Document ID#: 547200610058

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Recent Developments in Fiduciary Income Tax

AUTHOR: Newlon, Jeanne L.

PANEL: Recent Developments

DATE: 10/21/06 8:30a

COMMITTEE: Fiduciary Income Tax

RECENT DEVELOPMENTS IN FIDUCIARY INCOME TAX
April 30, 2006 – October 15, 2006
ABA Tax Section 2006 Annual Meeting
Denver, Colorado
October 21, 2006
Fiduciary Income Tax Committee

Jeanne L. Newlon, Esquire
Venable LLP
Washington, D.C.

U.S. Treasury Circular 230 Notice: Any tax advice contained in these materials (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties that may be imposed under the Internal Revenue Code or by any other applicable tax authority; or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein. We provide this disclosure on all correspondence to assure compliance with new standards of professional practice, pursuant to which certain tax advice must satisfy requirements as to form and substance.

Section 101 – Transfer for Value Rules

Private Letter Ruling 2006-36-086 (September 8, 2006) - Sale of an insurance policy by grantor to grantor trust does not cause inclusion in gross income under the transfer for value rules of Section 101(a)(2).

A created Trust 1 for the benefit of A's descendants. A's spouse, B, is the Trustee of Trust 1. B has the absolute discretion to distribute the net income and principal to A's descendants. Trust 1 is irrevocable. Trust 1 is a grantor trust for Federal income tax purposes.

A wishes to transfer, for valuable consideration, a variable universal life insurance policy to Trust 1. A originally purchased the policy and has paid all of the premiums.

Section 101(a)(1) provides that gross income generally does not include life insurance proceeds upon the death of the insured. If, however, the insurance policy is transferred for valuable consideration during the life of the insured, only an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequent paid by the transferee for the policy will be excluded from gross income. Section 101(a)(2).

The Service ruled that, because A is deemed the owner of the assets in Trust 1 for Federal income tax purposes, the sale is disregarded for Federal income tax purposes. Rev. Rul 85-13. Furthermore, because the sale is disregarded for Federal income tax purposes, the transfer is not a "transfer for value" within the meaning of Section 1.101-1(b)(4). Accordingly, the policy proceeds will be excluded from Trust 1's gross income under Section 101(a)(1).

Section 408 – Individual Retirement Accounts

Private Letter Ruling 2006-37-033 (September 18, 2006) – IRA payable to estate permitted to be rolled over into surviving spouse's IRA where surviving spouse sole executrix and sole beneficiary of estate.

D died before reaching age 70 1/2 owning an IRA. There was no record of a beneficiary designation for the IRA so D's estate became the beneficiary. Under D's Will, D's entire Residuary Estate was to be distributed to D's spouse, S. Accordingly, S, as the executrix of D's estate, planned to distribute the IRA to herself as the beneficiary of D's Residuary Estate and then roll over the proceeds into a spousal IRA within the required 60-day period following the distribution. However, an advisor from the firm that managed the IRA funds told S that she could not roll over the funds into a spousal IRA without first obtaining a private letter ruling. While trying to obtain the ruling, the 60-day period expired.

Section 408(d)(1) provides that, generally, any amount distributed from an IRA is includible in the gross income of the recipient. However, if such distribution is paid into an IRA for the benefit of the recipient within 60 days after the distribution, then no portion of the distribution is includible in the recipient's gross income. Section 408(d)(3). Section 408(d)(3) does not apply to individuals other than the surviving spouse when the IRA is acquired by reason of the death of another individual. Section 408(d)(3)(C). The surviving spouse may elect to treat the spouse's entire interest in the IRA as the spouse's own IRA. Section 1.408-8, Q&A 5. In order to make such election, the surviving spouse must be the sole beneficiary of the IRA and have the unlimited right to withdraw amounts from the IRA.

Generally, a surviving spouse may not elect to treat the decedent's IRA as the spouse's own IRA if the decedent's estate was the beneficiary of the IRA. This is the case even where the spouse is the sole beneficiary and sole executor of the decedent's estate. The Preamble to the Treasury Regulations, however, states that, if the surviving spouse actually receives a distribution from the IRA and rolls that distribution into her own IRA within 60 days of the distribution, then the rollover will be recognized so that the IRA is treated as the spouse's own IRA.

