Report #2

Monday, January 7, 2002

The below Report was compiled by our on-site Reporter, Bruce Stone, who is also a distinguished member of the Institute's Advisory Committee and a partner in the Miami, Florida law firm of Holland and Knight, LLP.

2:00 2:10 p.m.

Introductory Remarks

Tina Hestrom Portuondo,

Institute Director

Tina Portuondo convened the 36th annual University of Miami Heckerling Institute on Estate Planning by welcoming approximately 2,400 registrants.

After some brief remarks by Law School Dean Dennis Lynch, Tina introduced the panel that presented this year’s review of recent developments: Dennis Belcher, Carol Harrington, and Jeff Pennell.

2:10 5:15 p.m.

Recent Developments in Estate, Gift and

Income Taxation 2001 - Parts One and Two

Dennis I. Belcher

Carol A.Harrington

Prof. Jeffrey N. Pennell

Materials by Richard B. Covey

Dennis gave a brief overview of key provisions of the transfer tax changes made in the 2001 tax act. He noted that advisers and clients should not automatically assume that with the increase in the applicable exclusion amount from $675,000 to $1 million, an additional $325,000 can be gifted without incurring gift tax liability. Clients who had made adjusted taxable gifts in excess of the former applicable exclusion amount will owe some small amount of gift tax on a gift of $325,000. In fact, if adjusted taxable gifts of about $3 million have already been made, the additional amount that can be gifted now free of gift tax is only about $250,000.

Dennis briefly viewed what he regarded as other significant changes: the reduction in state death tax credit (which he predicted will cause a number of states to adjust their revenue laws fairly quickly and which will lead to more jurisdiction shopping for domicile); the repeal of section 2057 (QFOBI) and the expansion of benefits for conservation easements and estate tax deferral.

Carol reviewed some of the changes made to the GST tax in the 2001 legislation. She noted that the GST tax is de-unified from the estate tax for 2002 and 2003. The GST exemption for 2002 is $1.1 million, and it may be adjusted for inflation in 2003, but it will be identical to the estate tax applicable exclusion amount beginning in 2004.

In Carol's view, the most significant of the GST changes is the ability to accomplish downstream splits or severances in trusts which have an inclusion ratio of something greater than zero and less than 1. She noted that a good bit of activity can and should be expected in trust reformation to take advantage of this, but also cautioned that this remedy is not a substitute for good estate planning.

Other significant GST changes were the extension of section 9100 relief for allocation of GST exemption, the new automatic allocation rules (which she described as very complex, and potentially very dangerous), and the allowance of a late allocation of GST exemption if a nonskip child dies after creation of a trust but before the occurrence of a taxable termination. With respect to the last change, Carol was not sure how this will tie in with the ETIP rules.

Carol noted with some humor that with all the inflation adjusted exemptions and exclusions being rounded to multiples of thousands, tens of thousands, and hundreds of thousands of dollars, the 2002 amount of gifts which a US person can receive from a NRA without reporting is now $11,642.

Jeff Pennell reviewed the IRS business plan for pending projects. He noted that the IRS plan year is now on a fiscal year ending June 30, which is why there was no major flurry of regulations issued in December 2001 (unlike in prior years). Chief among the new projects will be new regulations defining income under section 643(b), the anticipated issuance of new model charitable remainder trust forms, the supposed issuance of section 2057 regulations (which Jeff doesn't think we will see because of the repeal of section 2057 itself), and regulations under section 2519 dealing with whether net gift rules will apply when a surviving spouse triggers acceleration of the remainder interest in a QTIP trust. The key question under section 2519 is whether the 2207A right to recover gift tax from the remainder beneficiaries will reduce the amount of the taxable gift, and Jeff believes the answer to that question should be "yes."

Dennis discussed the Mellon case (Federal Circuit, 265 F.2d 1275) which held that the 2% floor under section 67 applied to payments made by a trustee to outside investment advisers and for accounting and tax services. He noted that the IRS is now treating the deduction of those expenses as an audit item for trust 1041's. But he also noted that there is a case pending in the 4th Circuit which will address raises the same issue. The Service's position (and the holding of Mellon) is that to be deductible, expenses must be paid in the administration of the trust, and they must be incurred only because the property is held in trust.

