

AALU's Washington Report

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AALU Bulletin No: 05-41

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Subject: **General Estate and Gift Tax Developments: January 2005**

1. **Surviving Spouse's Interest in Testamentary Trust Does Not Qualify for Marital Deduction**

Major References: [*Estate of Davis v. Commissioner, F.3d*, No. 03-72240 \(9th Cir. 2005\), aff'g T.C. Memo 2003-55](#)

Prior AALU Washington Reports: 03-58

2. **Post-Death Sale of Closely Held Stock May Be Considered in Valuation for Federal Estate Tax Purposes**

Major References: [*Estate of Noble v. Commissioner, T.C. Memo 2005-2*](#)

3. **Wife May Disclaim Interest in Joint Brokerage Account Despite Partial Acceptance of Benefits**

Major References: [*PLR 200503024*](#)

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

This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the Internal Revenue Service in January of 2005, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Cases

1. ***Estate of Davis v. Commissioner***, ___ F.3d ___, No. 03-72240 (9th Cir. 2005), *aff'g T.C. Memo 2003-55*

The Ninth Circuit Court of Appeals has affirmed the decision of the Tax Court (see our Bulletin No. 03-58), holding that a marital trust in which the surviving spouse's right to income is limited by an ascertainable standard is not eligible for the Federal estate tax marital deduction.

Ralph H. Davis, of Stockton, California, ("Decedent") died on July 14, 1997, survived by his wife, Evelyn Davis, and two daughters of a previous marriage.

Decedent's estate plan consisted of a Will and revocable trust ("Trust"), both of which had been executed in 1993, and amended in 1996 upon his marriage to Evelyn. Pursuant to these amendments, Decedent transferred the residue of his estate to the Trust. The residue of the Trust was, in turn, distributable as follows:

Life Estate to Surviving Spouse of Trustor: After the death of trustor survived by his spouse and during the lifetime of his surviving spouse, the trustee shall pay to or apply for the benefit of the surviving spouse, in quarter annual or more frequent installments, all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living. . . .

Guideline -- Other Sources: Beneficiary: In making distributions to grantor's surviving spouse, the trustee, in her reasonable discretion, may consider any other income or resources of the beneficiary known to the trustee and reasonably available. . . .

Invasion of Principal for Surviving Spouse -- Narrow Standard: If the trustee shall determine that the income from this trust and that the income and principal from the surviving spouse's own trust² shall be insufficient to maintain surviving spouse's health, support, and maintenance, the trustee may, after surviving spouse has exhausted all assets of her own trust, invade the principal of this trust for the benefit of surviving spouse, in the trustee's reasonable discretion.

Decedent's wife was named the trustee of the Trust after Decedent's death.

Decedent's total gross estate, as reported on his estate's Form 706, was \$1,180,823. The estate claimed a total marital deduction of \$573,216, of which \$564,862 consisted of the amount to be held in the above trust. In September 2001, the government disallowed the marital deduction for the amount to be held in trust for Decedent's wife on the grounds that the interest was "terminable." A "terminable interest" is an interest in property - such as a life estate - that will fail or terminate with the passage of time.

We note that certain life estates may be eligible for the Federal estate tax marital deduction notwithstanding the terminable interest rule. These include a life estate in "qualified terminable interest property" (QTIP) and a life estate in property over which the surviving spouse has a general power of

appointment (GPA). Both QTIP and GPA trusts, however, must, at a minimum, require that the surviving spouse have an unrestricted right to all of the income from the trust property, payable at least annually, in order to qualify for the marital deduction.

In an apparent attempt to remedy the drafting errors in the original Trust, and to provide herself with an unrestricted right to trust income, Decedent's wife, on October 1, 2001 (less than one month after the issuance of the notice of deficiency to the estate), filed a "NOTICE OF IRREVOCABLE EXERCISE OF GENERAL POWER OF APPOINTMENT", in which she purported to exercise a general power of appointment to appoint all of the trust income to herself.

