ULLMAN YEAR IN REVIEW
ESTATE PLANNING UPDATE

2013-2014 ORGANIZATIONAL MEETING
THE FLORIDA BAR TAX SECTION

AMELIA ISLAND, FLORIDA
JULY 4-7, 2013

NATHAN R. BROWN
PROSKAUER ROSE LLP
2255 GLADES ROAD SUITE 421 ATRIUM
BOCA RATON, FLORIDA 33431
WWW.PROSKAUER.COM
P. 561.995.4729
NBROWN@PROSKAUER.COM

I. FISCAL CLIFF RETROSPECT – WHERE WE ARE FOR 2013

American Taxpayer Relief Act of 2012[1]

A. Overview of the American Taxpayer Relief Act of 2012.

1. At 2:07 a.m. on January 1, 2013, the Senate passed the American Taxpayer Relief Act of 2012 (the "2012 Act") by a vote of 89 to 8.

2. After a day full of speculation and controversy regarding what the House of Representatives would do with the 2012 Act, the House approved the bill shortly before midnight on the same day by a vote of 257 to 167.

3. President Obama signed the legislation on January 2, 2013.

4. In short, the 2012 Act permanently:

   (a) extends the estate, gift and generation-skipping transfer ("GST") tax provisions from 2012;

   (b) increases the top estate, gift and GST tax rate from 35% to 40%;

   (c) extends portability (with one technical correction); and

   (d) extends most of the other Bush tax cuts.

5. A brief summary of the key estate, gift and GST provisions is below:

	2013 and After
Estate tax exemption Top estate tax rate	$5,250,000 (adjusted for inflation) 40%
Gift tax exemption Top gift tax rate	$5,250,000 (adjusted for inflation) 40%
GST tax exemption Top GST tax rate	$5,250,000 (adjusted for inflation) 40%

B. Background.

1. Had Congress not acted, on January 1, 2013, the country's tax rules would have reverted to the rules in effect prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act"), and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act").

[1] 2012 HR 8.

2. Both the 2001 and 2003 Acts included what are commonly referred to as the "Bush tax cuts," which provided for significant income, estate, gift, and GST tax reductions. These provisions were extended through December 31, 2012 by the 2010 Act, which also made some additional changes.

3. President Obama's presidential campaign proposed extending the Bush tax cuts except for individuals earning more than $200,000 ($250,000 for joint returns), and the Obama Administration had proposed a $3.5 million estate and GST tax exemption with a 45% rate.

4. Republicans had generally been opposed to any tax increases and seemed to favor a $5 million indexed exemption for estate, gift and GST taxes with a 35% rate (with some Republicans continuing to push for complete repeal of the estate tax).

5. Negotiations seemed to be on and off all through December with President Obama and House Speaker Boehner. Ultimately, Vice President Biden and Senate Minority Leader McConnell reached an agreement with the 2012 Act, which was passed first by the Senate and then the House on January 1, 2013. Based on legislative procedure, all bills raising revenue are required to originate in the House. As a result, although the text of the 2012 Act originated in the Senate, it could not be introduced as a Senate bill, but instead had to be introduced as an "amendment" to an earlier House bill.

6. The remainder of this section highlights the key provisions of the 2012 Act.

C. Sunset Provisions.

1. Section 101(a) of the 2012 Act eliminates the sunset provisions of the 2001 Act and the 2010 Act.

   (a) The 2001 Act provided for significant changes to estate, gift and GST tax laws, but provided that all such changes would not apply "to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010" and thereafter the Internal Revenue Code[2] would apply as if the provisions and amendments of the 2001 Act "had never been enacted."

   (b) The 2010 Act amended the sunset provision in the 2001 Act so that the sunset date would be December 31, 2012.

2. By eliminating the sunset provisions, all the estate, gift and GST tax provisions of the 2001 Act and the 2003 Act have become permanent, which has not been the case for the past 12 years.

[2] Unless otherwise stated, section references shall be to the Internal Revenue Code of 1986, as amended (hereinafter, "Code").

D. Estate Tax.

1. Exemption.

(a) By way of background, the estate tax exemption rose to $5,120,000 in 2012 and was scheduled to revert to $1,000,000 on January 1, 2013.

(b) Section 101(c) of the 2012 Act permanently increases the exemption to $5,000,000, *subject to inflation*, which equates to $5,250,000 for 2013.

(i) Because the exemption amount is indexed for inflation, even clients who used their entire exemption in 2012 can expect to acquire additional exemption with each passing year.

(ii) Furthermore, it almost goes without saying that the permanent indexing will be significant. Typically, planners often plan around getting appreciation out of a client's estate. However, with indexing, the exemption amount will, presumably, grow at the same rate as the client's estate.

2. Rate.

(a) Section 101(c) of the 2012 Act also increases the effective estate, gift and GST tax rate from 35% to 40%.

(b) This is done by having a 37% bracket for amounts from $500,000-$750,000, a 39% bracket for amounts from $750,000-$1,000,000, and a 40% bracket for amounts over $1,000,000. Since the 37% and 39% brackets apply to transfers that are below the $5,000,000 exemption level, if a tax is imposed, it will be at 40%.

(c) State estate taxes continue to be deductible in calculating federal taxable estates.

3. Based on the current tax rate table, the Applicable Credit Amount is currently $2,045,800.

4. Portability.

(a) The 2012 Act makes portability permanent.

(b) In addition, Section 101(c)(2) also provides for a technical correction to the portability rules with respect to computation of the Deceased Spouse's Unused Exclusion ("DSUE") Amount.

(i) This was done by modifying § 2010(c)(4)(B) of the Code to strike the term "*basic exclusion amount*" and replacing it with the term "*applicable exclusion amount.*" This difference is important because an individual's "applicable exclusion amount" includes his/her basic exclusion amount <u>PLUS</u> any DSUE Amount he or she may have.

(ii) Section 2010(c)(4), in defining the "deceased spousal unused exclusion amount," originally provided as follows:

> "(4) <u>Deceased spousal unused exclusion amount</u>. For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of— (A) the basic exclusion amount, or (B) the excess of—(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."

(iii) Soon after the passage of the 2010 Act, the Staff of the Joint Committee on Taxation ("JCT") issued its Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 Scheduled for Consideration by the United States Senate on December 10, 2010 (i.e., 7 days before TRA 2010 was signed) (JCX-55-10), and provided in the portability discussion three specific examples of the working of portability.

(iv) The third such example, referred to as "Example 3," provided as follows:

> "Example 3. − [Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts.] [Wife subsequently marries Husband 2.] ... Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exemption amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exemption amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exemption amount of Wife."

(v) Note that to arrive at the conclusion in Example 3, the DSUE Amount calculation utilized Wife's applicable exclusion amount, whereas

§ 2010(c)(4)(B)(i) stated that the Wife's basic exclusion amount must be used.

(vi) Soon after enactment, in March 2011, the JCT issued an errata statement (the "Errata"), stating the following:

> "The provision adds new § 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under § 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in § 2010(c)(2), as amended by the provision."

(vii) The Service also adopted this position by issuing Treas. Reg. § 20.2010-2T(c), which stated that the term "basic exclusion amount" as used in § 2010(c)(4)(B)(i) should be interpreted to mean the "applicable exclusion amount."

(c) The technical correction included in the 2012 Act is the same as the correction discussed in the Errata statement and adopted by the Service.

(d) The correction applies as if it were included in the 2010 Act.

(e) <u>Practical Point</u>.

Now that portability has been made permanent, practitioners may want to re-evaluate standard credit shelter or bypass trust planning.

5. <u>Other Significant Provisions Made Permanent</u>.

(a) Elimination of the qualified family-owned business interest deduction.

(b) Expanded availability of the qualified conservation easement rules.

E. <u>Gift Tax</u>.

1. Exemption - Same as estate tax.

2. Rate - Same as estate tax.

3. Note: As a result of the exemption being indexed for inflation, clients can expect to acquire additional exemption each year. For example, clients who used up

their entire $5,120,000 exemption making gifts in 2012 have an additional $130,000 of exemption that they can use in 2013.

F. GST Tax.

1. Exemption - Same as estate tax

2. Rate - Same as estate tax.

3. Deemed Allocations - The rules in the 2001 Act which provide for deemed allocation of GST exemption to certain lifetime trust transfers will continue.

4. Qualified Severances – The ability to divide mixed inclusion ratio trusts by means of a qualified severance will continue.

5. Relief from Late Elections – The provisions in the 2001 Act providing relief from late GST allocations and allowing extensions of time if certain conditions are met will continue.

G. Income Tax.

1. The 2012 Act also extends the income tax provisions of the 2001 Act, with certain changes. The highlights of these provisions are as follows:

2. Top Rate - The most notable change is that the top income tax bracket has been increased from 35% to 39.6% for taxable income in excess of $400,000 for unmarried individuals and $450,000 for married individuals filing joint returns. The 39.6% rate applies to trusts and estates with income in excess of $11,950.

   (a) Note that in addition to the increased rate, a new 3.8% "Medicare" tax applies to net investment income if the adjusted gross income exceeds $200,000 (individual)/$250,000 (married filing jointly), which results in a 43.4% top federal rate.

   (b) For trusts and estates, the 3.8% tax applies to undistributed net investment income in excess of the income level at which the highest trust and estate rate applies (which is $11,950 for 2013).

   (c) The combination of the increased ordinary income tax rate and the new 3.8% Medicare tax will have an impact of trust administration planning.

3. Capital Gains – The rates on qualified dividends and long-term capital gains are adjusted by adding a 15% bracket for taxpayers with taxable income below $400,000/$450,000 and a 20% bracket for taxpayers with taxable income above $400,000/$450,000.

4. Phase Out of Personal Exemptions and Itemized Deductions – The phase out has been reinstated for individuals with adjusted gross income in excess of $250,000/$300,000.

5. Alternative Minimum Tax – Revised exemption amounts have been indexed for inflation.

6. Deduction of State and Local General Sales Tax – Has been extended through 2013.

7. Tax-Free Distributions from Retirement Plans to Charities – Has been extended through 2013.

8. Roth Rollovers – The 2012 Act allows a direct rollover from a traditional 401(k) plan to a Roth 401(k) without any need for distribution.

9. The following is a chart highlighting some of these provisions:

	2012	**2013 and Future Years**
Top Ordinary Income Tax Rate	35%	39.6%
Short-Term Capital Gains Rate	35%	39.6%
	2012	**2013 and Future Years**
Medicare Surtax on Net Investment Income	0%	3.8%
Long-Term Capital Gains Rate and Qualified Dividend Rate for taxpayers with taxable income below $400,000 (individual)/$450,000 (married filing jointly)	15%	15%
Long-Term Capital Gains Rate and Qualified Dividend Rate for taxpayers with taxable income above $400,000/$450,000	15%	20%

II. INFLATION ADJUSTMENTS FOR 2013

Rev. Proc. 2012-41[3]

A. As announced in IR-2012-78 (October 12, 2012), the Service set out inflation-adjusted items for 2013.

B. Section 2032A – for purposes of the Special Use Valuation Method, the aggregate decrease in value of qualified real property resulting from a § 2032A election increases from $1,040,000 to $1,070,000

[3] 2012-78 IRB, October 18, 2012.

C. Section 2503 –

1. Annual exclusion for gifts increased from $13,000 to $14,000.

2. Annual exclusion for gifts to non-citizen spouses increased from $139,000 to $143,000.

D. Section 6309F – Recipients of gifts from foreign persons must report the gifts if such gifts exceed $15,102.

III. OBAMA ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS

2014 Greenbook

A. Summary.

1. Among other items that have appeared in past years, new items in President Obama's fiscal year 2014 budget include two major proposals:

(a) A proposal to return estate tax rates to 2009 levels in 2018, whereby the estate, gift and generation-skipping transfer tax rates would be 45%, the estate tax and GST tax exemptions would be $3.5 million, and the gift tax exemption would be $1 million, with *no* indexing for inflation; and

(b) Clarifying the generation-skipping transfer tax treatment of health and education exclusion trusts.