Dennis also briefly discussed split dollar developments, which will be addressed later in the week in more detail. He noted the issuance of Notice 2002-8, which revokes Notice 2001-10. Notice 2002-8 sets forth positions expected to be found in the pending regulations. In essence, if the employer owns a split dollar policy, the arrangement will be characterized as an employment arrangement. If the employer is not the owner (which is more typical in estate planning situations), the arrangement will be treated as a loan arrangement subject to section 7872. January 28, 2002 will be a grandfather date for split dollar arrangements: inside build up will not be taxed annually, and the insurer's alternative rates (one year term) can be used. There will be a 2-year correction period allowed for rollout of split dollar arrangements.

Carol discussed the final charitable lead trust regulations governing measuring lives, and PLR 200127023, which analyzed the tax consequences of terminating a charitable remainder unitrust on an actuarial basis. She also discussed PLR 200140027, in which a donor who proposed to accelerate the charitable remainder by assigning his unitrust interest to the charitable remainder beneficiary. The ruling followed Rev. Rul. 86-60 in holding that the partial interest rule of section 170(f)(3) does not prevent the allowance of an income tax deduction for the released interest.

Dennis covered two rulings not in the seminar materials. In PLR 200150027, a charity formed a single member LLC to receive a gift of real estate which it did not wish to own directly, and the Service ruled that the LLC would be disregarded as a separate entity. Although the ruling did not address tax consequences under section 170, Dennis felt that a deduction should be allowable to the donor. PLR 200152018 addressed a charitable remainder unitrust in which the donor had retained the right to change the charitable beneficiaries. The donor proposed to exchange his 5% unitrust interest for a charitable gift annuity. The PLR addresses the income tax consequences to the donor arising out of the exchange.

Carol discussed the 2001 legislative changes to section 529, and Notice 2001-55 which liberalized the restrictions on making changes in investment strategy for 529 plans. Dennis noted that the definition of "education" under section 529 is broader than it is for gift tax purposes, because it includes room and board, which often are more significant than tuition payments.

Jeff discussed the proposed regulations under section 643(b). He noted that with respect to the inclusion of capital gains in DNI, the only really significant departure from prior law in the proposed regulation is that the governing instrument itself can now be the source of authority for allocation rules. He also noted that gains and losses must be netted out against each other before allocation under the DNI rules. He also cautioned that even though capital gains may be included in DNI, an in kind distribution of assets to satisfy a fixed amount (such as income) will trigger gain under the standard Kenan rules.

Carol discussed the conversion of GST grandfathered trusts to unitrusts under the proposed regulations. She noted that the proposed regulations had not addressed the consequences of moving a grandfathered trust from a state which does not have law authorizing an income interest to be defined in unitrust concepts to a state which does have such a law. Carol has asked the Treasury Department to address this in the regulations.

Dennis observed that in drafting unitrust clauses in total return trusts, rolling averages of fair market value should be used to avoid rapid and severe upswings or downswings in distributions to income beneficiaries due to market fluctuations.

Carol discussed the Read case (114 T.C. 14), which was recently affirmed by the Eleventh Circuit. The case involved the redemption of stock owned by a wife pursuant to a divorce decree, and at her husband's election the wife's stock spouse was redeemed by an ESOP. The redemption was treated by both courts has having been made on behalf of the husband.

In a general review of family limited partnership cases, Jeff stated that in the last 18 months, the government's arguments challenges to partnerships as bona fide arrangements that can achieve valuations discounts have failed. In addition the government's argument seeking to apply sections 2703 and 2704 have failed. Jeff noted that in FSA 200049003 the government still seeks to argue for gifts upon creation of FLPs, but he noted that the government has lost those arguments in Strangi (115 T.C. 478, which was appealed to the Fifth Circuit) and in Jones (116 T.C. 121).

Jeff observed that it is more accurate to state that the government is losing more valuation arguments based on its appraisals than that taxpayers are winning their arguments. In summary, Jeff believes that we are where we were 6 years ago: namely, that the governing rule is still "willing buyer, willing seller" – but that most people tend to focus only on the willing buyer and not the willing seller. Would the seller really sell at the appraised price?

Jeff noted that a New Jersey court has refused to allow a valuation discount for employee benefits because of the income tax liability that must be paid by the recipient. He stated that the public policy really should be that section 691(c) provides relief for this in the contest of estate tax valuations.

Carol discussed the 1997 Mitchell case (74 TCM 872) in which the burden of proof shifted to the IRS because its position in an estate tax deficiency notice was arbitrary and excessive.

