate under Code § 2036(a), despite the husband's power to control the distribution of income as general partner. The IRS noted that under applicable state law (Massachusetts) each partner has a fiduciary duty to the other partners. By analogy to *U.S. v. Byrum*, 408 U.S. 125 (1972), the IRS did not treat the general partnership interest as a retained right to control income of the transferred interest.

**Note.** This is an important ruling, since the IRS's previous ruling regarding gifts of limited partnership interests by a general partner involved a partnership that generated no
income. See Ltr. Rul. 9131006 (involving availability of the gift tax annual exclusion).


1. Power to Invade Principal for "Continued Comfort" is Not a General Power of Appointment.

_Estate of Visserling v. Comm'r, 93-1 U.S.T.C. ¶ 60,133_ (10th Cir. 4/1993), _rev'g_ 96 T.C. 749 (1991). A decedent's mother created a trust for the benefit of decedent and decedent's siblings, naming the decedent and a bank as co-trustees. The trustees were empowered to pay the decedent principal for the beneficiaries' "continued comfort, support, maintenance, or education." The decedent died without ever exercising the power. The Tenth Circuit, reversing the Tax Court, held that decedent did not have a general power of appointment. The court said that "comfort" would not be an ascertainable standard, but that "continued comfort" was an ascertainable standard related to health, education, support, or maintenance.

2. Retroactive Ohio Statute Assures That Trustee's Beneficial Interest in Trust is a Limited Power of Appointment.

_Ltr. Rul. 9323028_. A husband's will created a trust and named the wife and a bank as co-trustees. The trustees had discretion to distribute the income and accumulated income to the wife and to their child for whom the trust was created. Ohio Rev. Code § 1340.22 provides that a fiduciary cannot make discretionary distributions to himself or herself unless the power is limited by an ascertainable standard, and that any such power that authorizes
discretionary distributions expressed in terms of "comfort" (among other things) is limited by an ascertainable standard related to the health, education, support and maintenance. This statute was enacted effective October 8, 1992, but it states that it was the intention of the legislature that this rule would be a codification of existing law. The IRS said that the statute was declaratory of existing Ohio law, and that the trust did not grant the wife a general power of appointment over income or accumulated income.


Estate of Wall v. Comm'’r, 101 T.C. No. 21 (10/1993). In 1979 the decedent executed three trust instruments establishing irrevocable inter vivos trusts for the benefit of her children. The grantor retained the right to remove the corporate trustee and replace it with another corporate trustee which had to be "independent" from the decedent. In each case, the trustee had the authority to distribute principal and income to beneficiaries essentially unrestrained by an ascertainable standard. The decedent retained no other power or interest in the trusts other than the right to make additional contributions. The IRS asserted that the trusts were includible in the decedent's gross estate under § 2036(a)(2) or § 2038(a)(1) because in creating the trusts she reserved the right to remove the trustee and appoint a successor. The IRS argument was predicated on Rev. Rul. 79-353. The Court concluded that Rev. Rul. 79-353 is "supported neither by cogent argument nor by cited cases supporting the conclusion reached" and held for the taxpayer.

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1. No Deduction for Debts Owed to Children When Unsupported by Consideration.

_Estate of Flandreau v. Comm'r, 93-1 U.S.T.C. ¶ 60,137 (2d Cir. 5/1993)._ Decedent made a series of gifts to her sons and daughters-in-law, and then borrowed the money back. Each of the 12 promissory notes had a term of 15-years, despite the fact that the decedent was already 70 years of age when she began the gift-borrow back plan. None of the notes bore interest or were secured, and no repayments were ever actually made. The IRS said that no deduction was allowed to decedent's estate for the notes because they were unsupported by consideration. Affirming a memorandum decision of the Tax Court, the Second Circuit held that the circular nature of the transactions, including the fact that decedent would have been 95 before she received all of the repayments, suggested a lack of genuine intent to create a debt. Thus, no deduction was allowed under Code § 2053(c)(1)(A), because the debts were not "contracted bona fide and for an adequate and full consideration in money or money's worth."