In this case, although the IRA was payable to D's estate, S is the sole residuary beneficiary and sole executrix of D's estate, S will cause the IRA proceeds to be distributed to S and then will transfer such proceeds to an IRA established in S's name. No third party can interfere with such transfers. Therefore, the Service ruled that S should be treated as the beneficiary of D's IRA for purposes of Sections 408(d)(1) and 408(d)(3). The Service then waived the 60-day rollover requirement and granted S 80 days from the date of the Ruling to contribute the IRA proceeds to her IRA.

Section 642 – Charitable Contribution Deduction

Brownstone v. United States, __F.3d__ (2d Cir. 2006) (2006 TNT 189-15) – Distribution pursuant to exercise of testamentary power of appointment does not qualify for income tax charitable contribution deduction under Section 642(c).

Lucien Brownstone's Will created a trust (the "Trust") for the benefit of his wife, Ethel, that was intended to qualify for the Federal estate tax marital deduction. The Trust provided that the Trustees may distribute any part or all of the income and/or principal of the Trust to Ethel. The Trust granted Ethel a testamentary general power of appointment to distribute the remaining Trust principal however she chose. If Ethel did not fully exercise the power of appointment, the remaining Trust property would be distributed to the Lucien and Ethel Brownstone Foundation, Inc.

Ethel died in 1996 and exercised the power of appointment by directing that the remaining Trust property be distributed to her estate. Ethel's Will provided that the Executor should pay the debts and expenses of her estate and make 48 cash bequests to specified family and friends. The remaining property in her estate was to be divided among eight charitable organizations.

Prior to distributing the remaining trust property to Ethel's estate, the Trust paid income tax in the amount of $313,375.01 for tax year 1996. Then the Trust distributed $1,000,000 to the Executor of Ethel's estate. In October 1998, the Trust filed an amended income tax return for 1996, treating the $1,000,000 distribution as a contribution for charitable purposes and sought a refunded for the income taxes paid in 1997. The IRS granted the trust a $74,413 refund but disallowed the remaining $228,401. The Trustee of the Trust filed a protest stating that the Trust was entitled to a full refund on the basis that the $1,000,000 distribution should be treated as a deductible charitable distribution under Section 642(c)(1). The IRS responded that it would not grant the refund because the Trust did not qualify for a charitable contribution deduction under Section 642(c)(1). The Trust filed a Federal action challenging the denial of the deduction.

The district court granted summary judgment to the government. The district court reviewed two questions in granting summary judgment: (1) what is the "governing instrument"? and (2) was the distribution of the Trust principal made "pursuant to" the governing instrument? On the first question, the district court ruled that Lucien's Will was the governing instrument, stating that the statute speaks in the singular so there can only be one instrument. On the second question, the district court held that the $1,000,000 distribution was not made pursuant to Lucien's Will relying on *Ernest and May Hayward Weir Foundation v. United States*, 508 F.2d 894 (2d Cir. 1974), where the district court held that, whether a distribution is made pursuant to the terms of a governing instrument turns on the intent expressed in that instrument. In light of this, the district court concluded that Lucien's Will did not express any intent to give the remaining funds in the Trust to charity. The Trust appealed the decision to the Court of Appeals.

The Trust bears the burden of showing it is entitled to the charitable contribution deduction. Under Section 642(c)(1), the Trust is entitled to the deduction if the gift was "pursuant to the terms of the governing instrument[,]...paid for a purpose specified in Section 170(c)."

The Court relied on two cases in its analysis. First, in *Old Colony Trust Co. v. Comm'r*, 301 U.S. 379 (1937), the Supreme Court held that the governing instrument does not need to actually direct the charitable contribution claimed as long as the instrument expressed some charitable intent. The second is *Ernest and Mary Hayward Weir Foundation v. United States*. In that case, Ernest Weir established a trust for the benefit of his wife, Mary. Under the trust, Mary was granted an unrestricted general testamentary power of appointment. Mary's Will provided that the remaining trust principal be distributed to charity upon her death. Thus, the trust filed a claim for refund under Section 642(c)(1) stating that the trust was entitled to a charitable contribution deduction for the distribution by the trust to the charities directed under Mary's Will. The Second Circuit agreed with the district court that the trust property was not paid or permanently set aside for a charitable purpose pursuant to the governing instrument as required by Section 642(c). Therefore, the refund was denied.