Dennis discussed the 1999 Gross case (78 TCM 201), which dealt with the issue whether valuations of subchapter S stock should be "tax affected" by assumed corporate tax rates. The case was recently affirmed by the Sixth Circuit. Both the Tax Court and the Sixth Circuit rejected the taxpayer’s argument in favor of discounts. Dennis noted that this should not be a stand-alone issue. Depending upon which valuation methodology is being used (EBITDA, comparison to C corporations, inside asset valuations, etc.), tax effects may or may not have direct relevance, and should be address by a qualified appraiser in an overall composite manner.

Jeff said that there are now at least 3 cases where lottery winner with nonassignable winnings died before complete payout. One case (Shackleford, 262 F.2d, 9th Circuit) allowed a valuation discount, but two cases did not: Gribauskas (116 T.C. 142) and Cook (83 TCM 154).

Jeff also discussed the Schwan case (82 TCM 168), which involved a double evaluation, first for estate tax inclusion, and second for estate tax charitable deduction purposes. That led to a discussion among Jeff, Dennis, and Carol whether spendthrift clauses in a trust could produce a discount when valuing an the interest passing to a beneficiary. Jeff observed that this could be a double edged sword, and that perhaps spendthrift clauses should not be used automatically in boilerplate provisions, especially in marital deduction trust.

Jeff touched quickly upon some recent cases dealing with deductibility of administration expenses after the Hubert regulations, and he cautioned drafters to include language in governing instruments that will allow debts, expenses, and taxes to be paid from income or from principal.

Carol noted that in the current low interest rate environment, QPRTs and charitable remainder annuity trusts are not as attractive. Dennis commented that by the same token, charitable lead annuity trusts and GRATs are excellent tools now. Carol observed that the 7872 regulations were proposed in 1985 and have not been finalized. Under those regulations prepayment options are to be ignored. So in restructuring transactions that have already been completed in order to take advantage of the current low rates, refinancing should be a viable option. Dennis queried whether you can use long term rates if there is a prepayment option. Both he and Carol believe the answer is yes.

Jeff discussed the Armstrong case (132 F.Supp.2nd) where there had been a net gift in which the donees had agreed to pay gift taxes if the asset was valued over a certain amount. The IRS valued the asset in excess of that amount, and because the donor died within three years, the gift tax was also grossed up into the estate. the taxpayers argued that there should be a valuation discount because of the possibility of a gift tax liability and the potential for estate tax gross-up. The court ruled that the potential liability was too speculative to affect the value of the gift. Jeff commented that tax apportionment clauses in wills and trusts should be reviewed to see how they deal with gross-up of gift taxes. He also noted that net gift transactions should be carefully structured and clear, because the Armstrong court had characterized the transaction before it as "suspiciously confusing."

Carol and Dennis commented on the Trotter case (82 TCM 633), another case in which the government was successful in imposing estate tax under section 2036 where the decedent had continued to live in a residence that she had transferred to a trust of which she was not a beneficiary.

Jeff discussed PLR 200101021, which involved a joint revocable trust in which the first spouse to die would have a general power of appointment over the surviving spouse’s share of the trust assets. The objective was to achieve a 100% basis step up upon the death of the first spouse, in the same manner as community property. The ruling said that there would be no 100% basis adjustment, and Jeff said no one should be surprised that the government wouldn’t concede this in a ruling. However, he said that the ruling had a number of favorable points, and that it actually shows a valuable planning tool for married couples whose estates are less than two applicable exclusion amounts. The IRS ruled that 100% of the trust assets were included in the deceased spouse’s estate, which meant that a credit shelter trust could be created for the benefit of the surviving spouse without further inclusion of that credit shelter trust in the estate of the surviving spouse. The value of this as a planning technique is that you don’t need to worry about severing jointly owned assets into the separate names of each spouse to ensure use of the full unified credit. Jeff said that the most questionable part of the ruling was the IRS’s ruling that the surviving spouse’s grant to the deceased spouse of the general power of appointment over the surviving spouse’s share of the trust qualified for the gift tax marital deduction. Nevertheless, Jeff said that he feels planners can feel comfortable in relying on this ruling. Dennis pointed out that the estate planner should be aware of the conflicts of interest issues between the spouses, and also should make sure that there are no creditors (in states where assets subject to a general power of appointment can be reached by the decedent's creditors).

Carol discussed the 1997 Smith case (108 T.C. 412) in which the Tax Court allowed an estate tax deduction for a contingent claim based upon the amount of a settlement reached 15 months after death. That decision was reversed by the Fifth Circuit (198 F.3rd 515). She then discussed later cases raising these issues: McMorris (77 TCM 1552) and O'Neal (102 T.C. 666).