2. Notable items recurring from the administration's 2013 budget include the proposal to coordinate the income and transfer tax rules applicable to grantor trusts and the 10 year minimum GRAT term proposal.

B. New Proposals in 2014.

1. Restore 2009 Law.

(a) Stating that the American Taxpayer Relief Act of 2012 provided a tax cut to the most affluent taxpayers that "we cannot afford," the President's budget would, starting in 2018:

(i) Make permanent the estate, GST and gift tax parameters as they applied in 2009 - $3,500,000 estate and GST tax exemption and $1,000,000 gift tax exemption;

(ii) There would be no indexing for inflation;

(iii) No recapture would apply for prior gifts excluded from the tax at the time of transfer; and

(iv) Portability between spouses would continue to be allowed.

(b) Comments:

(i) The 2018 effective date for this proposal is interesting. Some commentators suggest this may have been done to give Congress time to react after making the laws permanent in 2013 and to show President Obama's displeasure with the deal he made.

2. Clarify GST Tax Treatment of Health and Education Exclusion Trusts.

(a) The proposal would clarify that the exclusion from the definition of a GST under § 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for the same purposes.

(b) This proposal would apply to trusts created after introduction of the bill proposing this change and to transfers after that date made to pre-existing trusts.

(c) Comments:

(i) The effective date being the date of introduction (rather than the standard date of enactment) and application to existing trusts are significant here.

(ii) This means that all the trusts that have already been set up can potentially be subject to the rule, even though such law did not exist when they were created.

C. Recurring Proposals From 2013.

1. Requirement for Consistency in Value for Transfer and Income Tax Purposes. This proposal would require the basis of property for income tax purposes to be the same as the basis of the property for estate/gift tax purposes.

2. GRAT Proposals. The proposal would add the following GRAT requirements: (a) a minimum term for a GRAT of 10 years, (b) a maximum term of the life expectancy of the annuitant plus 10 years, (c) the remainder interest must have a value greater than zero (however, the proposal states that this would not prevent zeroing-out the GRAT), and (d) prohibit any decrease in the annuity during the GRAT term.

3. Limit Duration of GST Tax Exemption to 90 Years. Under this proposal, on the 90th anniversary of the creation of the trust, the GST exclusion allocated to the trust would terminate. This would be accomplished by increasing the inclusion ratio of the trust to 1. GST exemption would have to be reallocated to keep the trust GST exempt.

4. Extend the Lien on Estate Tax Deferrals Provided under § 6166. This proposal would extend the lien on estate tax deferral provided under § 6166 to 14 years from the due date of the 706, rather than being limited to 10 years after the date of death.

5. Coordinate Income and Transfer Tax Rules Applicable to Grantor Trusts. Under this proposal, if a person who is a deemed owner of all or a portion of a trust under the grantor trust rules (this would cover a person other than the grantor under § 678(a)) engages is a transaction with the trust that constitutes a sale, exchange or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, the assets that are sold to the trust, plus any appreciation and accumulated income thereon, will be: (a) included in the deemed owner's gross estate; (b) subject to gift tax upon termination of grantor trust status with respect to the deemed owners; and (c) subject to gift tax upon distribution.

   This is a much more targeted proposal than that included in the 2013 Greenbook, and, by its terms, would have applied to all grantor trusts, with certain exceptions.

   The 2013 proposal provided generally, that if a trust is a grantor trusts and is created after or funded after the date of enactment all of the assets of such trust would be included in the grantor's gross estate. Whereas, the 2014 proposal targets only sales to grantor trusts.

   This treatment would not apply to any trust that is already includable in the deemed owner's gross estate, such as GRITs, GRATs and QPRTs. It also would not apply to any trust that is a grantor trust solely by reason of § 677(a)(3) – Saves life insurance trusts that do no contain any other provision that makes it a grantor trust (most practitioners will not rely solely on § 677(a)(3) to achieve grantor trust status for a life insurance trust).

   Huge Implications – Would presumably apply to the exercise of substitution powers, transfers of life insurance policies, complicate leveraging GST exemption.

D. Noticeably Absent From the Proposal.

1. Section 2704 Regulations. Noticeably absent from the 2014 budget proposal is the perennial proposal to add additional categories of applicable restrictions that would be disregarded in valuing transferred assets in family-controlled entities under § 2704.

2. So What Does This Mean? Either the Service has given up on further restrictions all together, or, the IRS has given up on further legislation and proposed regulations are on their way. The more likely scenario is that the Service is close to issuing regulations.

IV. 3.8% MEDICARE TAX

A. Summary.

1. Section 1411 of the Code imposes a 3.8% tax on the net investment income of individuals, trusts and estates with income in excess of specified threshold amounts for taxable years beginning after December 31, 2012. Generally, the 3.8% tax applies to the net investment income of individuals with AGI in excess of $200,000/$250,000 and the undistributed net investment income of trusts and estates with AGI in excess of $11,950.

B. Individuals.

1. Section 1411(a)(1) provides that, with respect to individuals, the tax is equal to 3.8% of the lesser of:

   (a) The individual's net investment income for such year, and

   (b) The excess, if any, of (i) the individual's modified AGI for such tax year, over (ii) the threshold amount applicable to the taxpayer.

2. The threshold amount for an individual is equal to $200,000 or $250,000 for a married couple filing a joint return.

C. Trusts and Estates.

1. Section 1411(a)(2) provides that, with respect to a trust or an estate, the tax is equal to 3.8% of the lesser of:

   (a) The trust's or estate's *undistributed* net investment income, and

   (b) The excess, if any, of (i) the trust's or estate's AGI (as defined in § 67(e) of the Code) for such tax year, over (ii) $11,950 (the dollar amount at which the highest tax bracket in § 1(e) of the Code begins).

D. Net Investment Income.

1. Net investment income generally includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, and passive activities. Virtually all income of a trust or an estate will be net investment income.

2. Accordingly, all estates and trusts with income in excess of $11,950 that have undistributed net investment income for a tax year, will be subject to the 3.8% tax. This is on top of the new 39.6% top income tax rate that will apply to such trusts or estates, resulting in a combined rate of 43.4%!!!

E. Effect on Trust Administration.

1. Because the 3.8% tax applies only to the *undistributed* net investment income of a trust, it may be possible to reduce the overall tax by distributing out the net investment income to the trust beneficiaries.

2. Trusts with undistributed net investment income and taxable income and AGI in excess of $11,950 will be subject to a combined tax rate of 43.4% (39.6% income tax and 3.8% Medicare tax). However, individuals are not subject to this combined 43.4% rate until they have taxable income in excess of $400,000/$450,000 and AGI in excess of $200,000/$250,000. Accordingly, if the terms of the trust permit, significant tax saving may be had by strategically distributing the net investment income of the trust out to the beneficiaries.

F. November 30 Fiscal Year Elections.

1. Because the 3.8% Medicare tax applies only to taxable years beginning after December 31, 2012, personal representatives should consider making a November 30 fiscal year election for the estates of decedent's dying in 2012.

2. This would prevent any undistributed net investment income of the estate through November 30, 2013 from being subject to the 3.8% Medicare tax.

V. CASES AND RULINGS

Private Letter Ruling 201235006 (September 5, 2012)

A. Summary.

1. The proceeds of a life insurance policy would not be includible in an insured decedent's gross estate because the insured did not possess incidents of ownership in the policy under § 2042(2).

2. The insured's power to substitute assets with respect to a trust that later acquired said insurance policy also did not render the proceeds includible in the insured's gross estate under §§ 2033, 2036 or 2038.

B. Facts.

1. The insured was the beneficiary of Trust A and the grantor of Trust B, of which his daughter and her descendants were the beneficiaries.

2. Trust A owned a life insurance policy insuring the life of the insured.

3. The trustee of Trust A intended to sell the life insurance policy to Trust B, which would be funded with sufficient assets to buy the policy for the value as set forth in Treas. Reg. § 25.2512-6(a).

4. Article XIX of Trust B provided that the insured had the power, exercisable at any time and from time to time in a nonfiduciary capacity (within the meaning of § 675(4)), without the approval or consent of any person in a fiduciary capacity within the meaning of § 675(4), to acquire or reacquire any asset or assets forming part of the trust estate by substituting other property of an equivalent value.

5. If this power was to be exercised, the insured, as Trustee, had a fiduciary obligation to ensure the compliance with the terms of this power by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Rev. Rul. 2008-22.

6. This power could not be exercised in a manner that could shift benefits among the trust beneficiaries.

7. The trustee of Trust A proposed that it would obtain from the issuing insurance company the interpolated terminal reserve value for the policy as of the date of sale and use that amount, plus the proportionate amount of premium last paid before the sale that covers the premium extending beyond the date of sale as the purchase price.

8. The insured would thereafter fund Trust B with the amount necessary to purchase the policy.

9. Upon acquisition, the trustee of Trust B (the daughter) would be designated as the beneficiary of the policy.

C. <u>Analysis</u>.

1. 6 Different Rulings were sought in this request; only Requests #5 and 6 will be discussed in this outline as those are the only requests pertaining to the estate and gift tax; the other four concern either the grantor trust rules (and, specifically, the provisions of § 675(4) and § 678(a)) and transfer for value rules.

2. Request #5 – the power to reacquire the corpus of Trust B by substituting other property of an equivalent value will not result in the insured possessing incidents of ownership in the policy under § 2042(2).

3. Under Treas. Reg. § 20.2042-1(c)(2), the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense.

    (a) Treas. Reg. § 20.2042-1(c)(2) provides that the term has reference to the right of the insured or the insured's estate to the economic benefits of the policy.

    (b) It further provides that the term includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

4. Rev. Rul. 2011-28[4]

   (a) The Service cited Rev. Rul. 2011-28 in its analysis, which was the first ruling to affirm that the "substitution power" under § 675(4)(C) did not cause gross estate inclusion as "incidents of ownership" under § 2042.

   (b) Determining that the facts in the current request were very similar to those in Rev. Rul. 2011-28, the Service concluded that the insured's power to reacquire the corpus of Trust B by substituting other property of an equivalent value in a nonfiduciary capacity did not result in the insured possessing incidents of ownership in the policy under § 2042(2).

5. Request #6 - no portion of the principal of Trust B will be included in the insured's gross estate under §§ 2033, 2036, and 2038.

6. Rev. Rul. 95-58[5]

   (a) In the first part of its analysis on Request #6, the Service cited Rev. Rul. 95-58, which modified Rev. Rul. 77-182[6]. Rev. Rul. 77-182 previously concluded that a decedent's power to appoint a corporate trustee only in the event of the resignation or removal by judicial process of the original trustee did not amount to a power to remove the original trustee that would have endowed the decedent with the trustee's discretionary control over the trust income.

   (b) Rev. Rul. 95-58 held that if the decedent possesses the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent has not retained the trustee's discretionary control over the trust income for purposes of §§ 2036 and 2038.

7. Rev. Rul. 2008-22[7]

   (a) The second part of the analysis focused on Rev. Rul. 2008-22, which considered whether corpus of a trust was includible in the grantor's gross estate under §§ 2036 or 2038 if the grantor retained the power, exercisable in

[4] 2011-48 C.B. 830.

[5] 1995-2 C.B. 191.

[6] 1977-1 C.B. 273.

[7] 2008-16 C.B. 796

a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value.

(b) The facts in Rev. Rul. 2008-22 were similar to the facts in Rev. Rul. 2011-28, except that Rev. Rul. 2011-28 involved corpus consisting of a life insurance policy.

(c) The Service cited Restatement (Third) of Trusts § 79 for the general rule that in situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted.

(d) Further, as in Rev. Rul. 2011-28, under the terms of the trust, the assets that the grantor transfers into the trust must be equivalent in value to the assets that the grantor receives in exchange, and the trustee has the fiduciary obligation to ensure that the assets exchanged are of equivalent value.