2. Interest Expenses Paid from Estate Income Does Not Reduce Residuary Estate.

_Rev. Rul. 93-48, 1993-25 I.R.B. p. 9 (7/1993)._ The IRS said that it changed its position as a result of several court rulings, and now holds that post-death interest paid by an estate from the residuary estate may be deducted as an income tax deduction, without reducing the amount of the residuary estate for
estate tax purposes. Therefore, a charitable or marital deduction from the residuary estate will not be prejudiced by the payment of interest from estate income, nor will such interest reduce the available credit under Code § 2013.


1. Administrative Expenses Paid from Estate Income Reduce Charitable Deduction.

_Burke v. U.S., 93-2 U.S.T.C. ¶ 60,146 (Fed. Cir. 8/1993)._ Decedent's executor successfully petitioned the state probate court to permit the payment of estate administrative expenses from income, rather than from the principal of the estate. Decedent's will directed the payment of administrative expenses from "the residuary estate" but with a clear goal of minimizing estate and inheritance taxes. A charity received the residuary estate "after paying therefrom ... all administration expenses." Affirming the trial court's decision, the Federal Circuit held that administrative expenses deducted out of income must reduce the charitable deduction from the residuary bequest. The Court said that the gross estate, as defined under Code § 2031, is the sole source for all administrative expenses, and any such expenses must be accounted for as part of this estate, without regard to income produced.


_Estate of Marine v. Comm'r, 93-1 U.S.T.C. ¶ 60,131 (4th Cir. 3/1993), aff'g 97 T.C. 368 (1991)._ Decedent's will left
several small specific bequests, including one to his housekeeper, with a charitable residue to two universities. To encourage the housekeeper to stay in his employ, decedent changed his will to give his personal representative discretion to make bequests of up to 1% of decedent's gross probate estate "to persons who contributed to [decedent's] well-being" or who "were otherwise helpful" to the decedent. After decedent's death, the personal representative made a few small bequests and then distributed the residuary estate to charity. The Fourth Circuit, affirming the Tax Court, held that the charitable residuary bequest was not deductible. The court noted that Regs. § 20.2055-2(a) denies a charitable bequest of a remainder interest unless it is ascertainable. Since there was no limitation on how many 1% bequests could be left to noncharitable beneficiaries, the residuary disposition was not ascertainable.

3. Commutation of Defective Charitable Remainder Trust Fails to Save Estate Tax Deduction.

_Estate of Burdick v. Comm'r, 1992-2 U.S.T.C. ¶ 60,122 (9th Cir. 11/1992), aff'g 96 T.C. 168 (1991)._ Decedent's holographic will left his estate in trust, with income to be paid to his brother, for his life, and the remainder then split between his brother's children and certain charities. The IRS disallowed the deduction for the charitable interest, when the executor obtained the consent of all of the parties to a commutation of the trust, giving the charity immediately the value of its remainder interest. The executor then reasserted the deduction, but the IRS reasserted its disallowance of the deduction. The Ninth Circuit
held for the IRS, and said that the only way in which a nonqualified charitable remainder trust can be made qualified is through a reformation pursuant to Code § 2055(e)(3), and that a commutation occurring after the estate tax return was filed could not save the charitable deduction.


1. Federal Circuit Agrees That Marital Deduction is Reduced by Administrative Expenses Paid From Income.

Fisher v. U.S., 93-1 U.S.T.C. ¶ 60,132 (Fed. Cir. 4/1993). Decedent's personal representative paid $38,694 of administration expenses from estate income. The estate deducted these expenses on the fiduciary income tax return. The IRS reduced the amount of the marital deduction by this amount. The estate relied on Estate of Richardson v. Comm'r, 89 T.C. 1193, 1201 (1987), and the IRS relied on Estate of Street v. Comm'r, 974 F.2d 723 (6th Cir. 1992). The Federal Circuit agreed with the Sixth Circuit, and held that Regs. § 20.2056(b)-4(a) applied directly and required that administration expenses be reflected in the marital deduction. The Federal Circuit agreed that administrative expenses accrue at death even though they may actually be paid later. Therefore, the administrative expenses must be reflected in the gross estate that exists at death. If administrative expenses are paid from the income of the estate that is earned after death, then the gross estate is larger than it would have been had the administrative expenses been paid from the principal of the gross estate.