In light of these cases, the Second Circuit affirmed the district court's decision and denied the Trust's refund. To reach this conclusion, the Second Circuit first sought to identify the governing instrument. The Trust argued that Ethel's power of appointment, alongside Lucien's Will was the governing instrument. The Trust cited the language of the predecessor to Section 642(c)(1). That provision referred to the "will or deed creating the trust". Section 642(c)(1) refers to the "governing instrument". The word "governing" means controlling. Thus, Ethel's power of appointment combined with Lucien's Will governs as together they control the distribution.

The government states that the predecessor language and the current language in the statute are comparable. Furthermore, *Weir Foundation* and *John Allan Love Charitable Foundation v. United States*, 710 F.2d 1316, 1319 (8^{th} Cir. 1983) have interpreted the term "governing instrument" to mean the "will or deed creating the trust". Thus, Lucien's Will, which created the Trust, is the governing instrument.

The Second Circuit did not find either argument sufficiently persuasive to stand on its own. It noted that in *Weir Foundation*, the parties conceded that the Will was the governing instrument. Also in *John Allan Love,* the parties agreed that the trust instrument was the governing instrument. Because they assume rather than interpret the meaning of governing instrument, the cases were not very helpful.

Nevertheless, the Second Circuit believes that the combination of the power of appointment and Lucien's Will to be the governing instrument "strains the statute's text". It noted that, where doubt exists, the courts should resolve the dispute in favor of the government, citing to *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1996). The Court further stated that Congress has not made it clear that a subsequent instrument when combined with the original instrument could together be considered the "governing instrument". Because there is no such provision, Ethel's power of appointment combined with Lucien's Will cannot qualify as the governing instrument. Therefore, the Court held that the governing instrument is Lucien's Will alone.

The Court then reviewed whether the distribution was made "pursuant to" Lucien's Will. A distribution is made "pursuant to" an instrument if done "in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according." *Old Colony*, 301 U.S. at 383-84. The instrument "must be shown to possess some positive charitable intent or purpose of the settlor-not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty." *Weir Foundation*, 362 F. Supp. at 939. According to the Court, Ethel's Will did not make the charitable distribution pursuant to the terms of Lucien's Will because Lucien's Will does not "express sufficient charitable intent with respect to the Trust principal." Lucien's Will gave Ethel a power to appoint the remaining trust property in any way she desired. Thus, only if Ethel chose to appoint the property to one or more charitable organizations would the property pass to charity. The choice was solely up to Ethel, Lucien's Will could not bind her to any action. Therefore, Ethel did not make her distribution pursuant to the governing instrument.

<u>Section 664 - Charitable Remainder Trusts</u>

<u>Chief Counsel Advice 2006-28-026 (August 8, 2006)</u> – Trust that pays amounts to Trustee, Trustee's wife and third parties and allows Trustee to use real property owned by the trust rent free does not qualify as charitable remainder unitrust.

A created a trust intending it to be a charitable remainder unitrust (CRUT). During the trust term, the Trustee writes checks from the trust's checking account to himself, his wife and third parties on a random but ongoing basis. In addition, the Trustee uses real estate owned by the trust rent free. Finally, the trust prepaid the Trustee's rent for ten years in a building owned by a third party. The issue is whether the trust should continue to be treated as a CRUT.

In order to qualify as a CRUT, Section 664(d)(1)(B) states that the trust cannot pay any amount other than the unitrust amount to or for the use of any person other than a qualified charitable organization. If, however, such amount is transferred for full and adequate consideration, then the amount so paid is not deemed to be paid to or for the use of a person other than a qualified charitable organization. Section 1.664-3(a)(4).

In this case, the Trustee, his wife and third parties are not qualified charitable organizations. Therefore, because the trust is making a payment other than the unitrust amount to or for the use of a person other than a qualified charitable organization, the trust does not qualify as a CRUT. However, the trust provides for the payment of the unitrust amount to A from the trust's income. A is the grantor of the trust. Section 677 provides that, if income may be distributed to the grantor of the trust, the trust is a grantor trust for Federal income tax purposes. Accordingly, the trust is a grantor trust and A is treated as the owner of the trust for Federal income tax purposes.

Section 671-678 – Grantor Trusts

Private Letter Ruling 2006-06-006 (February 13, 2006) – Power of substitution exercisable in fiduciary capacity does not cause inclusion in estate for estate tax purposes and no gift for gift tax purposes.