(e) Accordingly, the Service stated that the grantor cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase the grantor's net worth.

(f) Further, in view of the trustee's ability to reinvest the assets and the trustees duty of impartiality regarding the trust beneficiaries, the Service reasoned that the trustee must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by the grantor.

8. The Service concluded that the circumstances in this case mirrored the circumstances in Rev. Rul. 2008-22, and, therefore, based upon the facts provided and the representations made, the corpus of Trust B was not includible in the insured gross estate under §§ 2033, 2036, and 2038.

D. <u>Bottom Line</u>.

1. This ruling combined the principles set forth in Rev. Rul. 95-38, 2008-22 and 2011-28 in holding that the substitution power, when combined with the acquisition power in a subsequent trust, did not result in any adverse estate tax consequences.

2. While extremely detailed, this Private Letter Ruling clarifies the principles that most practitioners assumed were present after the preceding rulings were issued.

Keller v. United States, 697 F.3d 238 (5th Cir. 2012)

A. Summary.

1. The 5th Circuit Court of Appeals rejected the Service's arguments on appeal in this family limited partnership case, holding (i) that a decedent's intent to transfer assets to an FLP upon formation of the FLP was sufficient under Texas law to transfer such assets before her death, and (ii) that the retroactive restructuring of a transfer of assets into a loan was a necessarily incurred administrative expense which justified 9 years of interest payments on the loan being deductible.

B. Facts.

1. After the death of her husband, the decedent began consulting with her advisors regarding the creation of a family limited partnership. The decedent's accountants organized a spreadsheet listing specific assets to be transferred to the FLP, which the decedent reviewed. The accountants then created a flowchart and a series of notes indicating how various accounts would fund the FLP with assets amounting to $250 million.

2. Several months later, the decedent's attorney carefully went over the details of the partnership and LLC documents with the decedent in her hospital room. She signed the agreements multiple times, as required, and the attorney notarized her signatures. Schedule A of the partnership agreement, listing the Capital Contributions of the Members, was left blank, because the attorney "did not have firm market values" on hand.

3. While several extrinsic sources corroborated that the decedent intended to contribute certain specific assets as her initial capital contribution, she died prior to the funding of the FLP.

4. After the decedent died, her advisers initially believed they failed to fully create and fund the FLP before her death and paid over $147 million in estate taxes.

5. However, after attending a CLE seminar that analyzed the Church[8] case, the decedent's attorney reconsidered this position after learning that under Texas law a partnership could be funded based on the intent of the decedent prior to death. As a result, the decedent's advisors resumed activity with the FLP, including formally transferring assets to the FLP.

6. The decedent's advisors also then realized that having successfully established and funded the FLP meant that the decedent's estate lacked liquid assets to issue a $147 million tax payment. Consequently, the estate's advisors retroactively restructured this transaction as a $114 million loan from the FLP, and the estate issued a promissory note to the FLP at the applicable federal interest rate in effect.

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[8] 85 AFTR 2d 2000-804 (W.D. Tex.2000), aff'd without opinion, 268 F.3d 1063 (5th Cir. 2001).

7. The estate filed a claim for refund with the Service on two grounds: (i) the estate's initial assessment of the decedent's assets failed to discount appropriately the value of the FLP interest, and (ii) the estate accrued interest on its loan from the FLP to pay estate taxes, entitled the estate to a deduction.

8. The district court upheld the estate's position and valued the estate's limited partnership interest at a 47.5% discount. In addition, the court concluded that 9 years of interest payments on the loan were deductible as necessary expenses of the estate.

C. Analysis.

1. The 5th Circuit Court of Appeals evaluated two legal issues in the case –

   (a) Whether under Texas law the partnership was created before the decedent's death because of the decedent's intent to fund the FLP, and

   (b) Whether the interest on the retroactive loans could be deducted.

2. Valuation of the Estate.

   (a) The 5th Circuit was not convinced by any of the Service's challenges to Texas's overarching rule that intent determines property ownership.

   (b) As a result, the Court held that the decedent transferred the intended assets to the FLP prior to her death, and the district court correctly applied the relevant discount reflecting the encumbrance on the partnership interests.

3. Deductibility of the Retroactively Structured Loan.

   (a) The Court also affirmed the district court holding that the interest on the retroactive loan should be deductible, dismissing the Service's argument that the loan could have been retroactively characterized as a partnership distribution instead of a loan.

   (b) Unlike the estate in Estate of Black[9], the decedent's estate did not need to redeem FLP units in order to satisfy the loan because the estate had $110 million in illiquid ranch and mineral holdings outside of the FLP from which the loan could be repaid.

   (c) As a result, the Court said that it refused to collapse the estate into the FLP to functionally the same entity because they shared substantial common control, and therefore the district court's holding permitting a deduction for the interest was correct.

[9] 133 T.C. 340 (2009).

Estate of Bates v. Commissioner, T.C. Memo. 2012-314 (November 7, 2012)

A. Summary.

1. The Tax Court, in a Memorandum decision, determined that a settlement payment with respect to estate litigation does not qualify as an administrative expense under § 2053.

B. Facts.

1. Sylvia Bates executed a will in 1998, naming one of her grandchildren as the executor. The will left her estate to three grandchildren with several other bequests, one of which was a $100,000 bequest to Reggie Lopez, a care custodian who worked for Bates after she was diagnosed with Alzheimer's disease.

2. In 2005, Mrs. Bates executed a second will, naming Lopez as the executor and testamentary trustee. This will devised Bates' estate to one of her grandsons and Lopez.

3. Following Bates' death in 2005, her grandchildren submitted the first will for probate, and Lopez submitted the second will.

4. The two grandchildren who were not beneficiaries under the second will sued Lopez alleging, among other items, elder abuse.

5. The California Superior Court, on March 2, 2005, suspended Lopez's trustee powers, appointed a temporary trustee, ordered Mr. Lopez to surrender any Family Trust property, and issued a temporary restraining order prohibiting Mr. Lopez "from taking any action whatsoever" with respect to any of Mrs. Bates's assets.

6. In December 2005 those two grandchildren settled all litigation with Mr. Lopez. The Superior Court approved a settlement agreement that invalidated the second will and decided that Mr. Lopez was entitled to receive $575,000 from the testamentary trust in full satisfaction of any claim relating to the first will or the second will.

7. Almost one year after the date that Mrs. Bates's Form 706 was due, the granddaughter who was the executor filed the 706 and included as a Schedule J deduction the amount reportedly paid to Lopez of $498,113, plus other expenses.

C. Analysis.

1. Pursuant to § 2053(a)(3), a claim against an estate is deductible if it is supported by adequate consideration and not attributable to the testator's testamentary intent.

2. The problem in this case was that the executor attempted to deduct the settlement payment and did not present any support that the amount of such settlement

payment to a beneficiary delineated in the testator's will was a deductible administration expense.

3. In what the Judge Foley described as "desperation," the estate cited the case of Pitner v. United States,[10] where an estate was allowed to deduct certain litigation costs as administration expenses; Judge Foley distinguished the Pitner opinion because it involved a challenge by individuals "with no legitimate interest in the estate whatsoever," as opposed to Mr. Lopez who was a beneficiary under both documents.

4. Judge Foley concluded that the settlement payment was not deductible because it lacked adequate consideration and it was consistent with the decedent's intent, i.e., to benefit Mr. Lopez. Further, the payment was the satisfaction of a beneficiary's (Mr. Lopez's) distributive share, not a claim against the estate.

5. In another issue, the grandchildren sought to have any late filing and payment penalties abated under § 6651(a)(2), stating that they relied on the advice of their litigator who stated that the granddaughter who eventually served as the executor had no legal standing to file the 706.

6. The problem with this argument was that the litigator was not a tax adviser and testified that he "never discussed taxes with her." As a result, regardless of what advice he gave to the executor, the executor failed to establish that any reliance on his advice relating to filing of the 706 was justified.

D. Bottom Line.

1. The executor, who had standing as a claimed executor, should have filed a partially-completed 706 and should have formally requested the Service to abate any potential penalties.

2. In addition, any one of the grandchildren could have filed a separate 706 as a "statutory executor" pursuant to § 2203.

Private Letter Ruling 201245004 (November 9, 2012)

A. Summary.

1. A disclaimer of an interest in an IRA is possible even if the disclaimant has received distributions from the IRA prior to the disclaimer.

[10] 388 F.2d 651 (5th Cir. 1967)

B. Facts.

1. Prior to decedent's death, decedent established a retirement plan trust to benefit the decedent during his life. One of the assets transferred to the trust was an individual retirement account ("IRA").

2. The beneficiary designation form for the IRA (the "Form") listed the decedent's spouse ("Spouse") as the primary beneficiary of the IRA.

3. Prior to the decedent's death, the required minimum distributions ("RMD's") from the IRA were automatically deposited into a bank account held by the trust.

4. The decedent died testate survived by his wife, Spouse, and their four children.

5. For two months after the decedent's death, the monthly IRA distributions were made and automatically deposited into the Spouse's bank account; after those payments, the monthly IRA distributions were cancelled.

6. After the two months of distributions, the total withdrawals from the IRA during the calendar year (presumably by the decedent as well as the Spouse) exceeded the RMD's for that account.

7. No other amounts had been paid from the IRA, and the Spouse made no investment decisions with respect to the IRA.

8. The trust provided that upon the decedent's death, two trusts were to be created – a Marital Trust and a Family Trust. If Spouse survived the decedent and disclaimed her interests in the IRA, the disclaimed property would pass to the Marital Trust, and in the event that Decedent did not elect to treat the Marital Trust as qualified terminable interest property, then the disclaimed property would pass to the Family Trust.

9. No QTIP election was effected for the Marital Trust.

10. Spouse was disabled, so her son, Son, as her Attorney-in-Fact, exercised his authority under the Durable Power of Attorney and disclaimed Spouse's interest in the balance of the IRA and a proportionate amount of income attributable to such balance.

11. Spouse asked for a ruling that the disclaimer by Spouse of her interest in the IRA was a qualified disclaimer under § 2518 even though prior to making the disclaimer, the Spouse received from the IRA amounts in excess of the required minimum distribution for the year of Decedent's death.

C. Analysis.

1. Pursuant to § 2518(b) of the Code, a "qualified disclaimer" for Federal estate and gift tax purposes requires the following:

   (a) the disclaimer be in writing;

   (b) the writing be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of (a) the day on which the transfer creating the interest in such person is made, or (b) the day on which such person attains age 21;

   (c) such person has not accepted the interest or any of its benefits; and

   (d) as a result of such refusal, the interest will pass without any direction on the part of the person making the disclaimer and passes either, (a) to the spouse of the decedent, or (b) to a person other than the person making the disclaimer.

2. Rev. Rul. 2005-36[11]

   (a) Under this Revenue Ruling, a beneficiary received RMD's from an IRA and then purported to disclaim the balance of the IRA.

   (b) The Service ruled that receipt of the RMD constitutes acceptance of that portion of the corpus of such account, plus the income attributable to that amount; however, the Service also ruled that if the beneficiary disclaims the remaining balance of the IRA, assuming the other requirements of § 2518 are satisfied, the beneficiary's acceptance of the RMD amounts does not preclude the beneficiary from making a qualified disclaimer with respect to the balance of the IRA.

   (c) Citing Rev. Rul. 2005-36, and because, pursuant to the terms of the Family Trust, the Spouse did not retain any right to direct the beneficial enjoyment of the retained property, the Service held this to be a qualified disclaimer.

D. Bottom Line.

1. This PLR extends the reasoning set forth in Rev. Rul. 2005-36, in that the RMD, and, pursuant to this PLR, automatic distributions, are severable from the IRA so that such distributions do not "taint" the disclaimability of the account.

2. In other words, the RMD and such distributions are not deemed to be the recipient's "acceptance and control" over the entire account.

3. For further reading on this particular topic, see:

[11] Rev. Rul. 2005-36, 2005-1 C.B. 1368.