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2. Fifth Circuit Permits Executor's Option On Whether to Create QTIP.

_Estate of Clayton, Jr. v. Comm'r_, 976 F.2d 1486 (5th Cir. 11/1992), _rev'g_ 97 T.C. 327 (1991). Husband's Will created a marital trust for the wife (in which she had an absolute income interest), and a nonmarital trust for the benefit of the wife and their children. Husband's Will said that the executors (including the wife, who was a co-executor), could by timely election, treat any portion of the residue as qualifying for the estate tax marital deduction under the QTIP rules, and that the portion not thus deducted would be added to the nonmarital trust. The IRS said that none of the marital trust was deductible because of the executor's power to deny the widow her income interest through an election. The Tax Court agreed with the IRS, but the Fifth Circuit disagreed and held for the taxpayer. The Court reviewed the history of the marital deduction and examined the wording of Code § 2056(b)(7). The Court disagreed with the Tax Court over the "property" to which the election applied. The Tax Court had viewed the executor as making a partial election with respect to the entire residuary estate, and disallowed the marital deduction because part of the property over which the election was made would pass to someone other than the surviving spouse. The Fifth Circuit said that the executor's election only related to choosing a fractional share of the residue. The Court said that the law refers to the terms of the property that "the executor elected to treat as Qualifying Terminable Interest Property." § 2056(b)(7) (B)(i)(II). (The same language is contained in Prop. Regs. § 20.2056(b) -7(b)(3)). Thus,
the focus is on the terms of the QTIP after the election, not before.


_Estate of Street v. Comm'r_, 974 F.2d 723 (6th Cir. 9/1992), _aff'g in part and rev'g in part_ 56 T.C.M. 774 (1989). A decedent's estate left $10,000 to his estate and the balance to a marital deduction trust. The estate claimed interest and administration expenses as deductions on the estate's fiduciary income tax return, but did not use these items to reduce the estate tax marital deduction. The estate contended that these items were payable from estate income, rather than principal, and therefore did not reduce the marital deduction. State law (the original Uniform Principal and Income Act) did not state which expenses should be paid from income and which from principal. The Sixth Circuit held that interest paid by the estate from income did not reduce the marital deduction, but that administration expenses so paid did reduce the marital deduction. The Court said that the interest payments accrued only after death, and thus could be paid from income without reducing the marital deduction under Regs. § 20.2056 (b)-4(a). See _Estate of Richardson v. Comm'r_, 89 T.C. 1193 (1987). The Court said that administration expenses, however, accrue effective to the date of death, and thus must reduce the marital deduction whether paid from income or principal.
I. Estate Tax Procedures.

1. Beneficiaries of Life Insurance Policies Liable for Unpaid Estate Taxes and Interest, Even Though It Exceeds Proceeds Received.

*Baptiste, Jr. v. Comm'r*, 100 T.C. No. 16 (3/1993). The proceeds of a life insurance on decedent's life were included in decedent's gross estate for federal estate tax purposes. The beneficiaries were personally liable for the taxes as transferees. The total of tax due plus interest exceeded the proceeds received. The Tax Court agreed with the IRS that the beneficiaries were still liable for the tax, despite Code § 6324(a)(2), which limits transferee liability for unpaid estate tax and interest accrued thereon that is owed by a transferor. The Court held that the limitation does not apply to transferee liability for interest accrued on unpaid estate tax owed by a transferee. Instead the statute imposes a direct, personal and primary obligation on the transferee.

