ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

New Proposed Regulations on
IRC §2036 and §2039 Inclusion

By Jim Roberts

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On June 6, 2007, the IRS published new proposed regulations that provide guidance on what part of a trust is includable in a deceased settlor's estate under Sections 2036 and 2039 if the settlor retained the use of the trust property or the right to an annuity or other income from the trust for life (or some term that doesn't actually end before death). Many practitioners would immediately surmise that 100% would be included, but there are revenue rulings to the contrary.

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 proposed regulations. Basically, the IRS explained that these rulings can provide a means for claiming only a part of the value of a trust in the decedent's estate. The IRS explained that the new proposed regulations are designed to incorporate those rulings into the regulations, and also modify the existing regulations to update them with changes in the law.

In addition, the preamble explained that the proposed changes to the 2039 regulations were intended to point the practitioner back to 2036 for computational rules.

Basically, the new proposed regulations say that the amount includable is determined by taking the income stream the decedent was receiving, and then, using the 7520 rate in effect at the death of the decedent (or the alternate valuation date, whichever is applicable to the estate), determine what amount of money would have been required to produce that stream of income. If the principal needed would have been less than 100% of the trust, the estate inclusion is only that percentage. If the principal needed would have been more than 100% of the trust, then the amount includable is limited to the trust assets.

The illustrations are very helpful. In one, the regulations assume a husband and wife create a trust, with a mandatory income distribution clause, half to the husband and half to the wife, with the survivor getting all. For

the spouse who dies first, only half the trust principal is includable in the decedent's estate and the survivor's estate must include 100%.

In another example, the trust is a CRAT funded with $100,000, and the annual annuity payment to the settlor is $12,000. At the settlor's death, the trust has grown to $300,000 and the 7520 rate at that time is 6%. Only $200,000 is required, at 6%, to pay $12,000 per year, so only $200,000 is includable in the estate. And the result is the same if the settlor had relinquished his annuity payment within 3 years of death.

Another example is basically the same, except using a GRAT with monthly payments, and the regulations prescribe adjusting the 7520 rate with the monthly payments factor. As a result, $205,440 is includable.

When the switch to unitrusts is made, the computation becomes considerably more complicated. Same facts as above, with a CRUT, and the proposed regulations say, "*In this case, such amount of corpus is determined by dividing the trust's equivalent income interest rate by the section 7520 rate (which was 6 percent at the time of D's death). 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. Based on section 1.664-4(e)(3) of the Income Tax Regulations, the appropriate adjusted payout rate for the trust at D's death is 5.786 percent (6 percent x .964365). Thus, the equivalent income interest rate is 6.141 percent (5.786 percent / (1 - 5.786 percent)). The ratio of the equivalent interest rate to the assumed interest rate under section 7520 is 102.35 percent (6.141 percent / 6 percent).*" Because the percentage is more than 100%, the entire trust corpus is includable. And if the computation had produced a percentage less than 100%, that percentage would be the included amount.

Moving on to GRITs, a trust in favor of non-family members (Section 2704(c)(2)) with a provision paying all of the income to the settlor who dies before the end of the trust term, mandates that 100% of the trust assets be included in the deceased settlor's estate. The same result occurs with a QPRT.

These new proposed regulations, in part, renumber some parts of the existing regulations. Those renumbering provisions will be effective for decedent's dying after August 16, 2007. But the bulk of the proposed regulations will be effective when Treasury publishes its adoption of them in the Federal Register.

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UPDATE ON PATENTING TAX ADVICE

By Jim Roberts

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The idea of issuing patents in the area of tax planning has stirred significant controversy and has been reported on before in eReport. As previously noted, the expansion of patents in this area has worried many practitioners for a variety of reasons, most notably the possibility that a strategy conceived for a private client later exposed (typically through a dispute process with the IRS) may be the same as or substantially similar to an existing patent, triggering an infringement claim. And from that claim, discovery could reach into the practitioner's other files, and, if part of a firm, into the files of other practitioners in the firm.

In January of this year, the State Bar of Texas Board of Directors approved a request by that bar's Tax Section to submit to the Internal Revenue Service a response to its request for comment on this area, and, in that response, offering specific legislation to prohibit enforcement of tax strategy patents. The model for the proposed legislation is the language added in 1997 to prevent patents on surgical procedures from being enforced against doctors and hospitals.

Certain members of the Texas bar's Tax Section are reported to have approached members of Congress with the proposed legislation. Others, however, had another idea in mind, and proposed simply to make tax planning methods unpatentable. Apparently winning arguments were employed, and Representatives Rick Boucher and Bob Goodlatte, both of Virgina, proposed an amendment to the patent statutes that would deny patents to tax planning methods (defined as "as a plan, strategy, technique or scheme that is designed to reduce, minimize or defer, or has, when implemented, the effect of reducing, minimizing or deferring, a taxpayer's tax liability.")

This approach appears to one that may carry the day. On July 18, 2007, the House Judiciary Committee approved

their proposed amendment.

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SPLIT-INTEREST TRUST RESULTS IN DENIAL OF CHARITABLE DEDUCTION

By Jim Roberts

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The Third Circuit recently addressed the issue of a split-interest trust in the case of *Edmond C. Galloway v. United States*. The decision was handed down on June 21, 2007, and deals with an appeal of a case from federal district court seeking a refund. James Galloway, the decedent, created a trust that, on his death, continued until 2016. There were four beneficiaries of the trust, two of which were charities. The trust contained no provisions for dividing the trust at his death, and, as a result, the payments to the charitable and non-charitable beneficiaries came from the same items of trust corpus.

This whole case turned on the lack of the abusive provisions normally thought to be associated with pre-2055(e) split interest trusts i.e. where a non-charitable beneficiary gets first crack at the trust assets, resulting in little or no assets remaining for the charity, but with the decedent's estate claiming a charitable deduction for the supposed value of the remainder. The Court recited the history of the spit-interest trust arena leading up to the passage of 2055(e).

Basically, after the passage of 2055(e), the value of any amount that might pass to a charity in a trust, where charitable and non-charitable beneficiaries share an interest in trust corpus, is deductible only if the trust takes certain prescribed forms. Those forms are: (a) when the charity is getting a remainder interest, the split-interest trust must be either a charitable remainder annuity trust or a charitable remainder unitrust; and (b) if the charity's interest is any other kind of interest, the charity must get a form of guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the trust property determined on an annual basis.

In this case, the charity was not to receive a remainder, but was to receive distributions at the same time as the non-charitable beneficiaries. Under 2055(e), they should have been either in the form of a guaranteed annuity or as a fixed percentage distributed yearly. In this case, they were neither. There were only two distributions, one in

2006 and another in 2016, with the first being half the trust assets, and the later one being the rest, each distribution being divided equally among the four beneficiaries.

The Court was asked by the estate to determine that 2055(e) is ambiguous in that it does not clearly define what a split-interest trust is. The Court rejected the argument, stating that the statute is clear. The Court said, "In so saying, we recognize the unfortunate result in this case. *Section 2055(e)* was passed to protect against abuses that resulted most frequently from non-charitable beneficiaries exploiting their life interest in an estate and leaving a charitable beneficiary with a shadow of what was bequeathed to it. In this instance, there is little chance that the same sort of abuse would take place." But the Court had to conclude that the trust simply did not meet the requirements of 2055(e) and that the result is clearly spelled out in the statute – no charitable deduction.

99 AFTR2s 2007-3412 (3rd Circuit 2007)

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