

AALU's Washington Report

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

1. **Post-Gift Events Cannot Be Taken Into Account In Valuing Stock of Closely-Held Company**

Major References: [*Okerlund v. U.S., ___ F.3d \(Fed. Cir. 2004\)*](#)

Prior AALU Washington Reports: 01-71

2. **IRS Reaches Contrary Conclusions on Whether IRA Withdrawals May Be "Rolled-Over" Posthumously**

Major References: *PLRs* [200415011](#) and [200415012](#)

Prior AALU Washington Reports: 04-33

3. **Trust Fails to Qualify as Charitable Remainder Unitrust for Purposes of Federal Estate Tax Charitable Deduction**

Major References: [PLR 200414011](#)

Prior AALU Washington Reports: 97-70

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

Cases

1. ***Okerlund v. U.S.*, ___ F.3d ___ (Fed. Cir. 2004).**

On appeal, the Federal Circuit Court affirmed a trial court's determination that post-gift events may not be considered in determining the value of the gifted property on the date of the gift. In particular, the unanticipated death of the founder of a closely-held corporation may not be taken into account in valuing stock gifted prior to his death.

Marvin Schwan ("Marvin") was the founder and president of Schwan Sales Enterprises, Inc. (SSE), a privately held Minnesota company engaged in the frozen food business. SSE has the right-of-first refusal on all sales or transfers of voting and nonvoting common stocks held by certain stockholders, based on a fair market value transfer price.

Marvin died unexpectedly on May 9, 1993, at the age of sixty-four, leaving SSE without its founder and President. At the time of his death, 5,076 voting shares and 25,910,100 non-voting shares were held in the Marvin M. Schwan Revocable Trust. These shares, which comprised two-thirds of outstanding SSE stock, passed, under the terms of the trust indenture, to a charitable foundation. SSE redeemed the foundation's shares pursuant to a February 4, 1993, Amended Redemption Agreement.

On December 31, 1992, Marvin's four children and three of their spouses established separate trusts for the primary benefit of their respective children, using SSE shares that Marvin had previously distributed to his children. These shares were valued for gift tax purposes in June 1993 (after Marvin's death) by a firm called Business Valuation Consultants (known as "Gray") at \$24.03 per share as of the December 31, 1992 gift date. Based on this valuation, each plaintiff filed a gift tax return reporting a gift of \$600,750, a unified credit of \$192,800, a Generation-Skipping Tax (GST) exemption of \$600,750, and a tax of \$277.

In 1996, during litigation over the value of SSE shares in Marvin's estate (*see* our Bulletin No. 01-73), the estate retained a second firm to appraise the SSE shares. Although that litigation's settlement was based on a 1997 value of \$26.00 per share, the 1996 appraisal originally valued SSE at \$17.40 per share as of December 31, 1992. Based on this lower valuation, Marvin's children filed for a Claim for Refund and Request for Abatement with the IRS, seeking restoration of their respective unified credits in the amount of \$59,100, a restoration of their respective GST exemptions in the amount of \$165,760 each, and a gift tax refund of \$277.

The children also engaged in litigation with the IRS concerning the value of certain additional gifts of SSE shares during 1994. The Court of Federal Claims valued the shares at \$19.77 as of December 31, 1994, as urged by the children, and the government did not appeal this ruling. As a result of all of these transfers and the ensuing litigation, SSE stock had been determined to be worth widely varying amounts over the span of a two-year period.

In the refund suit brought by Marvin's children with respect to the 1992 gifts, the Court of Federal Claims (the trial court) adopted a valuation of \$44.29 before considering the necessary discount factors. After applying a 40% percent discount for lack of marketability, and a further 5% discount for the lack of voting rights, the court arrived at a valuation of \$24.36 per non-voting share of SSE, as of December 31, 1992. The children appealed this determination, arguing that events that occurred subsequent to the 1992 gifts should be taken into account in valuing the stock as of that date.

As stated by the appellate court,

“[a]ll of the Plaintiffs’ arguments on appeal . . . stem from a single source: the confluence of several risk factors that actually occurred during the years 1993 and 1994 . . . These risk factors included: (1) reliance on a home delivery route system; (2) thin management ranks; (3) reliance on a key management figure, Marvin Schwan; (4) the risk of food contamination; (5) the competitors’ greater human resources; (6) SSE’s inability to invest in a national advertising campaign, based on its lack of a nationally recognizable brand name and the demographics of its customer base; (7) less diversity in product offerings than the guideline companies; and (8) the relatively small size of SSE’s Board of Directors.”

By the end of 1994, Marvin Schwan had died, and an outbreak of salmonella in October 1994 led to a product recall, a plant closure, and a class action lawsuit. “In other words, several events that the appraisers had identified as foreseeable though unlikely risks in 1992 had actually occurred by 1994,” leading to declines in SSE’s sales and income during both 1993 and 1994, and a corresponding drop in the company’s value between the 1992 and 1994 valuation dates.

