STRING INCLUSION: FINAL REGULATIONS ON 2036 AND 2039

By

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A little over a year ago, on June 6, 2007, the Treasury and IRS published proposed regulations on what part of a trust is includable in a deceased settlor's estate under Sections 2036 or 2039 if the settlor retained an interest in the trust property – a so-called "string." This past month, Treasury finalized those regulations (TD 9419, issued July 11, 2008, effective July 14, 2008).

Major Points. Four major points can be made:

(a) inclusion will be computed under section 2036 and its newly amended Reg.Sec. 20.2036-1;

(b) inclusion will not be addressed or computed under section 2039, so says newly amended Reg.Sec. 20.2039-1;

(c) other sections of the Code, such as sections 2035 through 2039, can still be applied where the IRS thinks appropriate (at least one example illustrates that point); and

(d) the amount to be included is not the present value of the stream of payments.

Trusts Addressed. The trusts addressed by the regulations all have two things in common: (a) the settlor set up the trust; and (b) the settlor retained some income or other right. The trusts come in many different varieties, from certain charitable remainder trusts (CRTs) such as charitable remainder annuity trusts (CRATs) within the meaning of section 664(d)(1), charitable remainder unitrusts (CRUTs) within the meaning of section 664(d)(2) or (d)(3), and charitable remainder trusts that do not qualify under section 664, as well as other trusts established by a grantor (collectively GRTs) such as grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs), and various forms of grantor retained income trusts (GRITs), such as qualified personal residence trusts (QPRTs) and personal residence trusts (PRTs). A CRT is within the scope of the regulations whether or not the CRT met the qualifications of section 664(d)(1), (d)(2), or (d)(3) because either the CRT was created prior to 1969, there was a defect in the drafting of the CRT, there was no intention to qualify the CRT for the charitable deduction, or for any other reason. A GRT is within the scope of the regulations whether or not the grantor's retained interest was a "qualified interest" as defined in section 2702(b).

The Basic Computation. Basically, the new regulations say that the amount includable is determined by taking the stream of payments the decedent was supposed to receive, and then, using the 7520 rate, determining what amount of money would be required to produce that stream of income. The 7520 rate to be used is the one in effect at the death of the decedent (or the alternate valuation date, whichever is applicable). If the payments were to be made at other intervals, then the appropriate adjustment factor or

7520 rate for payment frequency, whether semiannual, quarterly or monthly, is to be used.

The above computation gets more complicated when dealing with unitrusts. The inclusion amount is determined by dividing the trust's equivalent income interest rate by the section 7520 rate. The equivalent income interest rate is determined by dividing the trust's adjusted payout rate by the excess of 1 over the adjusted payout rate.

After the computation, if the principal needed is less than 100% of the value of the trust, the estate inclusion is the lesser amount. If the principal needed is computed to be more than 100% of the trust, then the amount includable in the settlor’s estate is limited to the value of the trust assets.

Comments. The proposed regulations were the subject of multiple comments. One commonly made objection was inclusion should be computed by reducing to present value the stream of payments, rather than the above computational method which can cause 100% inclusion. And if the present value is zero, then the stream of payments must have been purchased for full and adequate consideration and, therefore, there should be no inclusion. But the Service argued that section 2036 is the applicable section, and, because of that, the Service said 2036 was originally adopted by Congress, and has been interpreted since then, to cause inclusion of the value of the asset as to which a “string” was held back by the grantor, not the value of just the string.

Similarly, when a commentator suggested that section 2036 applies only to the extent that the trust principal alone is insufficient to fully satisfy the annuity payment, the IRS and Treasury Department responded by saying that this would condition the estate tax treatment on the nature and performance of the investments selected by the trustee, and the application of section 2036 should not be dependent on either the trustee's exercise of his or her discretion to invest in income or nonincome producing assets, or the actual performance of the trust assets.

And where the remainder interest in a trust is zero, some suggested that the full and adequate consideration clause of section 2036 should apply, and, therefore, there should be no inclusion. But Treasury and the IRS argued that there is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a trustee. The former includes negotiation and agreement between two parties operating in his own interest, but when a grantor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property, and there is no other property owner negotiating for his own best interests. All of there terms are dictated by the transferor, and the transferor is retaining certain rights, whether possession, enjoyment in another form, or income. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036.