(a) Timothy H. Guare, *"IRA Minimum Distributions—What Really Happens After The Client Dies,"* as presented by Timothy H. Guare and Elizabeth R. Glasgow on May 12, 2012 at the Fiduciary Income Tax Committee meeting during the American Bar Association's Section of Taxation 2012 May Meeting in Washington, D.C.

(b) George D. Karibjanian, *"Disclaimers and IRA's: In Certain Circumstances, Beneficiaries Can Have Their Cake and Eat It Too,"* Leimberg Information Services LISI Employee Benefits & Retirement Planning Newsletter #583 (October 4, 2011).

Estate of Nancy P. Young v. United States[12]

A. Summary.

1. A penalty for late filing was upheld against an estate that had been advised by its accountants to file its estate tax return late because the estate tax had been paid and thus there would be no penalty.

B. Facts.

1. After Nancy P. Young died in 2008, the deadline for both her estate tax return and the payment of estate taxes was May 14, 2009.

2. The estate filed for and was granted an extension, extending the filing deadline until Nov. 14, 2009 and the tax payment deadline until May 14, 2010.

3. On May 14, 2009, before the original payment deadline expired, the Estate made a partial payment of $760,000.

4. A second payment of $2.2 million was made on Aug. 31, 2009, which was after the original payment deadline but before the extended deadline.

5. As this was in the midst of the "Great Recession of 2009," property values were plummeting and the estate sought to have its' real estate holdings revalued and sold.

6. As the filing deadline was approaching, the estate had two options:

(a) File the 706 with the appraised values, then file a supplemental 706 once the properties were sold; or

(b) Not file the 706 until the properties were sold.

[12] D. Mass., No. 1:11-cv-11829-RWZ, 12/17/12.

7. Based on the fact that the estate had paid more than its eventual tax liabilities, the estate's accountants advised the estate to file a late return because they believed there would be no penalty, and filing a single 706 (rather than a 706 and then a supplemental 706) would simplify the process for audit purposes.

8. The Service assessed the estate with late filing penalties of $259,325 and interest of $20,774, which the estate then paid and sued for a refund in the District Court.

C. Analysis.

1. The estate argued it had reasonable cause for not filing on time, citing the reliance upon erroneous tax advice holding in the Boyle decision.

2. The taxpayer argued that Boyle stands for the proposition that penalties should not be imposed for the taxpayer's reasonable reliance on tax advice as to a question of law.

3. The District Court did not hold this to be a question of law – rather, the estate was aware of the filing deadline and cannot rely on advice to miss a filing deadline because it was believed that penalties would be waived.

4. Further, the issue of simplifying a process because it will help with an eventual audit is also not reasonable cause.

5. The fact is that the estate had an obligation to file a return with the best information that it had at the time and it cannot claim reasonable cause based on advice that it should wait for complete information before filing the return.

D. Bottom Line.

1. The rule of thumb should be that regardless of what information is present, file the 706 and then seek to file a Supplemental 706 when additional information is received.

Estate of Elkins v. Commissioner, 140 T.C. No.5 (March 11, 2013)

A. Summary.

1. The Tax Court held that the value of a decedent's undivided fractional interest in 64 works of art was entitled to a 10% discount from pro rata fair market value, as opposed to the 44.75% discount claimed by petitioners because of certain restrictions. After application of § 2703(a), the Tax Court determined that such restrictions should not be taken into account. In addition, the Court held that only a nominal 10% discount was applicable because, based on the testimony of one of the decedent's children, the children would seek to repurchase the fractional interests from any hypothetical buyer.

B. Facts.

1. The GRIT Art.

(a) In 1990, husband and wife each created a grantor retained income trust (GRIT) funded by each's undivided 50% interest in three pieces of notable art. The wife died during the term of her GRIT, whereby her 50% interest in the art passed to husband. The husband outlived the term of his GRIT, whereby his original 50% interest passed in equal 16.6667% shares to his three children.

(b) After the termination of the husband's GRIT, an art lease was executed which leased the children's interests to the decedent (allowing him to retain year-long possession of the works). The lease required that the Lessee not sell his interest without the joinder of all the parties to the lease. Rent payments were not made until 6 years after the lease was signed.

2. The Disclaimer Art.

(a) Under the wife's will, her 50% interest in 61 other works of art was bequeathed outright to husband. However, husband disclaimed 26.945% of those interests, which equaled the unified credit amount, so that the interests could pass tax-free to the children. As a result of the disclaimers, each child owned 8.98167% of each piece of art and the husband owned 73.055% of each piece (i.e., his original 50% plus the 23.055% he retained from wife's estate).

(b) The husband and his children entered a Cotenants Agreement relating to the disclaimer art, which included a provision that any item could only be sold with the unanimous consent of all cotenants.

3. Death of Husband.

(a) When the husband (hereinafter, the "decedent") died, his Will bequeathed his tangibles and his fractional interests in the artwork to his children, and the remainder of his estate to a private family foundation.

(b) On a timely filed estate tax return, the decedent's executors reported a Federal estate tax liability of $102,332,524 – reporting the 50% interest in the GRIT art at $2,652,000 and the 73.055% interest in the disclaimer art at $9,497,650.

(c) These values took into account a <u>44.75%</u> combined fractional interest discount for lack of control and lack of marketability). The Service challenged these discounts.

4. Expert Testimony.

(a) The Petitioners had three expert witnesses testify in defense of their proposed discounts – including a member of the IRS Art Advisory Panel, an attorney who specialized in partition actions, and a director of valuation services.

(b) The Service had two experts testify – including an appraiser who stated that "there is no established marketplace for the sale of a partial interest in a work of art."

C. Analysis.

1. Is Section 2703(a) Applicable?

(a) The Court determined that, with respect to § 2703(a)(2), the only question to be answered is whether the property to be valued for estate and gift tax purposes is subject to a restriction on sale or use (not whether there is any *intent* for such a restriction to apply).

(b) The decedent's estate conceded that § 2703(a)(2) applied to the lease agreement for the GRIT Art.

(c) The Court examined paragraph 7 of the Cotenants Agreement (stating that property could only be sold with the unanimous consent of all cotenants) and concluded that it did not matter whether it was a restriction on the decedent's right to sell or on his right to use the art.

(d) Instead, the Court found that the paragraph effectively waived the decedent's right under local law to institute a partition action, and in doing so relinquished an important use of his fractional interests in the art. As a result, any restriction on the decedent's right to partition would be disregarded under § 2703(a)(2).

2. Do Any Discounts Apply in Determining the Fair Market Value of the Art?

Next, the Court analyzed the fair market value of the art and whether any discount should apply.

(a) Service's Arguments. The Service argued that no discount should be permitted in valuing the fractional interests in artwork, for two main reasons:

(i) First Reason: Because the market for fractional interests in all types of personal property is one in which the holder and other co-owners sell the entire item of property at retail, and therefore the interest holders each receive a pro rata share of the property or the proceeds thereof with no fractional discounts.

(ii) Court's Response: The Court noted that this argument did not have merit because of the "relevant facts" – in this case, that the decedent's children would be adverse to a partition or sale of the property that would result in new ownership.

(iii) Second Reason: Because of the Commissioner's long-standing position that fractional interests in art are not discounted for purposes of valuing charitable contributions.

(iv) Court's Response: The Court noted that there was support for discounts in valuing fractional interests in art because of the uncertainties that would confront a hypothetical buyer of art. As a result, the Court ultimately concluded that there was no bar, as a matter of law, to an appropriate discount from pro fair market value for valuing such interests.

(b) Taxpayer's Arguments. The taxpayers argued that a large, 44.75% discount was appropriate.

(i) Reasoning: The decedent's children would be hostile to any sale of the art and would have "staying power" not to sell it because the art was "part of the family."

(ii) Court's Response: The Court turned this argument around and strongly relied on one of the daughters' testimony that the children would be "willing to pay a fair price" to purchase a hypothetical buyer's 73.055%/50% interests in the art because of their strong sentimental desire to retain possession of it.

3. Conclusion.

(a) As a result, the Court reasoned that a hypothetical willing buyer and seller of the decedent's interests in the art would agree upon a price at or fairly close to the pro rata fair market value of the interests.

(b) In order to account for the "uncertainties" of the sale price, the Court agreed to a nominal 10% discount, reasoning that this would enable a hypothetical buyer to assure himself or herself of a reasonable profit on the resale of the art interests to the children.

D. Bottom Line.

1. Although only a nominal 10% discount was allowed, this case highlights that a fractional interest in personal property may be available to estates.

2. In addition, the evidence about the possible buyers of such property (in this case, the decedent's children), as opposed to a hypothetical buyer, seemed to very much affect the Court's decision.

(a) As Steve R. Akers pointed out in his thoughtful synopsis of this case, there have been other decisions that have been reversed because of the fact that the Court's analysis focused on a "strategic buyer" instead of the hypothetical willing buyer/seller.[13]

(b) As a result, it will be interesting to see if this case is appealed (to the 5th Circuit) and whether an appellate decision will address this issue.

<u>Private Letter Ruling 201313001 (March 29, 2013)</u>

A. <u>Summary</u>.

1. The Service held that the amendment of a stock purchase agreement by a decedent's estate and his son which (i) extended the terms of payment and (ii) clarified the interest rate payable did not constitute a substantial modification of the agreement and would not cause § 2703 of the Code to apply.

B. <u>Facts</u>.

1. Decedent died owning shares of a closely held company, which his son also owned shares in. Pursuant to a stock purchase agreement, the son was obligated to purchase the shares held by decedent's estate for a price to be paid in cash in semi-annual installments over a certain period of time with interest on the unpaid balance "at the prime rate" established by a certain bank.

2. The decedent's estate and the son entered into an amendment to the stock purchase agreement to (i) extend the terms of payment, (ii) clarify that the prime rate was to be established semi-annually (as the original agreement did not specify whether the prime rate was fixed or adjustable), and (iii) change the banking institution determining the prime rate.

C. <u>Analysis</u>.

1. The Service first determined that § 2703 of the Code applies to transfers after October 8, 1990. In this case, since the stock purchase agreement was executed prior to October 8, 1990, it was not subject to § 2703.

2. Furthermore, the Service held that the interest rate clarification was not a "substantial modification"[14] to the agreement, because it resulted in the proceeds

[13] Steve R. Akers, *Estate of Elkins v. Commissioner*, Bessemer Trust –Planning Insights (March 2013), http://www.bessemertrust.com. *See, e.g.*, *Estate of Jung v. Commissioner*, 101 T.C. 412 (1993), *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982), and *Morrissey v. Commissioner*, 243 F.3d 1145 (9th Cir. 2001). *But see also*, *Holman v. Commissioner*, 130 T.C. 170, *aff'd*. 601 F.3d 763 (8th Cir. 2010), where a 12.5% marketability discount was allowed for the sale of an LP interest, based in part on the fact that potential purchasers (i.e., remaining partners in the FLP) would have an interest in purchasing the interests for a certain price.

[14] Treas. Reg. § 25.2703-1(c)(1) provides that a right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the

of the sale more closely approximating fair market value, in accordance with Treas. Reg. § 25.2703-1(c)(2)[15]. In addition, the extension of the term of years did not result in anything other than a "de minimis change" to the quality, value and timing of the rights under the agreement.

3. As a result, it was held that the amendment to the stock purchase agreement would not constitute a substantial modification of the agreement under Treas. Reg. § 25.2703-1 and would not cause § 2703 to apply to the agreement.

Private Letter Rulings 201310002, 201310003, 201310004, 201310005 and 20131006 (March 8, 2013) – "DING Trust" Rulings

A. Summary.

1. After six years of not issuing rulings on "DING Trusts" (Delaware Incomplete Non-Grantor Trusts), the Service has issued a series of rulings relating to transactions involving irrevocable trusts established by a grantor for the benefit of himself and his issue, whereby distributions to beneficiaries could be made pursuant to the direction of a distribution committee (consisting of the grantor and his 4 sons), ultimately holding that:

   (a) The grantor would not be deemed the owner of any portion of the trust under the grantor trust rules;

   (b) The transfer of property by the grantor to the trust would not be a completed gift;

   (c) Distributions by the distribution committee to the grantor would not be considered completed gifts by the members of the distribution committee; and

   (d) Distributions by the distribution committee to beneficiaries other than the grantor would not be considered completed gifts by the members of the committee, but rather, would be considered completed gifts by the grantor.