A established an irrevocable trust with cash and marketable securities. A named B as Trustee. B is not a descendant of A and is not otherwise related or subordinate to A within the meaning of Section 672(c). During A's life, the Trustee may distribute the trust income and principal to A's spouse for any purpose. Upon A's death, the Trustee must distribute the trust income and principal to A's spouse for her health, maintenance and support and may distribute any additional trust income and principal for any purpose. A's spouse has a lifetime limited power of appointment to appoint trust property to any of A's issue, but A's spouse may not use the power of appointment to discharge her obligation of support. Upon A's spouse's death, A's spouse has a testamentary limited power of appointment over the remaining trust property. A's spouse has a Crummey power over contributions to the trust. Finally, A has a power of substitution over the trust assets that may only be exercised in a fiduciary capacity. This means that such power must be exercised in good faith, in the best interests of the trust and its beneficiaries and subject to fiduciary standards under applicable state law.

A wishes to exercise the power of substitution by transferring publicly traded stock in Company B to the trust in exchange for publicly traded stock in Company C currently owned by the trust. If necessary, A will transfer or withdraw, as the case may be, cash so that the value of the property transferred to the trust equals the value of the property transferred from the trust.

The first issue was whether the retained power of substitution causes the trust property to be included in A's estate for Federal estate tax purposes. The Service stated that, because A's power to reacquire trust property may only be exercised in a fiduciary capacity, the retention of such power will not cause the trust property to be included in A's estate under Sections 2033, 2036(a), 2036(b), 2038 or 2039.

The second issue was whether the transfer of the stock in Company B and possibly some cash to the trust will be treated as a gift. The Service ruled that, because the value of the assets transferred to the trust will be equal to the value of the assets transferred from the trust, the exercise of the power of substitution will not constitute a gift to the trust for Federal gift tax purposes.

Finally, the last issue was whether the trust should be treated as a grantor trust for Federal income tax purposes. Section 677(a) provides that the grantor is treated as the owner of the trust for Federal income tax purposes if the income may be distributed to or held for future distribution to the grantor or the grantor's spouse by the grantor or a nonadverse party without the approval of an adverse party. Here, the income may be distributed to A's spouse. Therefore, A is treated as the owner of the trust for Federal income tax purposes.

The Service reviewed Section 678. Section 678(a) states that a person other than the grantor will be treated as the owner of the trust for Federal income tax purposes if such other person has a power to vest the trust principal or income in himself. In this case, A's spouse has a Crummey power. However, Section 678(b) states that Section 678(a) does not apply if the grantor of the trust is treated as the owner of the trust. As noted above, A is treated as the grantor of the trust under Section 677. Therefore, Section 678(a) does not apply.

Private Letter Ruling 2006-27-003 (August 7, 2006) – Where income held to satisfy legal obligation, trust is a grantor trust under Section 677.

X is developing a project approved by a government agency. According to the Record of Decision and Plan Approval of the agency, X must set aside and invest funds to ensure sufficient funds for the implementation of the plan for the project. To do this, X created and funded a trust. All of the income and principal of the trust is held to satisfy X's legal obligation to monitor and mitigate potential groundwater impacts from the project. Upon the termination of the trust, the remaining trust assets must be distributed to X. The agency, however, may direct that the remaining trust property be distributed to a person other than X for use in accordance with the plan. If X is no longer in existence, the agency may withdraw all trust income.

Under Section 677, a grantor is treated as the owner of the trust where the income may be distributed to or held for future distribution to the grantor without the approval or consent of any adverse party. In addition, if trust income may be applied in discharge of a legal obligation of the grantor in the discretion of the grantor or a nonadverse party, then the trust is a grantor trust for income tax purposes. Section 1.677(a)-1(d).

Here, the trust income is held to satisfy X's legal obligation to monitor and mitigate potential groundwater impacts. Upon termination of the trust, all trust property will be distributed to X. Thus, X is the grantor and owner of the trust under Section 677.

Private Letter Ruling 2006-37-025 (September 19, 2006) – Trust not a grantor trust where grantor can decide on distributions of trust income and principal because decisions must be made with consent of an adverse party.