A commentator requested that the regulations address the formulas used to determine a pooled income fund's rate of return, and thus the value of the charitable gift, saying that funds that are at least three years old use the highest of the three last taxable years' rates of return, and funds that are less than three years old generally use the highest of the three calendar-year annual averages of the section 7520 rates minus 1 percent. See section 1.642(c)-6(e)(3) and (4). But Treasury and the IRS said this distinction based on the duration of the fund is not relevant because the retained interest is the right to all of the income, thus mandating the inclusion of the entire share of the fund's corpus attributable to the transferor. But a pooled income fund example was added for clarification.

Some commentators requested specific types of examples, or changes to examples. One request was for an example on how the alternate valuation date rules in Reg. Sec. 20.2032-1(d) affect the trust's value, but Treasury declined to deal with that, saying any such example should go into those regulations. Another request was to have examples or discussions of what happens when a donor creates a CRT for a term of years, and Treasury responded by modifying its examples, and concluded that a term of years CRT versus a lifetime CRT makes no difference on the amount includable. And a request for an example of how to deal with a graduated GRAT was thought to be a good idea, but Treasury declined to create one now, citing the need for further consideration. A similar response was given in response to a request that the example in the existing, non-amended part of the regulations at Reg. Sec. 20.2036-1(c)(1)(ii) be re-written to change the reference to a spouse with a child to avoid complications with section 2523.

Examples. The illustrations are very helpful. For example, Example 1 in the annuity-unitrust section, a CRAT is funded with $100,000, and the annual annuity payment back to the settlor is $7,500, with the annuity continuing after settlor dies for the settlor's child for life. At the settlor's death, the trust has grown to $300,000, the 7520 rate at that time is 6%, and the child is 40 years old. Only $125,000 is required, at 6%, to pay $7,500 per year, so only $125,000 is includable in the estate. And the result is the same if the settlor had relinquished his annuity payment within 3 years of death because of section 2035. The child's age is of no importance. If the settlor could change the charitable remainderman or revoke the child's annuity, then section 2038 might apply. And, finally, because of these new regulations, section 2039 does not apply.

Example 2 illustrates a 10 year CRAT with monthly payments. Example 3 is a CRUT, and shows how a computation that exceeds the trust assets can occur (the inclusion is limited to the assets in the trust). Example 4 illustrates a 15 year GRIT. Example 5 shows how to deal with a pooled income fund. And Example 6 shows full inclusion of a residence in a QPRT.

Revenue Rulings Now Obsolete. Rev. Rul. 76- 273, 1976-2 C.B. 268, and Rev. Rul. 82-105, 1982-1 C.B 133, are spotlighted in the preamble of the regulations. Basically, the IRS explained that these rulings could have provided a means for claiming only a part of the value of a trust in the decedent's estate. The IRS explained that the new regulations are designed to incorporate those rulings into the regulations, and, in doing so, render them obsolete.

NO DISCOUNTS FOR RMAs

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Restricted Management Accounts, or RMAs, are considered by many to be a simple, yet effective, means of discounting assets, particularly, stocks and cash, without the need for complex limited partnerships agreements or split-ownership planning. A parent might deposit stocks and bonds into an RMA for a fixed term, perhaps five years. By agreement, the institution, whether a bank or brokerage company, manages the account. It has discretion over the investments, while the person who established the account retains only a property interest in the assets. The RMA cannot be canceled, but the person who set up the account can transfer, with the consent of the institution, the rights of the creator of the account to a family member, a trust, or other permitted transferee. Typically, parents have used RMAs, funding them and then gifting interests in them to children. The restrictions on access to the account are that the parent holds an asset that has a lesser or discounted value and, thus, the gift of an interest in the account to a child or other is a discounted value gift.

While certain commentators earnestly believe that RMA discounts are viable and, if litigated, would be upheld, nonetheless, the Internal Revenue Service has ruled in Rev. Rul. 2008-35, 2008-29 IRB116, that an interest in an RMA is to be valued for transfer tax purposes without any reduction or discount on account of the restrictions imposed by the RMA agreement. For this reason, Reg. Sec. 20.2031-2(g) provides that if a decedent holds a trading account with a broker, all securities belonging to the decedent and held by the broker at the date of death must be included at their fair market value as of the applicable valuation date, even if pledged to secure a debt. Similarly, Reg. Sec. 20.20315 says that the amount of cash belonging to a decedent at the date of death, whether in the possession of the decedent or another person, or deposited with the bank, is included in the gross estate.