Both the trial and appellate courts rejected the children’s/plaintiff’s claims with respect to the consideration of subsequent events. Although such events need not in all cases be barred from consideration (they may be considered, for example, where foreseeable at the time of the gift, or where there are arm’s length sales shortly after the gift), the trial court concluded that consideration of post-valuation financial results in this case would be improper. It cited the government’s contention that “if such a technique were accepted, there would be little need to resort to the courts in valuation cases. The mere passage of time, together with the accumulation of post-valuation date data, would convert the valuation process from an inexact science to an exact science.” In other words, hindsight is 20-20.

In summary, the court ruled that “[t]he key to the use of any data in a valuation remains that all evidence must be proffered in support of finding the value of the stock on the donative date.” (The court’s emphasis.)

Private Letter Rulings

2. *PLRs 200415011 and 200415012*

Two sequentially numbered private letter rulings come to different conclusions on whether an amount withdrawn from an IRA prior to a decedent’s death may be rolled over after his death. IN the first case (PLR 200415011), the Revenue Service concludes that the withdrawn amount may not be rolled over. In the second, however, the Service grants relief to the decedent’s surviving spouse under the “hardship” rules of IRC § 408(d)(3)(I) and Rev. Proc. 2003-16, and permits the rollover.

In most cases, in order to defer current taxation on the receipt of a distribution from a section 408 individual retirement account (“IRA”), a section 401 qualified retirement plan, a section 403(b) annuity plan or a section 457(b) governmental deferred compensation plan, a recipient must rollover the distribution within 60 days of receipt. For distributions that occur after December 31, 2001, the Internal Revenue Service, as a result of changes to the Internal Revenue Code made in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), may waive this 60-day requirement on a showing of hardship. In recent months, the IRS has issued a flood of such waivers in situations “where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual.”

In January 2003, the IRS issued a formal pronouncement (Revenue Procedure 2003-16) instructing taxpayers how to apply for the waiver. *See* our Bulletin No. 04-33.

In PLR 200415011, an unmarried taxpayer died after taking a distribution from her IRA. Following her death, the executor of her estate returned a portion of the distribution to the same IRA. The executor was decedent's son, and also one of the beneficiaries of her estate.

The IRS ruled that the distribution was taxable. It did not qualify for either of the exceptions to the general taxability of IRA distributions in that it was neither contributed to another IRA for the benefit of the decedent within 60 days, nor was it rolled over to an IRA maintained for the benefit of a surviving spouse. (The decedent in PLR 200415011, being unmarried, had no surviving spouse.) The Revenue Service explained that the decedent, who was the individual on whose behalf the IRA was maintained, died prior to the date of the action of his executor. Furthermore, the executor (the decedent's son) was neither the recipient of the subject IRA distributions, nor the individual on whose behalf IRA was maintained. Nor was he the surviving spouse of the decedent. The executor's payment therefore was not a qualified rollover.

The ruling reaches a harsh result. It appears that the taxpayer did not invoke Rev. Proc. 2003-16, or the hardship relief provisions of IRC § 408(d)(3)(I), as added by EGTRRA. We note that, had the taxpayer done so, the legislative history of EGTRRA indicates that relief might have been in order, at least if there had been any evidence that the decedent had begun a rollover prior to her death. The Conference Report to EGTRRA (cited in Rev. Proc. 2003-16, *supra*) posits that relief from the 60-day rollover rule may be granted in circumstances "such as during a period in which a distribution in the form of a check was not cashed, or for errors committed by a financial institution, or *in cases of inability to complete a rollover due to death*, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error." (Emphasis supplied.)

In contrast, the Revenue Service permitted a post-death rollover beyond the 60-day period in PLR 200415012. In that ruling, the decedent, prior to his death, withdrew an unspecified sum from his IRA and deposited it in his personal bank account. More than 60 days later, his surviving spouse, who was the sole beneficiary of decedent's IRA, withdrew the deposited IRA funds from the bank, and contributed them to a second IRA as a rollover contribution.

The surviving spouse requested a hardship waiver under Rev. Proc. 2003-16, asserting that the delay was owing to the fact that she was in mourning over the death of her husband, and was involved in handling funeral arrangements for him. As soon as possible thereafter, she completed the "rollover."

In this case, the Service granted a hardship waiver from the 60-day requirement. The ruling states that

"The information also shows that you were individual A's wife as of the date of his death, and were the sole beneficiary of Individual A's IRA X. Furthermore, it shows that you have attempted to roll over said IRA X distribution into an IRA set up in your name to benefit you which, as Individual A's widow, you were entitled to do. However, said "rollover" was accomplished outside the requisite 60-day period. The information presented indicates that the reason for the failure to comply with the 60-day requirement was the death of Individual A, your husband, which effectuated the delay this caused in your handling of his financial affairs. Finally, this request for a letter ruling was submitted shortly after your attempted rollover and shortly after you discovered that the 'rollover' failed to comply with the requirements of section 408(d)(3) of the Code."