2. The rulings are largely consistent with prior rulings, with a few minor differences described below, but ultimately do not seem to answer the issues raised by IR-2007-127.[16]

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quality, value or timing of the rights of any party with respect to the property that is subject to the right or restriction is a "substantial modification."

[15] Providing that a substantial modification does not include a modification that results in an option price that more closely approximates fair market value.

[16] News Release IR-20070127; 2007 IRB 589 (July 9, 2007).

B. Background.

1. Beginning in the late 1990's, a number of states (including Delaware, Alaska, South Dakota, etc.) adopted statutes allowing for the creation of domestic asset protection trusts.

2. After the enactment of such statutes, several Private Letter Rulings[17] confirmed that under Delaware law a grantor could create a non-grantor asset protection trust for income tax purposes in a jurisdiction with no state income tax, fund the trust with assets without the transfers being considered taxable gifts, and still retain the right to receive discretionary distributions of trust income and principal, all while allowing the trust assets to escape state income taxation. Such a technique became known as a "DING" trust, a Delaware Incomplete Non-Grantor Trust.

3. Prior PLR's.

    (a) As noted above, a series of Private Letter Rulings addressed the transfer tax consequences of DING's.

    (b) Basic Fact Pattern of the PLRs.

        (i) Grantor creates a discretionary trust for the benefit of the grantor and others and a Delaware corporate trustee is appointed as the sole trustee of the trust.

        (ii) The distribution committee, consisting of two permissible beneficiaries of the trust, had the power (acting unanimously) to direct the trustee to distribute trust assets among the permissible beneficiaries.

        (iii) The grantor and one member of the committee could also direct the trustees to make distributions.

        (iv) If either member of the distribution committee died prior to the grantor, then that member had to be replaced with another permissible beneficiary.

        (v) The grantor retained a broad testamentary limited power of appointment over the trust assets.

    (c) The PLR's concluded that the grantor had not made a completed gift upon establishing the trust due to his/her retention of a broad testamentary limited power of appointment (although the grantor would be treated as making a completed gift when a trust distribution was made to a beneficiary other than the grantor).

[17] *See, e.g.*, Private Letter Ruling 200612002 (March 24, 2006), Private Letter Ruling 200502014 (January 14, 2005), and Private Letter Ruling 200247013 (November 22, 2002).

(d) The Service also found that the distribution committee members had substantial adverse interests to each other for purposes of § 2514 of the Code, and therefore did not possess general powers of appointment over the trust. As a result, distributions from the trust would not be considered taxable gifts with respect to the committee members.

(e) Private Letter Ruling 200729025 (April 10, 2007).

(i) The last PLR of this type to be issued was PLR 200729025, which was similar to the prior PLR's, except for the following:

I. The distribution committee consisted of three (not two) members, and

II. If one committee member predeceased the grantor, he would not be replaced.

(ii) The Service ruled similarly, except that it added the statement:

> "Accordingly, during the period the Power of Appointment Committee consists of B, C, and D, they will not be treated as making a taxable gift if Trust income or corpus is distributed [to the Grantor] under the terms of the Trust."

4. IR-2007-127, Revenue Ruling 76-502[18] and Revenue Ruling 77-158.

(a) Shortly after the issuance of PLR 200729025, the Service issued a News Release in IR-2007-127, in which it announced that it was reconsidering the results in the PLR's, with respect to whether the distribution committee members possessed general powers of appointment.

(b) Specifically, the News Release highlighted that the conclusions in the PLR's may not be consistent with Revenue Ruling 76-502 and Revenue Ruling 77-158, which had the following facts:

(i) Three siblings owning 1/3 interests in the family business contributed their interests to an irrevocable trust for the benefit of descendants, which permitted the trustees to distribute property to any beneficiary (including themselves).

(ii) Each trustee had the power to designate a relative to serve as successor upon his/her death or resignation, and if no successor was designated, his/her oldest living descendants would occupy the position.

(iii) The Rulings addressed whether any trust assets were includible in a deceased trustee's gross estate as a result of the trustee being treated as

[18] 1976-2 C.B. 275 and 1977-1 C.B. 285.

holding a general power of appointment under § 2041, ultimately concluding that 1/3 of the value of the trust estate was includible in the decedent trustee's estate.

(iv) The Rulings focused on the Regulations under § 2041 and highlighted that the remaining trustees did not have a substantial adverse interest to the deceased trustee, because a successor trustee was appointed on the decedent's death and the remaining trustees did not receive the entire power of appointment, but rather continued to share the power with the replacement trustee.

5. <u>Post-News Release</u>.

(a) In 2008, the Service invited public comments to the News Release. Many different professional organizations, including the American Bar Association, the Delaware Bankers Association, the New York City Bar Association, and the New York State Bar Association, submitted such comments.

(b) However, no further guidance or rulings on DING trusts have been issued by the Service since 2007.

C. <u>2013 PLRs</u>.

1. <u>Facts</u>.

(a) Grantor created an irrevocable trust for the benefit of himself and his issue.

(b) A corporate trustee was named as the sole trustee.

(c) During grantor's lifetime, the trustee was required to distribute such amounts of income and principal as directed by the distribution committee and/or the grantor as follows:

(i) ***<u>Grantor's Consent Power</u>***: At any time pursuant to the direction of a majority of the committee members, with the written consent of the grantor;

(ii) ***<u>Unanimous Member Power</u>***: At any time pursuant to the direction of all committee members other than the grantor; or

(iii) ***<u>Grantor's Sole Power</u>***: At any time, the grantor, in a nonfiduciary capacity, can direct distribution of principal to any one or more of his issue for their health, education, maintenance and support.

(d) The distribution committee was initially composed of the grantor and his four sons.

(e) The committee would cease to exist upon the grantor's death.

(f) The trust instrument provided that at all times at least two permissible beneficiaries must be members of the distribution committee, although a deceased/resigning member was not automatically replaced (the rulings are not clear as to whether a vacancy occurs when any member ceases to serve or only when there are less than two members serving).

(g) On the grantor's death, he had the power to appoint the remaining balance of the trust to any person or entity other than his estate, his creditors, or the creditors of his estate (Testamentary Limited Power of Appointment).

(h) **<u>Note</u>:**

(i) The facts are extremely similar to the prior PLR's, except that the grantor retained the *Grantor's Sole Power*, *i.e.*, the power, in a non-fiduciary capacity, to direct the distribution of principal to any one or more of his issue for their health, education, maintenance or support.

(ii) The language used in the trust instrument tracks the language of § 674(b)(5).

2. <u>Analysis</u>. The rulings gave five important rulings based on the above facts.

(a) <u>Non-Grantor Trust</u>. First, the rulings determined that nothing in the trust instruments would cause the grantor to be treated as the owner of any portion of the trust under §§ 673, 674, 675, 676 or 677. In order to reach this conclusion, the ruling apparently concluded that the distribution committee members were adverse to the grantor for income tax purposes.

(i) <u>Grantor's Consent Power</u>. With respect to the Grantor's Consent Power, distributions can only be made with the consent of an adverse party.

(ii) <u>Unanimous Member Power</u>. With respect to the Unanimous Consent Power, distributions can only be made with the consent of an adverse party.

(iii)<u>Grantor's Sole Power</u>. With respect to the Grantor's Sole Power, the grantor's power was limited to the distribution of principal limited by an ascertainable standard. *See* § 674(b)(5)(A).

(b) <u>Transfers to Trust By Grantor Are Incomplete Gifts</u>. Next, the ruling goes through each of the *Grantor's Consent Power, the Grantor's Sole Power* and the *Unanimous Member Power,* determining that each individual power causes the transfer of property to the trust to be "wholly incomplete" for federal gift tax purposes.

(i) Grantor's Consent Power. The Grantor's Consent Power causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes because it is a power in the grantor to direct the disposition of the gifted property exercisable without the consent of someone having a substantial adverse interest in the disposition of the property. Interestingly, despite ruling that the distribution committee members are adverse to the grantor for income tax purposes, the ruling nevertheless rules that the distribution committee members are non-adverse to the grantor for gift tax purposes.

(ii) Grantor's Sole Power. The Grantor's Sole Power is a power over the disposition of the property which caused the gift to be wholly incomplete.

(iii) Testamentary Limited Power of Appointment. The ruling concluded that the grantor's testamentary limited power of appointment caused only the remainder interest to be incomplete. This reiterates the controversial position taken in CCA 201208026.

(c) Distribution Committee Members Do Not Make Gifts When Distributions Made to the Grantor. Next, the ruling holds that the distribution committee members do not make gifts to the grantor when a distribution is made to the grantor, because any distribution to the grantor is merely a return of the grantor's property.

(d) Distribution Committee Members DO Not Make Gifts When Distributions Made to Beneficiaries Other Than The Grantor. Next, the ruling holds that the distribution committee members do not have general powers of appointment, because:

(i) With respect to the *Grantor's Consent Power* – the powers are exercisable only in conjunction with the grantor;

(ii) With respect to the *Unanimous Member Power* – the members have substantial adverse interests to each other, so any distribution made to a beneficiary (other than the Grantor), are not gifts by the distribution committee, but are gifts by the grantor.

3. Bottom Line.

(a) What does this mean?

(i) The Service is in fact issuing rulings on DING trusts, despite not having responded to the comments to the News Release or issuing any rulings for the past 6+ years. Some speculate that there are likely more rulings on DING issues to come in the near future.

(ii) This ruling does not demonstrate any new or changed views from the Service with respect to what constitutes an incomplete gift and whether members of the distribution committee possess general powers of appointment.

(iii) As a result, it is still unclear how Revenue Ruling 76-502 and Revenue Ruling 77-158 might apply to these transactions.

(iv) Therefore, clients creating DING trusts will likely want to wait for further clarification on these open issues or obtain their own private letter ruling before making significant transfers to these trusts.

(v) Query whether the Grantor's Sole Power was necessary for the IRS to reach its conclusions. If so, DING Trusts will no longer be effective in jurisdictions (such as Delaware) where a self-settled trust is not protected from the grantor's creditors if the grantor retains a lifetime power of appointment. If the grantor's creditors can reach the assets of the trust, then the trust will be treated as a grantor trust, thereby making the planning technique ineffective.

Estate of Kite v. Commissioner, T.C. Memo. 2013-43 (February 7, 2013)

A. Summary.

1. The Tax Court held that a transaction that consisted of certain QTIP and marital deduction trusts being liquidated, with the assets subsequently transferred to the income beneficiary's revocable trust, and such assets ultimately being sold to the beneficiary's children for deferred annuities, was not a disguised gift subject to gift tax because the transaction was for adequate and full consideration. However, the liquidation of the QTIP Trusts followed by the subsequent sale of the distributed QTIP Trust assets in exchange for the deferred private annuities were integrated transactions triggering the application of § 2519.

B. Facts.

1. Upon the death of her husband, the decedent, Mrs. Virginia Kite, was the beneficiary of four trusts:

(a) QTIP 1

(i) A 1995 inter-vivos QTIP Trust, which Mrs. Kite created for the benefit of her husband, which qualified as QTIP property pursuant to § 2523(f).

(ii) Upon Mr. Kite's death, the trust continued in further trust for Mrs. Kite and which qualified as QTIP property pursuant to § 2056(b)(7) in Mr. Kite's estate.

(b) QTIP 2

(i) An amount equal to Mr. Kite's maximum available GST exemption at his death passed in trust for Mrs. Kite's lifetime; this trust qualified as QTIP property pursuant to § 2056(b)(7) in Mr. Kite's estate.