The IRS took the position that an RMA agreement is merely a management contract between the owner of the property and the person agreeing to serve as the property manager, whether a broker, bank or other. The restrictions imposed by the RMA agreement relate primarily to the performance of the management contract, and do not place substantive restrictions on the underlying assets. Any restrictions in the RMA agreement on the ability of the depositor to withdraw assets, terminate the agreement, or transfer interests do not impact at all the price of those assets and, thus, do not affect the value of the assets in the RMA for gift or estate tax purposes. The Service reasoned that a RMA is comparable to a retirement fund or an Individual Retirement Account. They cited the cases of *Estate of Smith v. United States*, 391 F.3d 621 (5th Circuit 2004) and *Estate of Kahn v. Commissioner*, 125 TC 227 (2005) where courts reached the conclusion that assets in retirement accounts, which are subject to restrictions, are not entitled to any discount. From that, the Service concluded that assets in an RMA are not subject to any discount either.

S CORPS CORPORATION OWNED LIFE INSURANCE (C.O.L.I): NO ACCUMULATED ADJUSTMENT ACCOUNTS (AAA) EFFECT

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Estate planners commonly deal with clients who own interests in S corporations. Many times the planning involves life insurance to provide funds to pay off debts to lenders, or to provide a means for the corporation to survive at the death of the S corporation shareholder, or for other reasons. Those companies purchase and maintain S corporation-owned life insurance, generally referred to as "C.O.L.I." or, in this case "S.C.O.L.I." A question that has been raised from time to time is the impact of the payment of premiums for S.C.O.L.I. on the "accumulated adjustment accounts," or "AAA." AAA track the amount of undistributed income that has been taxed to the S corporation shareholder, similar to the manner in which E&P generally tracks a C corporation's undistributed income. AAA are the mechanism that allows previously-taxed but undistributed income to be distributed tax-free to S corporation shareholders to the extent of the shareholders' basis in their stock. If the payment of premiums reduces the AAA, then the S corporation's shareholders can take fewer distributions tax free.

Rev. Rul. 2008-42, 2008-30 IRB1, answers the question in a positive way for taxpayers, saying that the payment of premiums does not reduce AAA. As a result, the undistributed income accounted for in AAA is not reduced, and the shareholders may continue to take that amount tax free to the extent of their basis. The Service reasoned that Sec. 264(a)(1) prohibits the S corporation from taking a deduction for premiums paid on any life insurance, endowment or annuity contract if the S corporation is directly or indirectly a beneficiary. Similarly, Reg. Sec. 1.264-1(a) provides that premiums paid for life insurance on the life of any officer, employee or other person financially interested in a business carried on by the taxpayer, including an S corporation, are not deductible where the S corporation is directly or indirectly a beneficiary of the policy.

Reg. Sec. 1.1368-2, provides for the calculation and maintenance of AAA. It says that AAA are generally decreased by certain items of loss or deduction, including any non-deductible expense not properly chargeable to a capital account. Because premiums on life insurance are not deductible, then that portion of the regulation would indicate that the AAA should be reduced by those premiums.

However, the Service cited Reg. Sec. 1.1366-1(a)(2)(viii) which provides that, for the purposes of Subchapter S, <u>tax-exempt income</u> is permanently excludable from gross income in all circumstances. Normally, we might think of income from municipal bonds as tax-exempt. But, the Service reasoned that death benefits are also tax-exempt income. Sec. 1368(e)(1)(A) regulations under that, previously cited, say that the non-deductible expenses referred to above reduce AAA, <u>unless</u> the expenses are related to tax-exempt income. Since the premiums are related to the life insurance death benefits, and because the death benefits are tax-exempt income, even though the premiums are non-deductible and are not properly chargeable to a capital account and, thus, otherwise would reduce AAA, the exception for expenses related to tax-exempt income means that AAA are not reduced by those premiums.

This ruling is important. Without it, some would have suggested that having the S corporation buy, pay for, and be the beneficiary of, a life insurance policy, would have a double-negative effect: (1) the payment of the premiums would not be deductible; and (2) the payment would reduce AAA, thus making distributions taxable that otherwise would not have been. With this ruling, that double-negative effect is eliminated. The premiums are still not deductible; thus, the income used to pay them is still taxable, not being offset by any such deduction. But, at least the premiums don't increase the amount of tax on distribution from AAA as previously suggested.