A created an irrevocable trust. A Distribution Committee consisting of A's father and A's brother determine how the trust property is distributed during A's lifetime either by unanimous decision of the members of the Distribution Committee or by the unanimous decision of one member of the Distribution Committee and A. Distributions may be made to any of the following individuals, designation as the "Class": A, A's spouse, A's father, A's mother, any descendants of A's parents and any qualified charity. The Distribution Committee must always have two members, each of whom must be a member of the Class. Neither A nor A's spouse may be members of the Distribution Committee. Upon A's death, A has a limited testamentary power of appointment to distribute the trust property to any individual(s) or entity(ies) other than A, A's estate, A's creditors or the creditors of A's estate.

The primary issue is whether A should be treated as the owner of the trust under any of Sections 673, 674, 675, 676 or 677.

Section 673 provides that the grantor is treated as the owner of the trust if the grantor has retained a reversionary interest in the trust and the value of such interest exceeds 5 percent of the value of the trust. In this case, no portion of the trust can revert to A. Therefore, Section 673 does not apply to the trust.

Section 674 provides that the grantor is treated as the owner of a trust if the grantor or a nonadverse party or both control the disposition of the trust property without the consent of an adverse party. Section 672(a) defines an adverse party as any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of a power. Here, although A may make distribution decisions, A only may do so with the consent of a member of a Class. Each member of the Class is an adverse party. Therefore, Section 674 does not apply.

Under Section 675, a trust is treated as a grantor trust if any of the following administrative powers are present: (1) the grantor can deal with the trust principal for less than full and adequate consideration; (2) the grantor may borrow trust property without adequate interest or adequate security; (3) the grantor actually borrows trust property without adequate interest or adequate security; or (4) the grantor retains certain powers to vote stock, control investments or substitute property. Each power must be exercisable by the grantor or a nonadverse party without the consent of an adverse party. In this case, none of the administrative powers are included in the trust. Thus, Section 675 does not apply. However, the actual operation of the trust must be examined as well to see if Section 675 applies.

Section 676 provides that the grantor is treated as the owner of a trust if the grantor or a nonadverse party has the power to revest trust property in himself. A does not have the right to revoke the trust. Therefore, Section 676 does not apply.

Finally, Section 677 states that the grantor is treated as the owner of a trust if the grantor or a nonadverse party or both may, without the approval of an adverse party, distribute or hold for future distribution trust income to the grantor or the grantor's spouse. In this case, income may be distributed to A and A's spouse. However, such power of distribution is only exercisable with the consent of an adverse party. Therefore Section 677 does not apply.

Field Attorney Advice 20062701F (July 7, 2006) – Where trust agreement authorizes purchase of life insurance on grantor, trust considered grantor trust under Section 677(a)(3) even if no insurance is actually purchased on life of grantor.

The taxpayer, A, is the President and Chairman of a corporation. A entered into trust arrangement ("Trust X") designed to save transfer taxes and transfer assets offshore. The Trustees of Trust X were subject to A's control: (1) L, the vice president of the corporation, who was A's immediate subordinate at the corporation; and (2) M, a longtime acquaintance of A, who was A's tenant and provided professional architectural services to A. The beneficiaries of Trust X were A's spouse and children, all of whom are U.S. persons.

Trust X created a new trust, Trust Y, in a country other than the U.S. A third person, E, is the Trustee of Trust Y. L was named as the trust protector, with M as the successor trust protector. E had to obtain written consent from the trust protector of all actions taken with respect to Trust Y. A retained the right to appoint a new trust protector at any time. A's spouse and children are the beneficiaries of Trust Y. Trust Y purchased a life insurance policy on A. To pay the premiums, A would transfer funds to Trust X and the Trustee of Trust X would pay the premiums to the insurance company. The policy owned the stock of D, which was formed in a foreign country and reformed in another foreign jurisdiction. A entered into a private annuity agreement with D, by which A transferred shares in the corporation to D in exchanged for a private annuity policy.

A also entered into a OEL Agreement that resulted in assets being indirectly transferred to Trust X as follows: (1) premium payments to the insurance companies by Trust X; (2) transfer of shares of stock in the corporation to D in exchange for a private annuity policy; and (3) transfer of funds from the corporation through various entities to D's bank accounts.

The primary issue in this case was whether the taxpayer was required to file information returns under Section 6048 with respect to Trust Y, a foreign trust. Section 6048(a) provides that any U.S. person who gratuitously transfers property to a foreign trust must report such transfer on Form 3520. If the transferor does not file Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts), the transferor will be subject to a penalty equal to 35% of the gross value of the property transferred. Section 6677(a).