Both the Tax Court and the appellate court, however, found that the right of Decedent's wife to all of the income of the trust was severely restricted. The existence of an ascertainable standard of distribution, which the courts found to be present in this case, negates both the right to all of the income and the existence of a general power of appointment exercisable "alone and in all events."

The use of the words "health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living" when used to modify "all of the net income from the trust estate" were not sufficient, under California law, to make all of the income payable to the surviving spouse, as would be required in a QTIP trust. The Tax Court was particularly troubled by the clause "in accordance with the spouse's accustomed manner of living," which it determined to be fatal, under California case law, to a more liberal interpretation of the surviving spouse's powers over trust income.

The courts also rejected the argument that the Trust qualified as a GPA trust, since a "general" power of appointment under the marital deduction provision may not be limited by an ascertainable standard.

The appellate court placed particular emphasis on the absence of language in the Trust instrument that indicated the Decedent's intent that the bequest to his wife qualify for the marital deduction, noting that "[w]hen read as a whole, the Declaration of Trust and the Amendment unambiguously indicate that Ralph H. Davis intended to leave to his surviving spouse an interest in the trust income that is explicitly restricted by the purposes listed in the trust."

2. *Estate of Noble v. Commissioner, T.C. Memo 2005-2*

The Tax Court has ruled that the determination of fair market value of closely held stock for Federal estate tax purposes may be based on post-death sales of such stock.

"Decedent" Helen Noble died on September 2, 1996, leaving a gross estate that included 116 shares of stock in Glenwood Bank, representing 11.6% of the 1000 nonpublicly traded shares outstanding. Glenwood Bancorporation (Bancorporation) owned the remaining 88.4% interest in the bank. The shareholders of Bancorporation were John Dean (Dean), Dean's son, and Dean's son-in-law. Dean owned 69 percent of Bancorporation's stock, and he was unrelated to Decedent.

The estate tax return, filed on July 23, 1998, reported that the fair market value of each of the 116 shares equaled its 1996 book value (\$14,169 per share), less a 45% minority interest discount, resulting in a reported total fair market value of \$903,988. The IRS in its notice of deficiency asserted that the stock was worth \$1.1 million.

The Tax Court, in a memorandum opinion, found that the fair market value of the 11.6% interest was \$1,067,000.

At issue in the case was the extent to which post-death events could influence the determination of “date of death” value for Federal estate tax purposes.

Prior to Decedent’s death, Bancorporation purchased two blocks of Glenwood Bank stock. In June 1995, Bancorporation purchased 10 shares of Glenwood Bank stock at \$1,000 per share. Then, in July 1996, Bancorporation purchased 7 shares of Glenwood Bank stock at \$1,500 per share.

After decedent died, Dean sought to buy the 116 Glenwood Bank shares held by the estate and obtained an appraisal for this purpose. This appraisal, obtained on May 15, 1997, determined that, as of December 31, 1996 (almost 4 months after Decedent’s death), the fair market value of those shares was \$878,004 (\$7,569 per share). The appraisal stated that this fair market value included a 29-percent discount for minority interest and a 35-percent discount for lack of marketability. The estate, however, declined to sell its Glenwood Bank shares to Dean at this appraised price, and instead sold those shares to Bancorporation on October 24, 1997, for \$1.1 million (\$9,483 per share).

The Court stated that, “[w]hile listed market prices of publicly traded stock are usually representative of the fair market value of that stock for Federal tax purposes, the fair market value of nonpublicly traded stock is ‘best ascertained’ through arm’s-length sales near the valuation date of reasonable amounts of that stock, as long as both the buyer and the seller were willing and informed and the sales did not include a compulsion to buy or to sell.”

