

AALU's Washington Report

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

1. IRS Issues Final GRAT Valuation Regulations

Major References: [*T.D. 9181, 70 Fed. Reg. 9222-9224 \(February 25, 2005\)*](#)

Prior AALU Washington Reports: 04-123; 03-106; 03-18; 01-94; 01-95; 00-112

2. Testamentary Trust Does Not Qualify For Federal Estate Tax Marital Deduction

Major References: [*TAM 200505022*](#)

Prior AALU Washington Reports: 05-41; 05-18; 03-58

3. IRS Issues Rulings On Distributions From Qualified Plans In Absence of Beneficiary Designation

Major References: [*PLR 200505030*](#)

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 February of 2005, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Treasury Decisions

1. *T.D. 9181, 70 Fed. Reg. 9222-9224 (February 25, 2005)*

The Treasury has issued final regulations under Revenue Code section 2702 respecting gift tax valuation determinations for grantor retained annuity trusts (GRATs). These final regulations reflect the holding of the Tax Court in Walton v. Commissioner (permitting “zeroed-out” GRATs) and clarify the meaning of the regulations at issue in Schott v. Commissioner (relating to revocable spousal annuities). For a discussion of these regulations in their proposed form, and the Revenue Service acquiescence in the Walton decision, see our Bulletins Nos. 04-123 and 03-106.

The *Walton* and *Schott* cases may be summarized as follows:

a. *Walton v. Commissioner*, 115 T.C. 589 (2000). In *Walton*, the taxpayer successfully asserted that the value of her retained interest in two GRATs need not be reduced by the possibility of her death during the term of the annuity where the remaining annuity payments were payable to her estate. The Tax Court determined Treas. Reg. § 25.2702-3(e), *Example (5)*, which purported to require a contrary result, to be invalid. (See our Bulletin No. 00-112.)

Example (5) (prior to its amendment) read as follows:

“A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years *or until A's prior death*.” (Emphasis supplied.)

As amended, *Example (5)* provides that “[t]he interest of A (and A's estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.”

The Revenue Service refused to provide additional guidance (requested by some commentators) concerning the amount includible in the estate of the grantor of a Walton-type GRAT who does not survive the term. Similarly, it declined to provide guidance concerning the effect of death within three years after the end of the GRAT term. However, the preamble to the final regulation states that “Treasury and IRS will consider addressing [these valuation issues] in future guidance.”

b. *Schott v. Commissioner*, T.C.M. 2001-110, rev'd and remanded, 319 F. 3d 1203 (9th Cir. 2003). It has long been the Revenue Service's position that a revocable spousal annuity is not a Section 2702 “qualified interest” that would reduce the value of the gift of the remainder interest in a GRAT to the grantor's children if the spousal interest is subject to any contingency (other than the revocation). This interpretation purportedly is reflected in *Example 7* of Treas. Regs. § 25.2702-2(d)(1). In *Example (7)*, the grantor retains an annuity for 10 years, followed by an annuity for his spouse for 10 years. Although the grantor may revoke the spouse's annuity, *Example (7)* provides in this instance that the interest of the grantor's spouse is a qualified annuity interest retained by the grantor. In the Revenue Service's (and the Tax Court's) view, in *Example (7)*, the interests of both the grantor and his or her spouse, at the creation of

the trust, are fixed and ascertainable for specified 10-year terms and are therefore not contingent upon the grantor's death or the spouse's death.

The Service was successful in advancing its position (that a revocable spousal annuity is not a “qualified interest”) in *Cook v. Commissioner*, 269 F.3d 854, 858 (7th Cir. 2001), reported in our Bulletin No. 01-94, and at the trial court level in *Schott v. Commissioner*, T.C. Memo 2001-110, reported in our Bulletin No. 01-45, both of which upheld the Internal Revenue Service’s regulatory interpretation of *Example (7)*. In those cases, the courts accepted the Service’s argument that a qualified annuity interest “cannot be a contingent interest that may in fact never take effect.” In each of those cases, the spouse’s interest, in addition to being revocable, was contingent on the grantor’s death during the initial GRAT term, and was payable, upon the occurrence of that contingency, for the remainder of the initial term.

However, the Ninth Circuit reversed the Tax Court’s decision in Schott v. Commissioner, holding that the value of the gift was reduced by the revocable spousal interest. (See our Bulletin No. 03-18.)`

In response, the Service amended the regulation at issue in these cases to clarify, in new *Example (8)* and *(9)*, that the revocable spousal interest exception applies only if the spouse's interest, standing alone, would constitute a qualified interest, but for the grantor’s revocation power. In response to comments, language has been added to *Example (8)*, “to clarify that the grantor makes a completed gift to the spouse when the revocation right lapses on the expiration of the grantor's retained term (the grantor having survived the term and not having exercised the revocation right).”

The amendments are generally effective for trusts created on or after July 26, 2004. However, the Revenue Service has stated that it will not challenge any prior application of the changes to *Examples (5)* and *(6)*, thus providing need reassurance to those who drafted GRATs in reliance on the *Walton* decision prior to that date.

Technical Advice Memoranda

2. TAM 200505022

A decedent’s estate has once again forfeited the federal estate tax marital deduction for failure to provide for the distribution of all of the income to the surviving spouse at least annually.

Property bequeathed to a surviving spouse will not qualify for the Federal estate tax marital deduction if the spouse’s interest in the property is “terminable.” A “terminable interest” is an interest in property - such as a life estate - that will fail or terminate with the passage of time.

Certain life estates nevertheless 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.