(c) Marital Deduction Trust

(i) The balance of Mr. Kite's "marital" estate passed into a second trust for Mrs. Kite's benefit, under which she was granted a general power of appointment over the trust property at her death; this trust qualified for the marital deduction in Mr. Kite's estate pursuant to § 2056(b)(5)

(d) GST Exempt Residuary Trust

(i) The balance of Mr. Kite's estate passed into a third trust for Mrs. Kite's benefit.

(e) Mrs. Kite's Revocable Trust

(i) In addition to the four trusts of which Mrs. Kite gained an interest upon her husband's death, Mrs. Kite's personal estate plan consisted of her revocable trust, which, upon her death, would divide her property into GST Exempt and Non-Exempt shares for her children.

2. Over the course of five years, Mrs. Kite, her various trusts, and her children (or trusts for their benefit) entered into the following series of transactions:

(a) Formation of Brentwood Partnership

(i) On December 31, 1996, Mrs. Kite, her children and each of the five above-referenced trusts formed Brentwood Partnership.

(ii) The trusts were limited partners and Easterly Corp., a corporation owned by Mrs. Kite and her children, acted as the general partner.

(b) Gift of Brentwood Partnership Interests

(i) In January 1997, Mrs. Kite, as Trustee of the trusts, gifted approximately 1/3 of her Brentwood interests to the children, reporting a taxable gift of $2.954 million, which was the value after applying a 34.354% valuation discount.

(c) Merger of Brentwood into Baldwin Partnership

(i) In February 1998, seeking better state tax application, Brentwood and Easterly were reorganized in Texas, which resulted in the merger of Brentwood into Baldwin Limited Partnership.

(d) Sale of Baldwin Partnership Interests

(i) In May 1998, Mrs. Kite, through the trusts, sold her remaining interests in Baldwin to her children for approximately $12.5 million.

(ii) The children's consideration consisted of secured, fully recourse promissory notes, which provided that payments were to be made quarterly at 5.81% per annum from August 1998 through May 2013.

(iii)Mrs. Kite, as the income beneficiary of the trusts, received the payment on the notes.

(e) Formation of Kite Family Investment Company

(i) On December 31, 2000, the trusts and Easterly formed Kite Family Investment Co., a Texas general partnership ("KIC").

(ii) The trusts contributed the promissory notes, and Easterly Corp. contributed 1% of the value thereof.

(f) Liquidation of Trusts/Private Annuity Agreement

(i) On January 18, 2001, Mrs. Kite's attorney and trust officer discussed a private annuity transaction with Mrs. Kite's children. The basic structure of the transaction was that the trusts would distribute their assets to Mrs. Kite and she would then sell all of the assets to her children in exchange for a deferred annuity.

(ii) This transaction was implemented in three steps over a planned three-day period in March 2001. At the time of the transaction, Mrs. Kite, who was 74, visited her physician and the physician's report indicated that she was not terminally ill, was in good health and that there was a 50% probability of her living beyond the next 18 months**.** Mrs. Kite's life expectancy, based on IRS actuarial tables was 12.5 years.

ii. Change of Trustees and Termination of Trusts

I. On March 28, 2001, Mrs. Kite resigned as Trustee of the QTIP Trusts and the Marital Deduction Trust retroactive to January 1, 2001 and her children were appointed as trustees.

II. The children (as Trustees of the three trusts), also on March 28, 2001, terminated the trusts retroactive to January 1, 2001.

III. As a result, the assets in said trusts (i.e., the interests in KIC) were transferred to Mrs. Kite's revocable trust so that it held a 99% interest in KIC.

iii. Additional Capital Contribution to KIC

I. On March 29, 2001, Baldwin, now wholly owned by the Kite children/trusts, contributed an additional $13.68 million to KIC, receiving back a 55.8215% general partnership interest, which diversified the KIC holdings.

iv. Sale of KIC for Annuities

I. On March 30, 2001, Mrs. Kite's revocable trust sold the remaining interest in KIC to her children for three unsecured private annuity agreements.

II. Each child promised to pay $1.9 million to Mrs. Kite's revocable trust on March 30 of each year beginning in 2011 and ending on Mrs. Kite's death.

(g) Mrs. Kite's Death, Estate Tax Return and Deficiency Assessment

(i) Mrs. Kite died on April 28, 2004, well before the due date for the first annuity payment.

(ii) Mrs. Kite's 706 did not include any transferred interest in the Baldwin promissory notes nor KIC as part of either her gross estate or adjusted taxable gifts.

(iii) The Service assessed a $6.05 million deficiency for Mrs. Kite's 2001 gift taxes and a $5.1 million deficiency for estate taxes.

C. Analysis.

1. *Issue #1*: Whether the transfer of partnership interests to decedent's children in exchange for the private annuity agreements was a disguised gift subject to gift tax?

(a) Parties' Positions

(i) The Service argued that the transaction was nothing more than a disguised gift subject to the gift tax in that the annuity agreements did not constitute adequate consideration, because the annuities were never intended to be paid.

(ii) In contrast, the Taxpayer argued that the transaction was for full and adequate consideration because,

I. The parties used IRS actuarial tables to properly value the annuities,

II. The terms of the annuity agreements were legally enforceable under State law, and

III. Intent was supported by the Kite children's ability to make payments under the annuity agreements and Mrs. Kite's profit motive.

(b) Adequate and Full Consideration Discussion

(i) According to IRS actuarial tables in 2001, a 75-year-old woman without a terminal illness was expected to live 12.5 years, which was 2.5 years after the first annuity payments were due.

(ii) Further, in response to the Service's referencing of increased medical care costs for 2001 through 2003, the Tax Court stated that, although the increased medical costs and home health care indicate that Mrs. Kite's health was in decline, they alone do not suggest, let alone prove, that Mrs. Kite had a terminal illness or an incurable disease; rather, Mrs. Kite's increased medical costs merely demonstrate that Mrs. Kite was a wealthy, 75-year-old woman who, when faced with certain health problems, decided to employ health care aids at her home.

(iii) In addition, rejecting a comparison to annuities which were the focal issue of Estate of Hurford[19] (where the annuitant was being treated for stage 3 cancer at the time that the parties agreed to the annuity terms), the annuities involved in this case were enforceable and the parties demonstrated to the court their intention to comply with the terms thereof, and especially with Mrs. Kite having demand rights.

(iv) The Tax Court also found persuasive Mrs. Kite's expectation that she would receive payments, for the following reasons:

I. Mrs. Kite was very active in her financial affairs, so it was unlikely that she would have entered into such an agreement had it not been enforceable and in which she could profit.

II. The profit motive was demonstrated by her access to other assets which made her KIC interests available for a potentially risky, but lucrative, investment.

(vii) Thus, based on the above, the Tax Court held that the annuity agreements constituted adequate and full consideration and consequently were not subject to Federal gift tax.

[19] T.C. Memo. 2008-278.

(c) Economic Substance Discussion

(i) The Service attempted to argue that the transaction should be disregarded because it lacked economic substance.

(ii) The Tax Court believed that this was a valid argument worth analysis considering that, after the Baldwin contribution to KIC, the trustee of Mrs. Kite's revocable trust refused to sign the amended and restated KIC partnership agreement, giving an inference that Mrs. Kite maintained an indirect ownership interest in KIC after Baldwin's admission which could give rise to a potential § 2036 argument.

(iii) Looking to state law, Texas case law demonstrated that Texas courts generally rely on a partner's intent, whether direct or implied, as controlling when determining the legal consequences of certain transfers of partnership property.[20]

(iv) Based on the subsequent actions despite the flawed partnership agreement purporting to document Baldwin's admission as a general partner of KIC, Mrs. Kite's subsequent actions manifest the requisite intent affirming Baldwin's admission and, consequently, Mrs. Kite's diminished interest in KIC. Accordingly, Mrs. Kite did not maintain an indirect interest in KIC that would otherwise be included in the estate under § 2036.

2. *Issue #2*: Whether the transfer of the QTIP trust assets constituted a taxable gift of the remainder interest under § 2519.

(a) The Service attempted to argue that the annuity transaction constituted a disposition of the qualifying interests for life in the QTIP Trusts, which constituted a taxable gift under § 2519.

(b) If a surviving spouse disposes of all or part of a qualifying income interest for life, § 2519 treats the disposition as a transfer of all interests in QTIP other than the qualifying income interest.

(c) "Disposition" Defined

(i) Although § 2519 does not define a "disposition", Treas. Reg. § 25.2519-1(f) provides that the sale of QTIP, followed by the payment to the surviving spouse of a portion of the proceeds equal to the value of the surviving spouse's income interest, is considered a disposition of the qualifying income interest.

[20] *See, e.g., Keller v. United States*, 697 F.3d 238 (5th Cir. 2012), discussed in George D. Karibjanian and Hannah W. Mensch, "*Current Developments in Estate Planning*," as presented at the 2013 Midyear Meeting of the American Bar Association Section of Taxation, Estate And Gift Taxes Committee, on January 25, 2013 in Orlando, Florida, Outline Section VIII(A), p.35 (holding that a decedent's *intent* to create an FLP was enough to actually create the partnership under Texas law, despite assets not being transferred to the partnership before her death.)

(ii) Not included as a disposition for purposes of § 2519 is the conversion of QTIP into other property in which the surviving spouse has a qualifying income interest for life.

(d) The Tax Court first considered whether the various transfers of the QTIP Trust assets prior to the trust terminations triggered § 2519, and held that they did not because each transfer resulted in a reinvestment of the QTIP Trust assets in property in which Mrs. Kite had a qualifying income interest for life.

(e) The Tax Court then addressed whether the liquidation of the QTIP Trusts followed by Mrs. Kite's sale of the distributed QTIP Trust assets triggered § 2519.

(i) The Service argued that the termination of the QTIP trusts and the annuity transaction were a single integrated transaction, and that the substance of the transaction was that Mrs. Kite disposed of her income interest in the QTIP Trusts in exchange for the deferred annuity, and cited as precedent the judicial doctrine of "substance over form."

(ii) The Tax Court stated that in the sale of QTIP assets, followed by the payment to Mrs. Kite of a portion of the proceeds equal to the value of her income interest in the QTIP Trusts, Mrs. Kite had received full and adequate consideration; therefore, the Tax Court concluded that this was considered to be a disposition of her qualifying income interest in the QTIP Trusts under Treas. Reg. § 25.2519-1(f).

(iii) Thus, the sale of Mrs. Kite's interest in KIC that can be traced to the QTIP trusts was subject to Federal gift tax under § 2519 to the extent of the fair market value of the entire property subject to Mrs. Kite's qualifying income interest, determined on the date of the annuity transaction, less the value of her qualifying income interest.

(iv) However, because Mrs. Kite received adequate and full consideration for her income interest, she did not make a gift of her qualifying income interest under § 2511.

(v) The Tax Court did not address how much of a gift resulted from the deemed transfer of the remainder interests. However, because the Tax Court held that Mrs. Kite received full and adequate consideration for all of the distributed QTIP Trust assets, and not merely her income interest, the taxable gift under § 2519 should be zero.

2. *<u>Issue #3</u>:* Whether Mrs. Kite made a taxable transfer under § 2514 when she effectively released her general power of appointment over the corpus of the Marital Deduction Trust.

A. With respect to the Marital Deduction Trust, the Service argued that the release of the general power of appointment in the Martial Deduction Trust constituted a taxable transfer under § 2514.

(i) Section 2514(b) provides that an individual who exercises or releases a general power of appointment created after October 21, 1942, is deemed to have transferred the related property.

(ii) The Tax Court cited Treas. Reg. § 25.2511-1(c), which defines a "transfer of property" as "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or the devise employed."

(iii) The transfer of the trust assets to Mrs. Kite's lifetime revocable trust was not a transfer of property for gift tax purposes because Mrs. Kite did not transfer an interest in the property to another.