Section 677(a)(3) provides that the grantor is treated as a the owner of a trust for Federal income tax purposes if the income of the trust may, in the discretion of the grantor or a nonadverse party, be applied to the payment of premiums on insurance policies on the life of the grantor or the grantor's spouse. The decision to use such income must be made without the consent or approval of an adverse party. In this case, Trust X authorizes the trustee to purchase insurance on A's life without any limit on the amount the trustee may apply to the premiums. Thus, Section 677(a)(3) applies and Trust X is a grantor trust for Federal income tax purposes and A is treated as the owner of Trust X's assets for Federal income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184.

Under Section 679(a)(1), when a taxpayer directly or indirectly transfers property to a foreign trust, the taxpayer is treated as a owner of the portion of the trust attributable to the property transferred by the taxpayer. This rule applies only if there is a U.S. beneficiary of the foreign trust. Here, the Service is treating Trust X as a grantor trust. Applying the doctrine of economic substance to the transactions involving Trust X, Trust X is disregarded for Federal income tax purposes. Therefore, A is treated as making the transfers to Trust Y. The beneficiaries of Trust Y are A's spouse and children, all of whom are U.S. persons. Therefore, under Section 679(a)(1), A is treated as the owner of Trust Y to the extent of any property A caused to be transferred to Trust Y or to any entity in which Trust Y holds an ownership interest.

Section 691 – Income in Respect of a Decedent

Private Letter Ruling 2006-20-025 (May 24, 2006) – Distribution of IRA to special needs trust not considered a transfer under Section 691(a)(2).

A died at age 69 owning an IRA naming his four sons as equal beneficiaries. A’s son, B, is disabled and B’s mother, C, is his legal guardian. B is eligible to receive Medicaid and other public benefits, which he could lose if he owns an interest in the IRA directly. Thus, the IRA custodian established three separate sub-IRAs for B’s three brothers. One-fourth of the IRA remained in the original IRA, with only the required minimum distribution being made to B’s guardian.

The state court then authorized the creation of a trust for B’s benefit intending to qualify as a special needs trust so that the trust assets will not be considered B’s assets for purposes of determining his eligibility to receive public benefits. C is the Trustee of the trust and B is the sole beneficiary. C has complete discretion over distributions to B. Upon B’s death, any property remaining in the trust will be distributed to the State Department of Children and Families to the extent necessary to satisfy the medical assistance the department paid for B’s benefit during his life. Any remaining trust property will be distributed to B’s heirs under state law (other than C, as C disclaimed her rights).

C wants to transfer B’s one-fourth share of the IRA to an IRA benefiting the trust.

The first issue is whether such transfer will be disregarded for Federal income tax purposes and will not be considered a transfer under Section 691(a)(2). IRD includes any income that the decedent was entitled to receive at the time of the decedent's death, but was not includable in the decedent's gross income before death, and that was received after the decedent's death by a taxpayer as the decedent's successor in interest. Section 691(a)(1). If a right under Section 691(a)(1) is transferred by the estate or person who received such right by the decedent’s death, the estate or such person must include in gross income the fair market value of such right plus any consideration received in excess of fair market value. Section 691(a)(2). A distribution of the remaining balance of a decedent’s IRA to the beneficiary, less any nondeductible contributions, is IRD and thus includible in the beneficiary's gross income. Rev. Rul. 92-47, 1992-1 C.B. 198.

The trust created for B's benefit, however, is a grantor trust for Federal income tax purposes under Section 677(a) because income may be distributed or accumulated for the future distribution to B, the grantor of the trust. Under Rev. Rul. 85-13, 1985-1 C.B. 184, if the grantor is treated as the owner of a trust, the transfer of the grantor's assets to the trust is not recognized as a sale or disposition for Federal income tax purposes. Accordingly, because the trust is a grantor trust, the transfer of B's share of A's IRA to the trust is not a sale or disposition for Federal income tax purposes and not a transfer for purposes of Section 691(a)(2).

The second issue is whether the Trustee may calculate the annual distributions using B's life expectancy. The IRS ruled that, because the trust is a grantor trust, the trustee may use B's life expectancy for purposes of calculating the required minimum distribution.

Section 1361 – S Corporation Defined

S Corporation Reform Act of 2006 (Senate Bill S. 3838) –

On August 3, 2006, Senators Orrin Hatch (R-Utah) and Blanche Lincoln (D-Ark.) introduced the S Corporation Reform Act of 2006. The primary amendment would allow nonresident aliens and IRAs to be shareholders in S corporations.

