

# *AALU's Washington Report*

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AALU Bulletin No: 04-41

March 12, 2004

Subject: **General Estate and Gift Tax Developments: January 2004**

1. **IRS Finalizes Regs. Amending Definition of Trust Income**

Major References: [\*T.D. 9102, 69 Fed. Reg. No. 1, pp. 12-22 \(Jan. 2, 2004\)\*](#)

Prior AALU Washington Reports: 01-32

2. **Trust May Take Charitable Deduction That Flows Through From Partnership**

Major References: [\*Rev. Rul. 2004-5, 2004-3 I.R.B. 295\*](#)

3. **Deceased Spouse's General Testamentary Power of Appointment Over Surviving Spouse's Trust Creates Valid Credit Shelter Trust**

Major References: [\*PLR 200403094\*](#)

Prior AALU Washington Reports: 02-67

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

This *Washington Report* summarizes a few of the more important rulings in the estate and gift tax areas which were decided or reported by the Internal Revenue Service in January of 2004, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

## Final Regulations

### 1. *T.D. 9102, 69 Fed. Reg. No. 1, pp. 12-22 (Jan. 2, 2004)*

*The Treasury has issued final regulations under section 643 of the Code that re-define the concept of trust income for federal income tax purposes to take into account changes in the laws of several states. These changes redefine trust accounting income by reference to a “total return” concept. The new state law definitions would allow income to be defined as a unitrust amount in many cases.*

On February 15, 2001, the Revenue Service issued proposed regulations (REG-106513-00) containing proposed amendments to the income, estate, gift, and generation-skipping transfer tax regulations relating to the definition of income for trust purposes. (See our Bulletin No. 01-32.)

Section 643(b) of the Internal Revenue Code and the regulations thereunder define “income” of a trust or estate by reference to the definition contained in the governing instrument and local law, with the caveat that trust provisions that depart fundamentally from the concepts of local law in determining what constitutes income will not be recognized. These statutory and regulatory provision, however, were formulated in a time when, under the laws of virtually every state, dividends and interest were considered to be income - and thus allocable to the income beneficiary - and capitals gains were considered to be principal - allocable to the remainderman.

However, in recent years, a number of states have enacted laws that adopt a “prudent investor” standard for managing trust assets. Under this standard, trust assets may be invested for total positive return, a concept that includes both ordinary income and appreciation, in order to maximize the value of the trust. This has resulted in a state-sanctioned shift away from bonds and toward equities, which has, in some cases, disadvantaged the income beneficiaries of a trusts vis a vis the remainder beneficiaries.

To remedy this situation, many states have made revisions to the definitions of income and principal. Thus, in some states, a trustee may make an “equitable adjustment” between income and principal to ensure that both the income beneficiary and the remainder beneficiary are treated impartially. An equitable adjustment may permit a receipt of capital gains that previously would have been allocated to principal to be allocated to income, or vice versa. Other states have proposed legislation to allow the trustee to pay a unitrust amount (defined as a percentage of the annual value of trust assets) to the income beneficiary in satisfaction of that beneficiary's right to income.

In order to take these state law changes into account, the Revenue Service has finalized regulations that would revise the definition of income provided in section 643(b) and other Code provisions (such as the estate and gift tax marital deduction and the charitable remainder trust provisions) that rely on the section 643(b) definition of income. In general, under the final regulations, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. The final regulations state that switching between different methods of apportionment in different years will be respected so long as the trust complies with state law requirements for switching between methods.

Under the final regulations, the allocation of capital gain to income will be disregarded for tax purposes to the extent that such allocation is *prohibited* by state law (not just “fundamentally inconsistent” with state law, as was the case under the proposed regs.).

The proposed regulations included a special provision to insure that a “net income” charitable remainder unitrust could not rely on a state law definition of income that defined “income” as including a unitrust payment of less than 5 percent of the annual value of trust assets. In that situation (to prevent the possibility that the trust would be able to avoid the statutorily prescribed 5% minimum unitrust payment) the proposed regs. required the governing instrument of a net income charitable remainder unitrust to provide its own definition of trust income. This requirement has been eliminated in the final regulations.