2. Revenue Procedure Permits Relief on Three Estate Tax Elections.

*Rev. Proc. 92-85, 1992-42 I.R.B.,* p. 32 (10/1992). Relief is provided to taxpayers who reasonably and in good faith fail to make certain timely elections, if relief does not put the taxpayers in a better position than they would have been in had they made a timely election. The procedure provides for an automatic 12-month extension for the election to value qualified real estate under Code § 2032A(d)(1), the election to treat a qualified payment right as not being qualified under §
2701(c)(3)(c), and the election to treat any distribution as a qualified payment.

III. GIFT TAXES.


Noncharitable Gifts by Check Can Be Completed Transfers in Year That Check is Given to Donee, Even Though Check Not Cashed Until Following Year.

_Estate of Metzger v. Comm'r, 100 T.C. No. 14 (3/1993)._ Decedent's power of attorney authorized his son to make gifts from decedent's assets to decedent's heirs and their spouses. Decedent's son wrote annual exclusion checks to himself and his wife on decedent's checking account. The checks were written on December 14 and deposited on December 31, but they were not presented and accepted by the drawee bank until the following year. The IRS contended that the gifts were completed only in the year in which they were honored by the drawee bank, but the Tax Court disagreed. The Tax Court agreed that Maryland law treated a check as a completed transfer only when the drawee bank accepted it, but also held that the relation-back doctrine treats a gift by check as a completed gift in the year in which the check is drawn, if (a) the donor's intent can be clearly established, (b) delivery is completed unconditionally, and (c) the check is presented in the same year in which it is written.

Note. This should also apply in the estate tax context, and should be distinguished from situations in which the checks are not deposited or cashed until after death, or in which
circumstances suggest an understanding or arrangement to withhold cashing the checks until after death.

B. Code § 2511. Taxable Gifts.

IRS Continues to Equate Lack of Assertiveness with Gift-Giving.

Ltr. Rul. 9301001. An individual created a corporation with both voting common and voting preferred stock. He gave his children the common stock and retained the preferred stock that was to pay a $3 noncumulative dividend on each share. The market return on preferred stock of new publicly-held corporations when he created the corporation was 11.55%, but the yield on taxpayer's shares was set at .0038%. His voting control permitted him to compel liquidation and receive $2,500,000, increase the dividend rate on the preferred shares, or convert the preferred shares into common stock. The IRS ruled that he was making continuing gifts to his children (the holders of common stock) when he acquiesced to the corporation's not paying higher dividends.


O'Reilly v. Comm'r, 973 F.2d 1403 (8th Cir. 9/1992), rev'g and rem'g 95 T.C. 646 (1990). In 1985, an individual created a grantor retained income trust (GRIT), and assigned to it stock of several closely-held corporations. The trustee was given the power to invest and reinvest the trust assets. Historically, the
corporations had paid a dividend of under 1%, but the taxpayer valued the income interest in the GRIT according to the actuarial tables in the regulations, which, at that time, assumed a 10% rate of return. The IRS contended that the retained income interest had no ascertainable value and, therefore, under Regs. § 25.2512-1, said that the gift was 100% of the stock's fair market value. The Eighth Circuit reversed the Tax Court and held that the 10% tables could not be used when the real return on the investment was clearly far less than 10%. The Court also rejected the IRS zero-value analysis, saying that there was a dividend history and that the stock must be valued according to the actual dividend history.

2. Actuarial Tables Inapplicable When Wasting Asset Will Expire Before Trust's Income Interest.

Froh v. Comm’r, 100 T.C. No. 1 (1/1993). An individual assigned $1,500,000 worth of gas leases to three "Clifford" trusts, requiring that the net income be paid to his children for ten years and one month, with a reversion in him or his estate. The trustee was directed to create a depletion reserve to which 15% of the income would be credited. The grantor valued the income interests by allocating 85% of the $1,500,000 to the income interests and then applying the discounts for a ten-year trust under then-applicable Regs. § 25.2512-5(f). The Tax Court agreed with the IRS that the tables could not be applied to the trust income interest when the asset would expire before the ten-year term of the trust. The Court said that while the use of actuarial tables is presumptively correct, it is a rebuttable presumption and the
facts of this case showed that the tables should not apply. Therefore, the value of the gift was 85% of the $1,500,000.

