

AALU's Washington Report

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

1. **“Duty of Consistency” Requires Inclusion of Painting in Surviving Spouse’s Estate**

Major References: [TAM 200407018](#)

Prior AALU Washington Reports: 98-15

2. **Disclaimer of LLC Interest and Management Rights Is Timely and Will Be Qualified Disclaimer**

Major References: [PLR 200406038](#)

Prior AALU Washington Reports: 03-56

3. **Early Termination of CRT Is Not Self-Dealing**

Major References: [PLR 200408031](#)

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 February of 2004, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Technical Advice Memoranda

1. TAM 200407018

The IRS National Office has ruled that, under the doctrine of “duty of consistency,” the estate of a surviving spouse must include the value of a painting for which the Federal estate tax marital deduction was claimed in the predeceasing spouse’s estate.

Under the facts of TAM 200407018, “Decedent’s” spouse (“Spouse”) predeceased her, survived by Decedent and Spouse’s two children from a prior marriage. Spouse’s two children, Decedent, “X,” and “Bank” were appointed as co-executors of Spouse’s estate.

Under Section IV of his Will, Spouse bequeathed a life estate in all of his “oil paintings” to Decedent. Upon Decedent’s death, all of the oil paintings were to pass to Spouse’s children. No election was made by Spouse’s estate to treat the oil paintings that were the subject of this bequest as qualified terminable interest property (QTIP).

Under Section V of his Will, Spouse bequeathed a life estate in all other personal property to Decedent, with such property to pass on her death to Spouse’s children. This bequest was structured to comply with the requirements of the Federal estate tax marital deduction, and Spouse’s estate made a QTIP election with respect to that property. Spouse’s executors included in this bequest a certain painting, which, because it was thought to be a pastel, rather than an oil painting, was not included in the nonmarital bequest under Section IV of Spouse’s Will.

Decedent died sometime after the statute of limitations had expired on Spouse’s estate. Her two sons and her attorney were appointed co-executors of her estate. Decedent’s will provided, generally, that any estate taxes attributable to the inclusion of property in her gross estate under IRC section 2041 (regarding property over which a decedent possesses a general power of appointment) should be apportioned against such property.

After her death the “pastel” painting was sold for an undisclosed amount. Before the sale, however, it was determined that the painting was not a pastel, but an oil. Decedent’s estate thereupon contended that the painting passed under Section IV (the nonmarital portion) of Spouse’s will rather than Section V (the marital portion), and that, therefore, Decedent never possessed a general power of appointment over the painting. Accordingly, the painting should not be includible in Decedent’s gross estate under Section 2044 of the Code (which requires the inclusion of property for which the marital deduction was claimed in an earlier estate). Decedent’s estate apparently was willing to stipulate that the marital deduction claimed in Spouse’s (now closed) estate was erroneous, and that the painting should have been subject to estate tax in Spouse’s estate.

The IRS argued that the duty of consistency, sometimes referred to as “quasi-estoppel,” applied to require the inclusion of the painting in Decedent’s taxable estate. This doctrine “is based on the theory that the taxpayer owes the Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer’s own prior error or omission.” The doctrine generally precludes a taxpayer from taking one position on one tax return and a contrary position on a subsequent return after the limitations period has run for the earlier year, if the contrary position would harm the Commissioner.

Three elements must be present in order for the doctrine of the duty of consistency to apply: (1) a representation by the taxpayer; (2) reliance on the representation by the Revenue Service; and (3) an attempt by *the taxpayer*, after the statute of limitation on assessment has expired, to change the representation.

While it was unquestionable that, in TAM 200407018, the first two elements were present, it was also irrefutable that Spouse's estate and Decedent's estate were not the same "taxpayer." However, as the Revenue Service noted, "the duty of consistency can also be applied to bind one person to a representation made by another where the two are deemed to be in privity." Whether "privity" exists in turn depends on whether, under the facts and circumstances of each case, there is "sufficient identity of interests between the parties to warrant the application of the duty of consistency."