Jeff reviewed the handout materials which note that state law generally provides for interest on an outright bequest and for a share of income to be paid on bequests in trust. A choice between the two approaches can be made in a will or trust. When dividend yields on investments are low, it might seem preferable instead to provide for payments of interest. But the IRS position is that interest paid to the beneficiary is taxable as income but is not deductible by the estate or trust, whereas if the beneficiary receives an allocable share of estate or trust income, that will be deductible by the estate or trust under the DNI rules.

Carol discussed some recent GST developments. She cautioned the audience to remember the Cottage Savings case – even though the 2001 tax legislation and the laws of many states now allow GST trusts to be reformed and reorganized, if the beneficial interests before and after the reformation are materially different, there may be an income tax recognition event.

Carol reviewed PLR 200143019, which held that a loan from a grandfathered trust to beneficiaries did not cause the trust to lose its grandfathered status, because the loan was secured. Carol believes that the presence of absence of security is irrelevant, if the loan is bona fide.

In PLR 200107105, a child assigned a remainder interest in a charitable lead annuity trust to her children (who were skip persons), in hopes of avoiding GST tax by becoming transferor over the trust because of the gift of the remainder interest. The ruling concluded that the child became the transferor for GST purposes of a portion of the trust equal to the present value of her remainder interest, and that the original grantor remained such for the balance of the trust. Carol said that the ruling does not make a thorough or careful analysis of the issues, and that if you advise clients in carrying out such a transaction, be sure they understand there are risks and that the desired results might not be obtained.

Dennis reviewed the Cook case (269 F.3rd 854), in which the 7th Circuit affirmed that revocable spousal interests in a GRAT do not reduce the value of the taxable gift because they are not "qualified interests." Of course, that holding is not so important in light of Walton, which allows GRATs to be zeroed out for gift tax purposes, even though the IRS has appealed Walton. Carol does not expect Walton to be reversed on appeal.

Carol observed that it is important when zeroing out a GRAT to have the balance of the interest payable to the grantor’s estate. But what do you do with that interest once it is in the estate? One way to deal with it is to have the annuity paid to the surviving spouse by a specific devise in the will or revocable trust. This certainly works. If the remaining term interest is devised to a QTIP trust, the QTIP trust should require payment to the surviving spouse of the greater of the annuity interest or the QTIP trust income. Having the grantor's estate retain the reversionary interest in the GRAT avoids the nondeductible terminable interest rules under section 2056, if the annuity interest is then devised to the spouse.

Jeff very briefly mentioned the True case ((82 TCM 27), a 270 page opinion dealing with the effect of a buy-sell agreement in fixing values for estate tax purposes. Jeff said that the opinion is of some relevance to older buy-sell agreements but that case is mostly a testament to an arrogant taxpayer.

Dennis mentioned PLR 200129018, which allowed a change in the operation of a business from a trust to an LLC without adverse effects under section 6166.

Jeff discussed savings clauses and FSA 200122011. The FSA said that a formula clause awarding any "excess" value in a transaction to charity was void as against public policy. However, Jeff felt that not all savings and formulas clauses are invalid. He contrasted the Procter case (142 F.2d 824), which invalidated a savings clause, with the King case which upheld the validity of a clause which required the parties to restructure the transaction if the values found by the government were not in accord with the values set by the parties. But Jeff also referred to the McLendon case (TC Memo 1993-459) in which the Tax Court said King was specifically clear in that there was no donative intent, and further that the Tax Court likely would not reach the same holding in King if it were presented again. So Jeff says that there is uncertainty about tax savings clauses and formula clauses today. Carol commented on how inconsistent it is for the government to take this position in this context, whereas it specifically blesses formula clauses in matters such as QTIP elections. Jeff said that he was not defending the government's position, but that the FSA and the McLendon cases are clear warning signs, but he supposes that including such clauses in documents doesn't hurt. Carol disagreed somewhat, saying that clients can get whipsawed – the result would be that a document would require an interest to be transferred to a charity or other party based upon an adverse valuation determination, whereas the government would not give recognition to the interest actually being transferred.

Jeff closed the presentation with a brief review of an equitable recoupment case (Mueller, 107 T.C. 189),which held that equitable recoupment can be used defensively against a valid claim but not offensively to collect a time barred underpayment or overpayment of tax. Carol observed the very need to resort to equitable doctrines in Tax Court is somewhat humorous, and that a better technique is to file protective claims for refund while there is still time.

That is it for Report No. 2. The full text of all the Reports will be posted on the ABA RPPT Web site at http://www.americanbar.org/groups/real_property_trust_estate.html.

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