Also, with respect to CRUTs, the final regulations continue to provide that post-contribution capital gains may be included in the definition of income under the terms of the governing instrument or applicable local law, but not pursuant to a trustee’s *discretionary* power granted by the trust instrument, rather than by state statute, to allocate capital gains to income.

Other Code provisions for which special rules or other clarifications are provided include those applicable to pooled income funds, qualified S Corporation trusts, the definition of “distributable net income” (“DNI”), the federal estate and gift tax marital deduction, and the generation-skipping tax exemption.

The final regulations, in general, are effective for taxable years of trusts and estates ending after January 2, 2004. In addition, “taxpayers may rely on the provisions of the final regulations for any taxable years in which a trust or estate is governed by a state statute authorizing a unitrust payment in satisfaction of the income interest of the income beneficiaries or granting the trustee a power to adjust between income and principal, in each case as described in the final regulations.”

## Revenue Ruling

### 2. *Rev. Rul. 2004-5, 2004-3 I.R.B. 295*

***The Revenue Service has issued a revenue ruling (Rev. Rul. 2004-5) to clarify that a trust isn't prohibited from taking Code Sec. 642(c); charitable deduction for trust's distributive share of charitable contribution made by partnership from partnership's gross income even though trust's governing instrument doesn't authorize trustee to make charitable contributions.***

In Rev. Rul. 2004-5, the governing instrument of “Trust” does not authorize the trustee to make charitable contributions. Under applicable Code and regulatory provisions, Trust is a “simple” trust, in that its trust indenture provides that all of its income is to be distributed currently to the beneficiaries, and no amounts are to be paid, permanently set aside, or used for charitable purposes. Simple trusts are taxed under different provisions of the Internal Revenue Code that “complex” trusts - *i.e.*, trusts that are not required to distribute all income currently and that may make or set aside charitable contribution amounts.

However, one of Trust’s asses is an interest in “Partnership,” which has contributed cash from its gross income to a charitable organization during the taxable year. The ruling stipulates that none of Trust’s income for the taxable year of the contribution is unrelated business income. In computing its income tax for

the taxable year, Trust must take into account its distributive share of Partnership's income, gain, loss, deductions (including charitable contributions), and credits.

Generally, under Section 642(c) of the Internal Revenue Code (which is the provision of the Code that governs charitable income tax deductions of trusts), a deduction is allowed to a trust in computing its taxable income for any amount of its gross income, without limitation, that *pursuant to the terms of the governing instrument* is, during the taxable year, is paid for a charitable purpose. The deduction is in lieu of the charitable deduction allowed to individuals and corporations by Code Section 170(a).

Because of the “governing instrument” requirement of Section 642(c), the Revenue Service, for many years, disallowed flow-through partnership charitable contribution deductions by trusts (and estates) that did not have a specific provision in the trust indenture permitting charitable contributions. The Service was not very successful in convincing the courts, however, to adopt its interpretation of the charitable deduction requirements under Section 642(c) and its predecessors. *See, e.g., Estate of Bluestein v. Commissioner*, 15 T.C. 770 (1950), *acq.*, 1951-1 C.B. 1, and *Estate of Lowenstein v. Commissioner* 12 T.C. 694 (1949), *acq.* 1949-2 C.B. 2, *aff'd sub nom, First National Bank of Mobile v. Commissioner*, 183 F.2d 172 (5th Cir. 1950), allowing a flow-through partnership charitable deduction to estates that did not authorize the making of charitable contributions.

For this reason, and because the partnership rules require Trust to include in gross income its share of Partnership's income, deductions (including charitable contributions), and credits, the Revenue Service has decided to change its position officially. Therefore, Trust will be allowed to deduct its share of Partnership's charitable contributions so long as the other requirements of Section 642(c) are satisfied. Thus, for example, for the taxable year of the contribution the trust may not have any income that would be considered “unrelated business income.”

The Service also ruled that Trust would be a “complex” trust (subject to different tax rules) for the taxable year because it is allowed a charitable deduction under Section 642(c) for that year. However, the Service stated that “[t]he same result would apply if [Trust] were always a complex trust because it was not required to distribute all its income currently.”