3. IRS Concedes Minority Discount Despite Family Control.

Rev. Rul. 93-12, 1993-7 I.R.B., p. 13 (1/1993). The IRS has finally bowed to the weight of judicial authority and has ruled that, where a donor gives 20% of the stock of a closely-held corporation to each of the donor's five children, the factor of corporate control in the family should not be considered in valuing the stock for gift tax purposes. Thus, a minority discount is allowed despite the fact that the transferred interest, when aggregated with interests held by family members, is part of a controlling interest.

IV. SPECIAL VALUATION RULES

A. Use of Adjacent Guest House Does Not Prejudice QPRT.

Ltr. Rul. 9328040. An individual proposed to create a QPRT to hold a 1.65 acre parcel of land that includes a large main house and a small adjacent ranch house. The primary property is used as a vacation house for himself. The ranch house has a value of less than 4% of the total value of the property. He occasionally permits family members to use the guest house without rent. The IRS ruled that the trust remained a QPRT, and that the incidental rent-free use of the guest house by family members did not mean that the property was used as a residence under Regs. § 25.2702-5(c)(2)(iii).
B. Favorably Reviewed QPRT Also Taxed as Grantor Trust.

Ltr. Rul. 9315010. An individual transferred her community property interest in a residence to a 20-year QPRT that required payment of all income to her during the trust's term. The trust provided that she had to agree to pay all expenses relating to the maintenance of the residence. The IRS ruled that the trust was a wholly-owned grantor trust because of the right to receive income and a power of appointment held by a special trustee who was a subservient, related or subordinate party. Neither the trust provisions requiring her to pay maintenance costs nor the proposed sale of a 1/5 remainder interest in the residence trust adversely affected the trust's status as a QPRT. Because the grantor retained no powers over the disposition of the income or principal of the residence trust, upon execution of the trust, the grantor made a completed gift of 4/5 of the remainder interest to four trusts established for the benefit of her children.

C. Private Annuity Bought From Trust is a Qualified Interest Under Code § 2702.

Ltr. Rul. 9253031. An individual transferred $5,000,000 in marketable securities to a $19,000,000 trust created in 1933 by his father. The trust will pay him an unsecured annuity valued in accordance with the tables under Code § 7520. The agreement will require that he make no other contributions to the trust during his lifetime and will preclude prepayment of the annuity. The IRS ruled that the private annuity arrangement is a qualified interest under Regs. § 25.2702-3(b) and 25.2702-3(d).
D. GRAT Qualified Under Code § 2702; As Grantor Trust It May Hold S Corporation Stock; IRS Declines to Value Annuity.

Ltr. Rul. 9248016. An individual created a trust to pay a fixed quarterly annuity (or, if greater, all of the trust income), for 15 years or until his death, whichever first occurs. Neither he nor his spouse may serve as trustee, and the remainder beneficiaries are his children and their descendants. He retained the nonfiduciary power to reacquire the trust assets by substituting assets of equivalent value. The IRS ruled that this was a qualified GRAT, and that the nonfiduciary power to reacquire assets made the trust an eligible S corporation stockholder. Code § 675(4). The IRS valued the right to the annuity ignoring the right to excess income. It also noted that, because of the size of the annuity and the trustee's power to invest in speculative assets (such as the S corporation stock), the entire trust fund might be exhausted before the expiration of the 15-year term. Therefore, the IRS refused to express an opinion regarding the use of the entire 15-year term in valuing the annuity interest. Citing Rev. Rul. 77-454, 1977-2 C.B. 351.

V. A CRYSTAL BALL

The following items may be considered in future tax legislation during this Congress.
A. A change in § 2035(d) to clarify when gifts made within three years of death from a revocable trust are included in the donor's gross estate.

B. A clarification to § 2207A regarding inadvertent waivers of the right to recovery for estate taxes attributable to qualified interest property.

C. A repeal of the "throwback rule" under §§ 665 and 666.

D. Provisions to conform the income tax treatment of revocable trusts (after the death of the grantor) to the manner estates are treated for income tax purposes.