The surviving spouse thereupon was granted a period of 60 days from the issuance of the ruling letter to complete the rollover.

The differing outcomes in the two PLRs may indicate that the Service will only issue waivers where the person attempting the rollover is someone who would have been entitled to make a timely rollover in the first place – *i.e.*, either the (live) account owner, or his or her surviving spouse.

3. *PLR 200414011*

A trust that purports to be a charitable remainder unitrust is not qualified as such for purposes of the Federal estate tax charitable deduction because the actuarial value of the charitable remainder interest is less than 10% of the value of the trust corpus. Further, the trust may not be reformed to comply with the requirements of a valid charitable remainder unitrust because no reformation was commenced within the time limits prescribed by the Internal Revenue Code.

Section 2055(a) of the Code allows a deduction from the gross estate for federal estate tax purposes for the value of certain charitable bequests. However, Section 2055(e)(2) disallows the charitable deduction where an interest in the same property passes to both charitable and non-charitable beneficiaries unless, in the case of a remainder interest to charity, such interest is in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

Split-interest bequests that are not in one of the required forms may nevertheless be reformed in certain circumstances so that a deduction may be allowed if: (i) any difference between the actuarial value of the qualified (reformed) interest and the actuarial value of the reformable interest does not exceed 5% of the actuarial value of the reformable interest; (ii) in the case of a charitable remainder interest, the non-remainder interest, both before and after the qualified reformation, terminates at the same time; and (iii) such change is effective as of the date of the decedent's death. In order to take advantage of the qualified reformation provisions, a proceeding must be commenced to reform the interest not later than the 90th day after the last date (including extensions) for filing the federal estate tax return.

One of the requirements of a qualified charitable remainder trust, added to the Revenue Code as part of the Revenue Reconciliation Act of 1997 (*see* our Bulletin No. 97-70), states that the value of the remainder interest in each contribution of property to the trust must be equal to at least 10 percent of the net fair market value of such property on the date of contribution. A trust that fails to meet this requirement may be (i) declared null and void ab initio, or (ii) changed by reformation, amendment, or otherwise to meet such requirement by reducing the payout rate or the duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement, pursuant to a proceeding that is commenced within the 9-month period described above. However, in a case in which no Federal estate tax return was **due, or the trust was created during the donor's lifetime, reformation** must begin within 90 days after the due date (including extensions) for the trust's first income tax return.

In PLR 200414011, an unqualified *inter vivos* charitable remainder unitrust that failed to meet the "10 percent remainder" requirement could not be reformed to qualify for the Federal estate tax charitable deduction because the trustee failed to begin a reformation within the required period.

In the ruling, the trust indenture of "Charitable Trust," which was executed by "X" during his lifetime, provided that, in each taxable year of the trust, the trustees must pay to X, during X's lifetime, a unitrust amount equal to 8 percent of the net fair market value of the Charitable Trust valued as of the first day of each taxable year of the trust. Upon X's death, the unitrust amount is to be divided into two equal shares. One such share must be paid to Y during Y's lifetime. The remaining such share must be paid in

equal shares to A, B, and C, or the survivors of them, during the lifetime of Y. Upon the death of the survivor of X and Y, the trustees are to distribute all of the then principal and income to one or more qualified charitable remaindermen.

As is common with most charitable remainder trusts, the trustees have the power, in their sole discretion, to amend the Charitable Trust in any manner required for the sole purpose of insuring that the Charitable Trust qualifies and continues to qualify as a charitable remainder unitrust under the Internal Revenue Code.

Unfortunately, in this case, Charitable Trust was not qualified as a charitable remainder unitrust because the initial value of the remainder interest in the Charitable Trust, as of the date of the trust's creation, was determined to be less than 10 percent of the net fair market value of the property contributed to the Charitable Trust.

The Revenue Service concluded that the termination of the ½ of the unitrust payments to A, B and C upon the death of Y was a "qualified contingency" that would not cause the Charitable Trust to fail to meet the definition of a CRUT. However, the value of the charitable remainder interest must be calculated without regard to the qualified contingency – *i.e.*, Y's death. Presumably, the actuarial value of the remainder interest therefore must take into account the interest of A, B and C. The result of this calculation caused the trust to fail the 10 percent requirement.

Moreover, since Charitable Trust was funded during the donor's lifetime, and since no reformation was commenced within 90 days of the trust's first income tax return, the trust could not be reformed to qualify for the Federal estate tax charitable deduction.

It is notable that the ruling cites the failure of the trust to qualify under the 10 percent remainder test as of the date of its inception (*i.e.*, when X was alive and funded the trust). Presumably, this date was after 1997, when the 10 percent remainder requirement was added to the Code. (The provision applied generally to "transfers in trust" after July 28, 1997.) The Federal estate tax charitable deduction at X's death was nevertheless denied based on this initial failure.

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