(iv) Instead, Mrs. Kite maintained her interest in the property as the grantor and the sole income beneficiary of her lifetime revocable trust, so she did not make a taxable transfer of the marital deduction trust assets under § 2514.

D. Bottom Line.

1. After all that, the only taxable transfers determined by the Tax Court were the portions of the annuity value originally traceable to the ownership interest of QTIP Trusts in KIC, less the value of Mrs. Kite's qualifying income interests in QTIP Trusts.

2. So…..if the primary transaction – the sale for the annuity interest – was deemed to be for adequate and full consideration, what exactly was the amount of the gift cited by the Tax Court in the last paragraph of the opinion, paraphrased above? The opinion was silent on this point.

3. An interesting conclusion as to the annuity payments especially since evidence was admitted stating that based on the current financial positions, the children would not have been financially solvent to pay any annuity payments past the third year, yet the Tax Court held that the annuity transaction had substance.

4. The focal point of the Tax Court's arguments were that each layer of the transaction did not involve a disposition of the qualifying income interest in the trusts but rather involved a reinvestment of the existing property after which Mrs. Kite continued to have a qualifying income interest.

5. If the Tax Court dissected each layer separately, and viewed each independently, then how did it arrive at a § 2519 conclusion as to the final disposition, especially since there were no QTIP Trusts from which the disposition occurred (recall that it was Mrs. Kite's revocable trust, and not the QTIP Trusts, that sold the interests

for the annuity)? According to Steve R. Akers, the answer is that the Tax Court did consolidate the last two steps to reach this conclusion: "Though never stated directly in the opinion, the court apparently believed that if the QTIP trust had sold its assets to the children in return for the 10-year deferred annuities, that would have been a § 2519 transfer. The court viewed the two steps together so that the sale of assets triggered § 2519…"[21]

6. According to Prof. Jeffrey Pennell, a significant taxpayer victory in Kite is that the Tax Court held that there was no gift from the children on the termination because Mrs. Kite would have owned the entire fee, and thus, from a gross estate inclusion perspective, before and after, Mrs. Kite had full inclusion; however, whereas before the transaction, the children were guaranteed a remainder, but after the transaction, the annuity posed the possibility that Mrs. Kite might live longer than the mortality tables predict. In that case the children could have been significantly disadvantaged by this transaction. Whether those facts suggest that the children made a gift apparently did not warrant government attention, and the court similarly dismissed it.[22]

7. For an additional article on this decision, *see* Owen G. Fiore, *Owen Fiore on Kite v. Commissioner*, LISI ESTATE PLANNING Newsletter #2066 (February 19, 2013).

Estate of Koons v. Commissioner, T.C. Memo. 2013-94 (April 8, 2013)

A. Summary.

1. The Tax Court adopted the Service's valuation of a revocable trust's interest in a business with mostly liquid assets, finding that the taxpayer's valuation overstated the marketability discount appropriate for the large size of the interest and the business's liquidity.

2. The Tax Court also held that the estate was not entitled to deduct the projected interest expense on a "Graegin loan,"[23] finding it was unnecessary to borrow the funds to pay estate taxes.

B. Facts.

1. Prior to his death, the decedent was president and CEO of a soft drink company that became involved in a dispute with Pepsi. Eventually, the decedent sold his

[21] Steve R. Akers, *Steve Akers on Kite*, LISI ESTATE PLANNING NEWSLETTER #2072 (March 5, 2013), http://www.leimbergservices.com.

[22] Jeffrey Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?*, LISI ESTATE PLANNING NEWSLETTER #2062 (February 11, 2013), http://www.leimbergservices.com.

[23] *See Estate of Graegin v. Commissioner,* T.C. Memo. 1988-477 (September 28, 1988).

company to Pepsi. An LLC was formed to hold the proceeds from the Pepsi sale, the settlement Pepsi gave the company and other assets.

2. The decedent created a revocable trust and transferred all of his membership interests in the LLC to the trust. On the date of his death in 2005, the revocable trust owned a 46.94% voting interest in the LLC.

3. Prior to the decedent's death, the LLC offered the decedent's children the right to be redeemed. All of decedent's children accepted the redemption offer prior to the decedent's death, however, the redemptions were not completed until a few weeks after the decedent's death. After the redemption, the trust's voting interest in the LLC increased to 70.42%.

4. Several months later, the LLC loaned the revocable trust $10,750,000 in exchange for a term promissory note at 9.5% per year interest with principal and interest due in 14 equal installments starting in 2024 (i.e., 18 years later). The terms of the loan prohibited prepayment. The total interest component of the 14 installments would be $71,419,497. The proceeds of the loan were to be used by the revocable trust to make a payment towards the estate and gift tax liabilities of the estate (i.e., a Graegin loan).

5. At the time of the loan, the revocable trust's primary asset was its LLC interest. At such time, the LLC had over $200 million in highly liquid assets plus two operating companies.

6. On its timely filed Form 706, the decedent's estate reported the value of the revocable trust's LLC interest as approximately $117 million and claimed a deduction for the $71 million interest on the LLC loan.

C. <u>Analysis</u>.

1. <u>Deduction for Graegin Loan – "Unnecessary"</u>.

   (a) The Court determined that the estate could not deduct the projected interest expense on the LLC loan to the revocable trust, because it was unnecessary.

   (b) The Court found that the fact that the trust had a 70.42% voting interest in the LLC (which had over $200 million in liquid assets) meant that the trust could force the LLC to make a pro rata distribution to its members.

   (c) This ability to force the LLC to make a distribution made it unnecessary for the trust to borrow from the LLC.

   (d) While the estate tried to argue that the loan was preferable to a distribution because it left cash in the LLC to buy businesses, the Court pointed out that, as its primary asset, the LLC would ultimately have to distribute cash for the trust to repay the loan.

(e) The Court also pointed out that keeping the estate open for 18-25 years until the loan was repaid hindered the "proper settlement" of the estate.

2. FMV of LLC Interest.

(a) The Court then analyzed the marketability discounts proposed by each party – the estate's expert determined a 31.7% discount should apply, while the Service's expert contended that a 7.5% discount should apply.

(b) The estate's expert applied a regression analysis and factored in potential litigation and limitations on the transfer of LLC interests, but did not take into account the redemption of the children's interests.

(c) The Service's expert took into account that the redemptions would in fact occur, because the children had signed offer letters prior to the decedent's death. The Court agreed with this approach and also agreed with how the expert took into account LLC liabilities. As a result of the trust's 70.42% voting interest, the trust could order the LLC to distribute most of its assets, and therefore a minimal 7.5% marketability discount was held to apply.

Estate of Liftin v. United States[24]

1. Summary.

(a) The Court of Federal Claims held that an estate was not entitled to a refund of a late-filing penalty, finding that although the estate initially had reasonable cause for the late filing of the estate tax return to address the marital deduction because the decedent's spouse was becoming a U.S. citizen after his death, it lacked reasonable cause for waiting nine months to file the return once the spouse become a naturalized citizen.

2. Facts.

(a) The decedent died on March 2, 2003 and under § 6075(a), the estate was required to file a federal estate tax return by December 2, 2003.

(b) The decedent was survived by his spouse, who at the time of his death was a U.S. resident and citizen of Bolivia.

(i) Before the filing deadline, the surviving spouse consulted legal counsel concerning whether to apply for U.S. citizenship to allow the estate to take a marital deduction for bequests to her under the Will.

[24] 111 AFTR 2d 2013-587, Ct Fed. Cl. (March 29, 2013).

(ii) The surviving spouse also asserted claims against the estate arising out of her rights under a prenuptial agreement (hereinafter referred to as the "ancillary matters").

(c) The executor of the estate employed an attorney who had "expertise in private wealth services and estate and gift tax planning" to assist with the estate's Form 706, advising the executor that if the surviving spouse became a citizen before the return was filed and was a resident of the U.S. at all times after the decedent's death, the estate would be entitled to a marital deduction for bequests passing to her.

(d) Based on the attorney's advice, the estate requested a 6 month extension of time to file the estate tax return and made a tax payment of nearly $900,000, which the estate estimated would be sufficient to satisfy taxes due even if it were unable to claim the marital deduction.

(e) At the time the extension expired, the surviving spouse intended to apply for citizenship but was not yet naturalized; as a result, the attorney advised the estate that based on his interpretation of Treas. Reg. § 20.2056A-1(b), that filing the return late to claim the marital deduction would not trigger a penalty as long as the return was filed within a reasonable time after the spouse became a citizen **and** the ancillary matters were settled.

(f) On August 3, 2005, approximately 14 months after the extended deadline, the spouse became a U.S. citizen, and in early 2006, she and the estate entered into an agreement settling the ancillary matters. On May 9, 2006, the estate filed the Form 706.

(g) One month later, the Service issued a Notice of Adjustment reflecting a penalty for late filing and late payment for 25% of the tax due.

3. Analysis.

(a) The Court determined that the attorney's advice to the estate constituted *reasonable cause* for the estate to delay its filling until after the surviving spouse became a U.S. citizen, satisfying the standard set in Estate of La Meres v. Commissioner.[25]

(b) However, the Court further concluded that the attorney's advice did not, as a matter of law, constitute reasonable cause to delay filing until all "ancillary matters" were concluded, because such advice was not an interpretation of substantive tax law.

[25] 98 T.C. 294 (1992), which held that a taxpayer may demonstrate that its late filing was due to reasonable cause when (i) the taxpayer made full disclosure to an expert; (ii) the expert gave advise upon which the taxpayer claims to have relied; (iii) the taxpayer relied in good faith on the expert's advice; and (iv) the taxpayer did not otherwise know that the return was due.

4. Bottom Line.

(a) Although the estate's reliance on its attorney's advice to delay filing of the Form 706 until after the surviving spouse became a U.S. citizen was reasonable cause to file the return late, there was no reasonable cause to further delay its filing after citizenship was granted. As a result, the estate's additional nine month delay subjected it to the maximum late-filing penalty.

Private Letter Ruling 201304003 (January 25, 2013)

A. Summary

1. The IRS ruled that the exchange by an irrevocable trust of a second-to-die life insurance policy for a new first-to-die life insurance policy after the death of the first insured would qualify for nonrecognition treatment under § 1035 of the Code.

B. Facts

1. Husband and wife purchased a second-to-die life insurance policy (the "Old Policy") and transferred it to an irrevocable trust ("Trust A").

2. After husband's death, wife formed a new irrevocable trust ("Trust B") and transferred the Old Policy to Trust B.

3. Then, the trustee of Trust B exchanged the Old Policy for a new life insurance policy insuring only wife's life (the "New Policy").

C. Analysis

1. The taxpayer requested a ruling that the exchange of Old Policy for New Policy would qualify for nonrecognition treatment under § 1035 of the Code.

2. Section 1035(a)(1) provides that no gain or loss will be recognized on the exchange of a contact of life insurance for another contract of life insurance. However, Treas. Reg. § 1.1035-1(c) provides that § 1035 does not apply to an exchange of policies if the policies exchanged do not relate to the same insured.

3. The ruling concluded that because, at the time of the exchange, wife was the sole remaining insured on Old Policy and the sole insured on New Policy, the exchanged did not involved a change of insured, and, therefore, § 1035 applied to the exchange.

***Windsor* and *Perry* Updates** – The Supreme Court Briefs and Oral Arguments

A. Introduction.

1. Oral arguments were heard on March 27, 2013 for the two "Defense of Marriage Act" cases currently before the United States Supreme Court, namely, Windsor v.

United States[26] and Hollingsworth v. Perry,[27] with a decision expected in mid-to-late June.

2. The impact of the cases is far reaching – at one end, both cases could result in the affirmance of the legality of the "Defense of Marriage Act" ("DOMA"), or both cases could result in a broad overturning of all Federal and State DOMA-type statues and Constitutional provisions.

B. Summary of the Cases.

1. Windsor

(a) Same-sex married couple Edie Windsor and Thea Spyer resided in New York at a time when same-sex marriage was not recognized. Upon Mrs. Spyer's death, Mrs. Windsor, as her executor, filed a Form 706 qualifying all property passing to or for her benefit for the marital deduction.