The Service noted that, in *Estate of Letts v. Commissioner*, 109 T.C. 290 (1997), (*see* our Bulletin No. 98-15), the Tax Court held that the duty of consistency requires that a trust for which the federal estate tax marital deduction was improperly claimed by the estate of a decedent be included in the surviving spouse's estate for federal estate tax purposes. Although the Taxpayer in *Estate of Letts* argued that a duty of consistency did not apply between the decedent's estate and the estate of her husband, the Tax Court disagreed. The Tax Court, finding a sufficient identity of interest between the estate of Mr. Letts and that of his spouse, stated that, "[i]t is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the gross estate of the surviving spouse."

The Revenue Service also found sufficient privity under the facts of the TAM, noting that, for transfer tax purposes, the estates of Decedent and Spouse are treated as a single economic unit. There was also the fact that Decedent was an executor of Spouse's estate and should have been aware of the facts underlying the marital deduction claim. The Service found the fact that Spouse's children ultimately would bear the burden of taxes imposed on the painting did not make them the "Taxpayer" (in lieu of Decedent's estate), so that any lack of privity between the children and Decedent's estate was irrelevant.

Private Letter Rulings

2. *PLR 200406038*

The Revenue Service has ruled that the disclaimer of an interest in an LLC by the heir of an intestate estate, and of the management rights in the LLC, will be a qualified disclaimer, and thus that the LLC interest will be viewed as having passed directly from the decedent to the decedent's other heirs at law.

"Decedent" died intestate on "Date 1," survived by her mother ("Mother"), and Decedent's brothers, "Son 1" and "Son 2." One of Decedent's siblings predeceased her, survived by three children, Grandson 1, Grandson 2 and Grandson 3. Mother and Son 1, who were Decedent's co-guardians prior to her death, were appointed as co-personal representatives of Decedent's estate. Under the laws of intestate succession, Decedent's entire estate will pass to Mother.

One of the assets included in the Decedent's estate is an X% interest in LLC, a State limited liability company, from which there have been no distributions since the date of Decedent's death. Mother proposes to disclaim the interest in the LLC passing to her under State intestacy laws. As a result of the disclaimer, Mother will be treated as predeceasing Decedent with respect to the disclaimed property and under State law, and the disclaimed LLC interest will pass to Son 1, Son 2 and Grandsons 1, 2 and 3.

Mother is currently co-manager of the LLC, but, apart from the LLC interest inherited from Decedent, has no ownership interest. The other members of the LLC have proposed amending the LLC agreement to designate Son 1 as the sole manager of the LLC. The agreement also will be amended to provide that certain actions - such as amending the agreement and removal of the manager - that previously required an affirmative vote of members holding more than 50% of the outstanding units, will now require an affirmative vote of members holding at least 67% of the outstanding units. Prior to her death, Decedent, through her guardianship, was the only LLC member with a greater-than-50% interest in the LLC. All current members of the LLC and all those who will become beneficial owners of units in the LLC as a result of the disclaimer will execute the amendment.

After disclaiming her interest in the LLC, Mother will execute the foregoing amendments as co-personal representative of Decedent's estate. Mother will then resign as co-manager of LLC.

Mother's disclaimer of the LLC interest will be executed within 9 months of Decedent's death. State law provides that an interest of any nature in or to the estate of an intestate decedent may be declined, refused or disclaimed without ever vesting in the disclaimant.

Generally, for Federal transfer tax purposes, if a person makes a "qualified" disclaimer of an interest in property, the estate, gift, and generation-skipping transfer tax provisions will apply to that interest as if it had never been transferred to the disclaiming person. A "qualified" disclaimer (under Section 2518 of the Revenue Code) is an irrevocable refusal of an acceptance of an interest in property that is made, in writing, within 9 months of the date (in the case of property passing by reason of death) of the decedent's death. In addition, the person disclaiming the interest may not, prior to disclaiming, accept the interest or any of its benefits; and, as a result of the disclaimer, the interest must pass to the taker(s) in default without any direction by the person making the disclaimer. If these conditions are satisfied, the decedent will not be treated as making a gift.

Under applicable Treasury regulations, if a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by such person in the exercise of fiduciary powers to preserve or maintain the disclaimed property (e.g., directing the harvesting of a crop, or maintenance of a home) is not treated as an acceptance of such property. However, the fiduciary's disclaimer of a beneficial interest is not a qualified disclaimer if the fiduciary exercised a discretionary power to allocate enjoyment of the interest among members of a class.