The estate protested that actual sales may be probative of fair market value only if they occur within a reasonable time *before* the valuation date. The estate also asserted that “a prior sale of property conclusively sets the fair market value of that property on a later valuation date even if the seller was not knowledgeable of all relevant facts as to that property and even if the property that was the subject of the sale was not of comparable size to the property subject to valuation.” The Court, however, citing *Morrissey v. Commissioner*, 243 F.3d 1145, 1149 (9th Cir. 2001), stated that a determination of fair market value on the basis of actual sales “has often been said to include requirements that a seller be knowledgeable and that the seller’s property be comparable to the property subject to valuation.”

On this basis, the Court determined that the two prior sales of 10 shares and 7 shares, either separately or together, were not an accurate measure of the applicable fair market value of Decedent’s 116 shares because the two prior sellers did not sell their stock for the amount set forth in an appraisal. Moreover, although valuation should generally be made based on a “hypothetical” willing buyer and seller, the Court found that “it was reasonably foreseeable as of the applicable valuation date that the other shareholder, Bancorporation, would eventually want to buy that 11.6-percent interest at some unknown time and that this added a special value to the interest.” A hypothetical seller would have been aware of this fact, and, thus, would not have equated the selling price for the 10 shares and 7 shares with the hypothetical selling price of Decedent’s 116 shares.

Thus, the Court held that the evidence of the later sale properly should be considered. Thus, the Court summarized:

“Petitioners try to downplay the importance of the subsequent (third) sale of the estate's 116 Glenwood Bank shares by characterizing it as a sale to a strategic buyer who bought the shares at greater than fair market value in order to become the sole shareholder of Glenwood Bank. Respondent argues that the third sale was negotiated at arm's length and is most relevant to our decision. We agree with respondent. Although petitioners observe correctly that an actual purchase of stock by a strategic buyer may not necessarily represent the price that a hypothetical buyer would pay for similar shares, the third sale was not a sale of similar shares; it was a sale of the exact shares that are now before us for valuation. We believe it to be most relevant that the exact shares subject to valuation were sold near the valuation date in an arm's-length transaction and consider it to be of much less relevance that some other shares (e.g., the 10 shares and 7 shares discussed herein) were sold beforehand. The property to be valued in this case is not simply any 11.6-percent interest in Glenwood Bank; it is the actual 11.6% interest in Glenwood Bank that was owned by decedent when she died.”

The Court thus accepted the post-death sales price as the most probative evidence of value, permitting an adjustment only for inflation that may have occurred between the date of death and the date of sale.

Private Letter Rulings

3. *PLR 200503024*

The IRS has ruled, in PLR 200503024, that a surviving spouse may disclaim an interest in a joint brokerage account, even though she has withdrawn cash from the account, directed that the account be re-titled in her name, and directed that some assets in the account be purchased and sold.

Section 2518 of the Internal Revenue code (relating to qualified disclaimers) provides that, if a person makes a “qualified” disclaimer of an interest in property, the estate, gift, and generation-skipping transfer tax provisions apply to that interest as if it had never been transferred to the disclaiming person. A “qualified” disclaimer is an irrevocable, unqualified refusal of an acceptance of an interest in property that is made, in writing, within nine months of the date -- in the case of property passing by reason of death -- of the decedent's death. The person disclaiming the interest may not, prior to disclaiming, accept the interest or any of its benefits, expressly or impliedly. Acceptance generally is demonstrated by an affirmative act that is consistent with ownership of the interest in property, as, for example, by using the property, accepting income from the property, and/or directing others to act with respect to the property. In addition to the foregoing, as a result of the disclaimer, the interest must pass to the taker or takers in default without any direction by the person making the disclaimer. If these conditions are not satisfied, the disclaimant will be treated as making a gift.

PLR 200503024 illustrates the extent to which a disclaimant may exercise act of ownership with respect to disclaimed property without transgressing the requirements of § 2518.

In that ruling, “Wife” disclaimed her survivorship interest in Wife and Husband's joint brokerage account in order to fund a credit shelter, or “bypass” trust. Prior to Wife’s disclaimer, however, the following acts occurred:

1. Because Wife's stockbroker advised her that the Brokerage Account could not be held under the social security number of a deceased individual, Wife directed the stockbroker to transfer title in the Brokerage Account to Wife's name.