Rev. Rul. 2004-5 provides much-needed clarification to practitioners in this area of the law.

### Private Letter Ruling

#### 3. *PLR 200403094*

*The Internal Revenue Service has ruled that a husband's gift to a revocable trust, over which his wife retains a testamentary general power of appointment in the amount needed to fund a credit shelter trust in the wife's estate, won't be a completed gift until the power is exercised. Nor will the assets over which the power is exercised be includible in the husband's estate. The ruling, which has created some stir in the estate planning community, allows the wealthier spouse's assets to be used to fund a credit shelter trust for the poorer spouse without losing control of those assets during the wealthier spouse's lifetime.*

Under the facts of the PLR, "Husband" created a trust for his own benefit that was revocable during his lifetime. The trust contained the following provision giving "Wife" a testamentary general power of appointment over a portion of the trusts' assets, should she predecease Husband:

At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will.

If Husband predeceases Wife, the Husband's trust creates a Family Trust in the amount of Husband's available credit shelter amount, for the benefit of Wife during her lifetime. Wife is granted a testamentary special power to appoint the assets of Husband's Family Trust remaining at Wife's death to any of Husband's descendants. Upon the death of the survivor of Wife and Husband, any assets of Husband's Family Trust that Wife does not appoint will be distributed to Husband's then living descendants.

Wife proposes to execute a Will exercising her general testamentary power of appointment over Husband's trust, as follows:

I exercise in favor of my estate the power of appointment given to me by Section 4.5 of the Trust created by [Husband] dated [\_\_\_], and direct that assets having a value equal to (i) the amount of my remaining applicable exclusion amount less (ii) the value of my taxable estate, determined by excluding the amount of those assets subject to this power, be distributed to my estate as soon after my death as possible.

Wife's Will contains an outright marital distribution to husband and a residuary credit shelter trust ("Wife's Family Trust") for the benefit of husband during his lifetime. Husband is granted a testamentary special power to appoint the assets of Wife's Family Trust remaining at his death to any of his descendants. In default of the exercise of this special testamentary power of appointment, the assets of Wife's Family Trust will be distributed to Wife's then living descendants.

In these circumstances, the Revenue Service issued the following rulings:

1. On the death of Wife during Husband's lifetime, if Wife exercises the general testamentary power of appointment granted her under Husband's trust, Husband will be treated as making a completed gift that qualifies for the federal gift tax marital deduction to Wife with respect to that portion of the trust appointed by Wife. This is the moment in time at which Husband relinquishes dominion and control over the assets subject to Wife's power of appointment.

2. If Wife predeceases Husband, the value of the assets of Husband's trust over which Wife holds a power of appointment will be included in Wife's gross estate.

3. Any assets that originated in Husband's trust, and that pass to or from Wife's Family Trust established under her Will, will not constitute a gift from Husband to the other beneficiaries of Wife's Family Trust. When Wife exercises her general power of appointment in favor of her estate, the assets become part of her estate, and pass under her Will, not as a gift from Husband.

4. Any assets that originated in Husband's Trust, and that pass to Wife's Family Trust established under her Will, will not be included in Husband's gross estate. This last ruling is important because, even though Husband is a beneficiary of the credit shelter trust established in Wife's Will, he will not be viewed as having "retained" - within the meaning of Section 2036 of the Internal Revenue Code - an interest in the assets funding the trust.

The technique described in PLR 200403094, like the joint revocable trust (described in our Bulletin No. 02-67) funded with jointly held property over which both spouses retain a general power of appointment, is a way to create a credit shelter trust in a situation in which that objective might otherwise prove difficult, particularly as the combined credit shelter amount (now up to \$3 million per married couple) increases. This technique should prove particularly useful where there is an inequality of wealth between the spouses, and the wealthier spouse does not want to transfer assets (or control of those assets) to the poorer spouse during his or her lifetime. Furthermore, since the trust in the PLR is revocable by the grantor spouse, it arguably is more flexible than the *inter vivos* QTIP that is sometimes used for this purpose.

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