In the PLR, Mother proposed to disclaim her entire interest in the LLC (including her management rights). The Revenue Service noted that, pursuant to the above-described regulation, Mother's execution of the amendment to the agreement in her capacity as co-personal representative of Decedent's estate, will not be considered the acceptance of the benefits of the disclaimed interest. Accordingly, the proposed disclaimer will be a qualified disclaimer, and the property will be treated as passing directly from Decedent pursuant to State law.

Note: The disclaimer technique might help some taxpayers avoid "Strangi" type issues that might arise if a beneficiary of an inherited LLC or partnership interest accepts that interest and later seeks to give it away. (See *Estate of Strangi v. Commissioner*, T.C. Memo 2003-145 (May 20, 2003), the third separate opinion in the much litigated *Strangi* dispute, discussed in our Bulletin No. 03-56.) In this case, "Mother" is not treated as the transferor of the LLC interest, and no issues will arise on her death concerning the includibility of that interest in her estate.

3. *PLR 200408031*

The Revenue Service has determined that the noncharitable beneficiaries of a net-income-with-makeup charitable remainder unitrust (NIMCRUT) will not be engaged in self-dealing when the trust is terminated and its assets distributed to the charitable and noncharitable beneficiaries on an actuarial basis.

On June 8, 1998, Donor executed a qualified charitable remainder unitrust providing for an annual payment to Donor, during her lifetime, of a unitrust amount equal to the lesser of 5% of the annually determined fair market value of the trust or the net income of the trust. The unitrust amount for a given year also includes a “make-up” provision, pursuant to which any amount of trust income for any year that is in excess of the amount otherwise required to be distributed may be distributed to the extent that the aggregate of the amounts paid in prior years was less than 5% per year.

Upon Donor’s death, the unitrust amount is to be paid, in equal shares to “B” (who also was the initial trustee of the trust) and “C” (currently a co-trustee), until the death of the survivor of them. Upon the death of the last to die of B and C, the balance of the trust is to be held in further trust for the benefit of any one or more qualified charitable organizations that may be designated by Donor. During that time, income must be distributed, and principal may (in the discretion of the trustee) be distributed, to the designated charitable organizations, or, if none are designated by Donor, to such charitable organization or organizations as the trustee, in his sole discretion, may determine. Donor has not designated the charitable beneficiaries for the benefit of which the trust corpus is to be held on the deaths of B and C. B and C, as co-trustees, therefore have designated three such charitable beneficiaries.

During 1999, B and C, as co-trustees, successfully petitioned a court, which issued an order on November 22, 1999, to reform the trust to provide for the payment of a unitrust amount equal to a flat 5% of the annually determined fair market value of the trust, in lieu of the NIMCRUT amount. Donor, B and C also have indicated that, upon Donor’s death, the trust intends to distribute to B and C an amount equal to the present value of the interests held by B and C, as well as an amount equal to the present value of the charitable interests to the designated charitable organizations.

Donor, B and C (as substantial contributors to the trust and foundation managers) are all “disqualified persons” with respect to the trust, which is treated as a private foundation for purposes of the “self-dealing” rules of the Revenue Code.

The Revenue Service, upon request, ruled that such a transaction will not constitute a direct or indirect act of self-dealing under the relevant Code and regulatory provisions, and will not result in any benefit to the income beneficiaries because state law allows for early termination; all beneficiaries favor early termination; and the trust will use the income tax regulations formula for determining the present values of the income and remainder interests in a charitable remainder trust. The Service noted that the physician of B and C has signed an affidavit under penalties of perjury that neither B and C has a medical condition expected to result in a shorter-than-average longevity.

What is potentially interesting (and not explained in the ruling), is which actuarial factors will be used in determining the relative shares of the charitable and noncharitable beneficiaries upon Donor’s death. In June, 1998, when the trust was established, the applicable federal rate used for determining the relative values of the unitrust and remainder interest was 7%. It is now 3.8% (which would result in a larger value assigned to the noncharitable unitrust interest), and the rate at the date of the Donor’s death is unknowable at

this time. Although variations in interest rates are less significant in valuing charitable remainder unitrust interests than they are in valuing charitable remainder annuity trust interests, it would seem that there is still some room for manipulation, depending on which rates are applicable.

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