SAMPLE CHARITABLE LEAD UNITRUST FORMS FROM IRS

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The Treasury and Internal Revenue Service are continuing in a project to provide sample forms for various uses that the IRS has determined are acceptable and can be used without being challenged by them. Most recently, the Service has issued two Revenue procedures: Rev. Proc. 2008-45, 2008-30 IRB224, and Rev. Proc. 2008-46, 2008-30 IRB238, both released July 28, 2008. In those, the Service is providing sample Charitable Lead Unitrust Forms. The first Rev. Proc. provides inter vivos forms and the second provides testamentary forms.

The forms are annotated and explain their purposes. For example, in the first of those two Revenue procedures, the IRS defines the Charitable Lead Unitrust Form as "an irrevocable split interest trust that provides for a specified amount to be paid to one or more charitable beneficiaries during the term of the trust. The principal remaining in the trust at the end of the term is paid over to, or held in a continuing trust for, a non-charitable beneficiary or beneficiaries identified in the trust." The annotations continue by giving guidance on whether and to what extent there may be charitable deductions, and the annotations explain, in the inter vivos trust forms, the difference between a grantor CLUT and a non-grantor CLUT.

In both of the Revenue procedures, the IRS has indicated that, in general, it will not issue private letter rulings for the inter vivos or testamentary CLUTs to the extent that they use these standard forms. They did, however, say they would issue letter rulings related to the tax consequences of the inclusion in the CLUT document of substantive trust provisions other than those contained in the sample documents.

These unitrust forms complement the Charitable Lead Annuity Trust Forms, both inter vivos and testamentary, issued on June 22, 2007, in Rev. Proc. 2007-45, 2007-29 IRB1, and Rev. Proc. 2007-46, 2007-29 IRB1.

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e|Report

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Group and Committee News

Employee Benefit Plans and Other Compensation Arrangements Group

The RPTE Employee Benefit Plans and Other Compensation Arrangements Group is hosting and co-hosting several programs at the RPTE/Tax Section Joint Fall CLE Meeting to be held in San Francisco September 11-13.

Programs include:

• PBGC, Underfunded Plans & Distressed Companies: A Practical Guide at 10:30 a.m. on September 12
• Health Plan Design and Compliance Issues at 2:00 p.m. on September 13
• Reporting & Disclosure of Fees for 401(k) and Other Plans - Coping with the New Regime at 3:30 p.m. on September 13

The Group also invites members and other interested individuals to participate in its next quarterly conference call focusing on welfare plan matters on October 14, beginning at 1:00 p.m. Eastern (call-in number: 1-800-504-8071; passcode: 9885683#). The Group hosts conference calls each quarter as a free benefit to Group members. The calls generally feature a brief presentation of a timely topic followed by an open discussion among participants about the topic area. The July conference call featured a discussion, lead by the Fiduciary Responsibility, Administration and Litigation Committee, about the standard of review of claims decisions when a fiduciary has a conflict of interest after the *Glenn* decision. In addition to its regularly scheduled quarterly conference calls, the Group hosted a series of supplemental conference calls during which Group members discussed special challenges associated with assisting clients to comply with Internal Revenue Code Section 409A. For 2009, the quarterly conference calls presently are scheduled to occur at 1:00 p.m. Eastern on the third Wednesday in January, April, July and October.

About the Group:

Employee benefits and compensation are critical components of the economic wealth, well-being and welfare of employees and their families. Concurrently, compensation and benefit matters also play a vital role in the ability of businesses to recruit, retain and motivate employees, to structure and execute real estate and other common business transactions and create legal risks for businesses and others involved in employee benefit plan sponsorship and administration. This group focuses on all aspects of employee benefit plans and other compensation arrangements, including issues relating to qualified plans, medical and other welfare plans and nonqualified deferred compensation plans, the fiduciary responsibilities of plan trustees, plan administrators and other plan fiduciaries, plan administration, plan transactions, plan terminations, and litigation involving this area of practice.

The Group invites persons interested in joining or other involvement opportunities to contact Chair Mike Macris (mmacris@cahill.com) or Vice Chair Cynthia Marcotte Stamer (cstamer@gpm-law.com).

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