(b) Upon denial by the Service on account of DOMA, Mrs. Windsor paid the tax and sued for a refund in the Federal Southern District of New York, which held in favor of Mrs. Windsor and struck down DOMA as unconstitutional for violation of the Equal Protection Clause of the Fifth Amendment to the United States Constitution (the "Federal Equal Protection Clause").

(c) By a 2-1 opinion, the three-judge panel from the Federal Second Circuit Court of Appeals upheld the decision, again finding that DOMA violated the Federal Equal Protection Clause.

2. Perry

(a) As part of a series of cases referred to as the "In re Marriage" cases[28] which began in 2004 and culminated with a California Supreme Court decision in 2008, the California Supreme Court held that that any anti-same-sex marriage statute was in violation of the California Constitution.

(b) As a result of a successful petition, the matter was put to a vote and, in 2008, the California voters approved Proposition 8, which effectively amended the California Constitution to ban same-sex marriages.

(c) Lawsuits soon followed, the most notable of which was Perry v. Schwarzenegger, in which the Federal Northern District of California held that not only was Proposition 8 a violation of the California Constitution, but

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[26] 133 S.Ct. 786, 184 L.Ed.2d 527 (U.S. December 7, 2012) (No. 12-307).

[27] 133 S.Ct. 786, 184 L.Ed.2d 526 (U.S. December 7, 2012) (No. 12-144).

[28] In re Marriage Cases, 43 Cal.4th 757, 76 Cal.Rptr.3d 683, 183 P.3d 384 (2008).

that it violated the Equal Protection Clause of the 14th Amendment to the United States Constitution (the "State Equal Protection Clause").[29]

(d) On appeal, the Federal Ninth Circuit Court of Appeals upheld the Northern District's decision, but limited it to the California Constitution.

3. For additional background of the cases and the Federal appellate analysis, see George D. Karibjanian and Hannah W. Mensch, "*Current Developments in Estate Planning*," as presented at the 2013 Midyear Meeting of the American Bar Association Section of Taxation, Estate And Gift Taxes Committee, on January 25, 2013 in Orlando, Florida, Outline Section IV(A), p.16, and Outline Section IV(B), p.23.

Greene Archives, Inc. v. Marilyn Monroe LLC[30]

A. Summary.

1. In a lengthy opinion by the 9th Circuit regarding the posthumous right of publicity of Marilyn Monroe, the Court affirmed the district court's ruling that Monroe was domiciled in New York at the time of her death, and therefore her executors (who consistently represented during the probate proceedings and elsewhere that she was domiciled in New York to avoid payment of California estate taxes) were judicially estopped from asserting California's posthumous right of publicity, which is not recognized in New York.

B. Facts.

1. Marilyn Monroe executed her Last Will and Testament while living in New York City on January 14, 1961, naming New York attorney, Aaron Frosch, as her executor. She then traveled to California in the spring of 1961, where she first stayed in a hotel, then moved to a rental apartment, and again moved into a home that she purchased in 1962 while filming a movie. While she was in California, she maintained her New York apartment and staff. She died in her California home on August 5, 1962.

2. During the 40 year probate process, Monroe's executors consistently represented in numerous judicial and quasi-judicial settings that Monroe was domiciled in New York when she died, insisting that California inheritance and income taxes should not apply as a result of such domicile.

3. In 2005, Marilyn Monroe LLC (the residuary beneficiary of Monroe's estate, hereinafter, the "LLC") sued parties claiming ownership of Monroe's right of publicity and alleging that the parties violated such rights by using Monroe's

[29] Perry v. Schwarzenegger (referred to in the pertinent appellate opinion as "Perry IV"), 704 F.Supp.2d 921 (N.D. Cal. 2010).

[30] 9TH Cir., No. 08-56471, August 30, 2012.

image and likeness for unauthorized commercial purposes. The LLC asserted that Monroe died domiciled in California, which began to recognize a posthumous right of publicity in 1984.

C. Analysis and Conclusion.

1. The Court ruled that New York law applied to the question of whether the LLC had the right to enforce Monroe's posthumous right of publicity, and, because no right existed under New York law, the LLC could not enforce such right.

2. In analyzing the issue, the Court determined that because Monroe's executors consistently represented during probate proceedings and elsewhere that she was domiciled in New York, they were judicially estopped from asserting a right of publicity under California law.

Technical Advice Memorandum 201317010 (April 26, 2013)

A. Summary.

1. Trusts did not materially participate in the activities of an S corporation during tax years at issue under § 469 of the Code because the trustee and special trustee, in their capacities as trustees of the trusts, were not involved in the operations of the S corporation on a regular, continuous and substantial basis.

B. Facts.

1. Trust A and Trust B (the "Trusts") each own an interest in S Corp. A, an individual, owns the remaining interests in S Corp. S Corp owns 100% of QSub.

2. The trust agreements for the Trusts appoint B, an individual, as the sole trustee of the Trusts, and appoint A as the Special Trustee of the Trusts.

3. Pursuant to the trust agreements for the Trusts, the Special Trustee has control over all decisions regarding the sale or retention and the voting of all of the stock of S Corp and QSub. These are the only powers the Special Trustee is given.

4. A is also the President of QSub, and is involved in QSub's day-to-day activities. A is unable to differentiate his time spent as President of QSub, as Special Trustee of the Trusts and as a shareholder of S Corp.

5. B, as trustee of the Trusts, in not involved in the operations of S Corp or QSub.

C. Analysis.

1. The Service asserted that the Trusts did not materially participate in the activities of S Corp, arguing that the only activities to be taken into consideration are those performed by B, in his fiduciary capacity as trustee of the Trusts, and those performed by A, in his fiduciary capacity as Special Trustee – A's time serving as

President of QSub should not count towards meeting the material participation requirement because A is not the Trustee of the Trusts.

2. The taxpayer, on the other hand, argued that, because A is a Special Trustee of the Trusts, all of the services performed by A for QSub should be counted towards the material participation requirement.

3. Section 469(h)(1) defines material participation as an activity in which the taxpayer participates in on a regular, continuous and substantial basis. Although regulations provide additional guidance on when an individual materially participates, there is no additional guidance for trusts.

4. After reviewing the legislative history, the Service concluded that the sole means for the Trusts to establish material participation in S Corp and QSub activities is if the fiduciaries, <u>in their capacity as fiduciaries</u>, are involved in the operations of S Corp and QSub on a regular, continuous and substantial basis.

5. Based on the facts presented, the Service concluded that the only activities that should count towards meeting the material participation standard are those performed by A is his capacity as Special Trustee of the Trusts, and because his powers as Special Trustee were restricted (selling and voting stock), and A's activities as shareholder of S Corp and President of QSub are not taken into consideration, the Trusts did not materially participate.

D. <u>Bottom Line</u>.

1. The TAM's conclusion is at odds with the only judicial authority on this issue in <u>Mattie K. Carter Trust v. U.S.</u>, 256 F.Supp.2d 536 (N.D. Tex. 2003), which held that the activities of the trust's fiduciaries, employees and agents should be considered to determine whether the trust materially participated in an activity. Although TAMs are not precedential, given the lack of authoritative guidance on how trusts materially participate, any new pronouncement is significant because it shows that this issue is far from resolved.

2. It should be noted, that at least one case is now pending before the Tax Court regarding the requirements for material participation by a trustee for purposes of the passive loss rules (<u>Frank Aragona Trust v. Commissioner</u>, U.S. Tax Court Docket 015392-11).

3. Although the TAM addresses material participation in the context of § 56(b)(2)(D) of the Code (dealing with the ATM), it should have equal application in determining whether a trust or estate materially participates in an activity for purposes of applying the 3.8% Medicare Tax.

4. Under the standard set forth in the TAM, it could be very difficult for a trust to meet the materially participation standard.

In re Huber, 201 B.R. 685 (Bankr. W.D. WA May 17, 2013)

A. Summary.

1. The U.S. Bankruptcy Court for the Western District of Washington invalidated an Alaska self-settled asset protection trust governed by the laws of the State of Alaska because the trust was void under the laws of Washington, which the court held had a more substantial relation to the trust than Alaska. Additionally, the court held that the transfers made by the Settlor to the trust were made with an intent to hinder, delay or defraud his creditors, and therefore, the assets of the trust were includible in the Settlor's bankruptcy estate under §§ 548(e)(1) and 544(b)(1) of the Bankruptcy Code.

B. Facts.

1. Debtor had been involved in real estate development and management in Washington for over 40 years. Most of the Debtor's real estate investments were undertaken by the Debtor though LLCs. However, the Debtor was required to sign as guarantor on many of the projects.

2. As the markets began to deteriorate, in September of 2008, the Debtor engaged a Washington-based attorney to set up an Alaska asset protection trust for the benefit of the Debtor and his descendants (the "Trust") in anticipating that he might incur liability on the person guarantees. In fact, the examiner (appointed by the court to gather facts) indicated in his report that the Debtor was or had to be aware of the "gathering storm clouds." In addition to the threat of the collapsing housing market, a review of court files after the establishment of the Trust reflected that several loans in existence prior to creation of the Trust were fragile at best.

3. Alaska USA Trust Company and two of the Debtor's children were named as Trustees of the Trust.

4. The Debtor, the beneficiaries and all of the Trust's assets (with the exception of a $10,000 CD) were located in Washington.

5. The Debtor filed for chapter 11 bankruptcy in February 2011.

C. Analysis.

1. The court addressed several issues relating to the validity of the Trust and whether the Trust's assets were includible in the Debtor's bankruptcy estate.

2. The first (and, for purposes of this outline, the most significant) issue before the court was whether, in determining the validity of the Trust, to apply Alaska law (which was the governing law set forth in the Trust) or Washington law. Alaska law permits self-settled trusts, whereas, Washington law prohibits them.

3. The court cited to Section 270 of the Restatement (Second) of Conflict of Laws (1971), which addresses the validity of an inter vivos trust in movables. Section 270 provides, in relevant part, that "[a]n inter vivos trust of interests in movables is valid if valid under the local law of the state designated by the settlor to govern the validity of the trust, provided…that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship…."

4. According to the court, the Debtor's choice of Alaska law designated in the Trust should be upheld if Alaska has a substantial relation to the Trust.

5. In analyzing whether the Trust had a substantial relation to Alaska, the court noted the following:

   (a) Alaska – At the time the Trust was created, the Settlor was not domiciled in Alaska, the assets were not located in Alaska, and the beneficiaries were not domiciled in Alaska. The only relation to Alaska was that it was the location in which the Trust was to be administered and the location of one of the Trustees.

   (b) Washington – The Debtor resided in Washington, all of the property placed into the Trust (other than a $10,000 CD) was transferred from Washington, the creditors of the Trust were located in Washington, the Trust beneficiaries were Washington residents and the attorney who drafted the Trust was located in Washington.

6. Because (a) the Trust had only a minimal relation to Alaska and a substantial relation to Washington and (b) Washington has a strong public policy against self-settled asset protection trusts, Washington law applied and the Trust was held to be invalid.

7. The Court also held that the Debtor made transfers to the trust with the actual intent to hinder, delay or defraud his creditors, and as a result, all transfers to the trust by the Debtor were void under §§ 548(e) and 544(b)(1) of the Bankruptcy Code.

D. Bottom Line.

1. In light of the holdings that the transfers to the trust were fraudulent, and therefore void, finding the trust invalid under Washington law was unnecessary to the ultimate conclusion of the case. Nevertheless, it may provide some insight as to type of relation the trust must have to the state of creation in order for that state's laws to govern the trust's validity.

2. The holding in *Huber* could have significant application beyond self-settled asset protection trusts. For example, the Court's reasoning could be used to invalidate a trust established in Delaware by a Florida resident to take advantage of the

relaxed notice provisions or to perpetual trusts set up in states that permit them by a resident of a state that does not permit them.

This outline was last updated on June 21, 2013

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