2. During the eight months after Husband's death, Wife directed the stockbroker to sell certain securities in the Brokerage Account and to purchase other securities for the account.

3. During this period, Wife also withdrew certain amounts of cash from the account.

In the ninth month after Husband's death, Wife executed a written disclaimer in which Wife disclaimed "her beneficial survivorship interest in [Husband's] share in [the Brokerage Account]," less the assets in that share (and earnings on those assets since Husband's death) in which Wife accepted benefits.

After the disclaimer, Wife's attorneys directed the stockbroker to establish and fund three accounts: the "TIC" Account, the Wife's Account, and the Estate Account. The TIC Account held assets – in the name of Wife and Husband's estate as tenants-in-common - that could not be evenly divided. This account did not include any proceeds from the securities sold in the eight months following Husband's death or any of the securities purchased during that period.

The remaining assets in the Brokerage Account were divided between the Wife's Account, held in Wife's name, and the Estate Account, held in the name of Husband's estate. The Wife's Account held assets attributable to Wife's contributions to the Brokerage Account and also held assets attributable to Husband's contributions with respect to which Wife directed sales or purchases after Husband's death, - *i.e.*, any proceeds from the securities sold in the eight months following Husband's death as well as the securities purchased during that period. The Estate Account held assets attributable to Husband's contributions with respect to which Wife made no withdrawals and directed no sales or purchases after Husband's death. Each of the three accounts also held the earnings from the date of Husband's death on the assets placed in each account. The Estate Account and the estate's one-half interest in the TIC Account represent the disclaimed interest, and will pass, pursuant to the terms of Husband's will and revocable trust, to the credit shelter trust.

The Revenue Service, in ruling that Wife's disclaimer was "qualified" under § 2518, noted that "[m]erely taking delivery of an instrument of title, without more, does not constitute acceptance" of property. Thus, the mere transfer of title to the brokerage account to Wife's name after Husband's death was not an "acceptance." Nor is a disclaimant considered to have accepted property merely because under applicable local law title to the property vests immediately in the disclaimant upon the death of a decedent.

The acceptance of one interest in property will not, by itself, constitute an acceptance of any other separate interests created by the transferor and held by the disclaimant in the same property, so long as the interests are severable. Therefore, Wife's disclaimer of the assets held in the Estate Account and the estate's one-half share of the TIC Account may be a qualified disclaimer even though Wife withdrew (severable) cash from the account during the eight months following Husband's death. In contrast, Wife may not disclaim those assets (or the proceeds thereof) in the brokerage account that she directed be purchased or sold prior to the disclaimer.

Further, 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 are not treated as acceptance of such property or any of its benefits, so long as the fiduciary does not retain a wholly discretionary power to direct the enjoyment of the disclaimed interest.

In the PLR, Wife was a co-trustee and – with her children – a beneficiary of the credit shelter trust that would be the recipient of the disclaimed property. Although Treasury regulations permit a disclaiming surviving spouse to retain an interest in disclaimed property, if the surviving spouse retains the right to direct the beneficial enjoyment of the disclaimed property, the disclaimer will not be qualified unless such power is limited by an ascertainable standard. Under the facts of the PLR, wife’s power, as trustee, to distribute the disclaimed assets in the credit shelter trust to Husband and Wife’s children was limited by an ascertainable standard. In addition, under applicable State law, although named as co-trustee, Wife could not participate as a trustee in making any distributions to herself as beneficiary of the credit shelter trust and, thus, could not be deemed to have accepted any part of the disclaimed property in her role as co-trustee.

Accordingly, the Service ruled that Wife's disclaimer of her survivorship interest in the Brokerage Account, *i.e.*, the assets held in the Estate Account and the estate's one-half share in the TIC Account, is a qualified disclaimer.

PLR 200503024 provides a roadmap for a disclaimer of severable joint assets in a situation in which pre-disclaimer actions may arguably be at odds with the requirements of qualification under § 2518.

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