In addition, the new law would change the current law so that preferred stock would not be treated as a second class of stock. The House Small Business subcommittee has stated that it believes this would help families retain control of family businesses.

There also are proposed changes to the taxation of S corporations. Specifically, the law would increase the passive income percentage from 25 to 60 percent of gross receipts before such income is subject to tax under Section 1375 and reduce the tax rate to 15% on the excess net passive income. There is also a proposal to eliminate the provisions in Section 1362 that cause a corporation's S status to be terminated when it receives excessive passive income.

Finally, S. 3838 would amend Section 1446 so that S corporations will no longer be required to withhold tax on income that is allocated to an electing small business trust.

This bill was referred to the House Ways and Means Committee and no further action has been taken.

S Corporation Reform Act of 2005 (H.R. 4421) –

The S Corporation Reform Act of 2005 was introduced by Rep. E. Clay Shaw (R-Fla.) on November 18, 2005. This bill proposed the following:

- Reducing the built-in gain recognition period from 10 years to 7 years
- Permitting the issuance of preferred stock and convertible debt
- Eliminating the provisions that cause a corporation's S status to be terminated when it receives excessive passive income
- Increasing the passive income percentage from 25 to 60 percent
- Repealing the passive income capital gain category
- Allowing IRAs to become shareholders
- Allowing nonresident aliens to become shareholders

This bill was referred to the House Ways and Means Committee and no further action has been taken.

Private Letter Ruling 2006-37-024 (September 18, 2006) – Although trust agreement does not require that all income be distributed to beneficiary, because all income is actually distributed to beneficiary, trust qualifies as QSST.

Trust A owns stock in an S corporation. All of the net income of Trust A is to be used as required or necessary for the support and maintenance of B. If the net income does not equal a certain dollar amount each year, the Trustee may distribute principal to B for emergency purposes. No distributions may be made to anyone other than B during B's lifetime. In addition, the Trustees actually distribute all of the net income of Trust A to B, at least annually. Upon B's death, Trust A will terminate, and the remaining property in Trust A will be distributed to B's children.

The issue is whether Trust A meets the requirements of a Qualified Subchapter S Trust ("QSST"). Section 1361(d)(3)(A) sets forth the requirements for a trust to qualify as a QSST. To qualify as a QSST, (i) the trust must have only one income beneficiary during the life of the current income beneficiary, (ii) distributions of principal may only be made to the current income beneficiary, (iii) the income interest of the current income beneficiary must terminate on the earlier of the death of the current income beneficiary or the termination of the trust and (iv) if the trust terminates during the life of the current income beneficiary, the trust assets must be distributed to the current income beneficiary.

In this case, as long as all of the income of Trust A is distributed to B each year, Trust A will qualify as a QSST.

Section 1362 – Inadvertent Terminations of S Corporation Status

Private Letter Ruling 2006-38-004 (September 26, 2006) – Trust provisions did not meet requirements for QSST but because trust was administered as QSST, corporation did not lose S corporation status.

Upon A’s death, A’s Will provided that shares in an S corporation were transferred to a trust. The trust provided that the income beneficiary could designate a person other than herself to receive distributions of the trust principal. However, during the term of the trust, the trust always only had one beneficiary.

Section 1361(d)(3) provides that, in order to qualify as a QSST, there may be only one beneficiary. The ability to appoint property to another person caused the trust to fail this requirement. Because the beneficiary never exercised the right to appoint the trust property to another person, the trust was deemed to qualify as a QSST and the corporation's termination of S status was inadvertent under Section 1362(f).

<u>Speaker Biography</u>

Jeanne L. Newlon is a Partner with the law firm of Venable LLP, in Washington, D.C. Her practice involves advising individuals of significant means on estate and gift planning issues, including business succession, charitable planning, and planning with life insurance. Jeanne received her J.D. from The George Washington University with High Honors, her L.L.M. in Taxation from Georgetown University and her B.S.B.A. with a degree in Finance from the University of Florida. Jeanne is a member of the District of Columbia Estate Planning Council, Co-Editor of the Council's newsletter and Co-Chair of the Communications Committee. She also was named as a 2005-2006 John S. Nolan Fellow by the ABA Section of Taxation. Jeanne is licensed to practice in the District of Columbia, Maryland, Florida and Virginia.