While these rules are of long standing, practitioners nevertheless manage to run afoul of the terminable interest rule with remarkable frequency. (See, e.g., *Estate of Davis v. Commissioner*, ___ F.3d ___, No. 03-72240 (9th Cir. 2005), *aff'g* T.C. Memo 2003-55, discussed in our Bulletins Nos. 03-58 and 05-41, and **TAM 200444023**, discussed in our Bulletin No. 05-18.

In **TAM 200505022**, “Decedent” died testate survived by his spouse (“Spouse”) and their children. Spouse and “Trustee,” an independent corporation, are the co-executors of Decedent's estate. Decedent's will, executed prior to 1981 (when the unlimited Federal estate tax marital deduction took effect), bequeaths Decedent's interest in his personal residence and all personal property to Spouse. All the rest and residue of Decedent's property, real and personal, passed in trust to Trust A, of which Trustee, a bank, is the Trustee, for the primary benefit of Spouse.

Trust A states that:

“During the lifetime of my wife, [Spouse], the Trustee shall, subject to the limitations and provisions hereinafter set forth, distribute the net income of the Trust created hereby to my wife *in such amounts and at such times as my wife, in her sole discretion but in consultation with the Trustee, shall desire for her maintenance, education, health or support commensurate with her station in life*. In this connection, if at any time, or from time to time in the opinion of my wife, the income of said Trust is insufficient to provide for her maintenance, education, health or support commensurate with her needs, the Trustee, taking into consideration of all the sources of income or other capital available to it, is authorized and directed to distribute to my wife portions of the principal of this trust in such amounts as shall be desired by my wife, in her sole discretion but in consultation with the Trustee, for her maintenance, education, health and support. Any income not distributed shall be added to the principal.” (Emphasis supplied.)

Upon Spouse's death, Trust A will terminate, and its assets will pass to Trust B, for the benefit of Decedent's children.

Although Decedent's will contains no reference to the estate tax marital deduction and no specific statement providing that it is Decedent's intent that Trust A qualify for the estate tax marital deduction, two letters to Decedent from the attorney who drafted the will state that, under the terms of the document, Spouse has the right to obtain all income and principal from the trust by making the request to the trustee. A third letter (dated within two months of the date of the will) from the attorney who drafted the will to a trust officer at the Trustee recites that the Decedent has “maintained his decision that he wants his wife to have complete discretion with respect to the disposition of the trust assets . . .”

The Revenue Service, on audit of Decedent's federal estate tax return, disallowed the election, by Decedent's executor, to treat the property passing to Trust A as QTIP. The Service determined that she had neither the right to all of the income from the trust, nor the unlimited right to appoint the assets to herself, her estate, or the creditors of either.

With respect to the right to all of the income, the Service notes that Spouse's right is limited under the terms of Trust A to those amounts desired by Spouse for her “maintenance, education, health or support,” to be determined “in consultation with the trustee.” Further, these limitations on Spouse's power to the all of

the income – which also apply to distributions of corpus to her - are such that the power cannot be considered a general power of appointment.

Decedent's estate countered that the will was ambiguous on the matter and extent of Spouse's interest in Trust A, and therefore that the letters written by Decedent's attorney during the period the will was being drafted should be considered as evidence that Decedent intended that Spouse have unrestricted access to the trust assets.

The Revenue Service, however, disagreed with the estate's contention that the will was ambiguous, noting that the use of the limiting words "maintenance, education, health or support" "have been universally recognized" as not constituting a general power of trust assets. Believing that "Decedent's intent is clear," the Service ruled the property passing to Trust A was not eligible for the estate tax marital deduction.

Private Letter Rulings

3. *PLR 200505030*

The Revenue Service has ruled that a series of timely disclaimers will result in the assets held by a qualified government defined benefit plan and a Section 457(b) plan being deemed to pass directly to the participant/decedent's surviving spouse, who may then roll them over into an IRA maintained in her own name.

In this ruling, the decedent was a participant in a qualified government defined benefit plan, and a qualified deferred compensation plan maintained under Section 457(b) of the Internal Revenue Code. Decedent died prior to having reached age 70 ½ survived by his spouse (Spouse), two children (Daughter 1 and Daughter 2), two grandchildren (Grandchild 1 and Grandchild 2), a sister (Sister), who died 7 days after Decedent, and a sister-in-law (Sister-in-law). In addition, Sister had two children, Nephew 1 and Niece 1, and Sister-in-law had five children, Nephews 2-5 and Niece 2.

On Date 1, Decedent designated Trust 1, an inter vivos trust established by Decedent, as the beneficiary of his interests in both plans. However, on Date 2, Decedent established Trust 2, a revocable trust, and executed a new Last Will and Testament. At the same time, Decedent destroyed the Trust 1 agreement and his prior will, thereby revoking both instruments. Decedent did not, however, designate a new beneficiary of his interest in either retirement plan. In accordance with the terms of those plans, their assets, in the absence of a designated beneficiary, were distributable to Decedent's estate.

The terms of Decedent's Will provide that his estate will be distributed to Trust 2, which, in turn, provides for the division of the estate into a credit shelter (bypass) trust, and a marital trust. Both of these trusts are for the benefit of Spouse during her lifetime, and for Decedent's issue after Spouse's death. If the Decedent has no then living issue, the remaining trust property will be distributable one-half to Sister-in-law, or if she is not then living to Sister-in-law's then-living issue *per stirpes*, and one-half to Sister, or if she is not then living to Sister's then-living issue *per stirpes*.

Spouse, Daughter 1, Daughter 2, Grandchild 1, Grandchild 2, Sister (through, her legal representative), Sister-in-law, Nephew 1 and Niece 1, Nephews 2-5 and Niece 2 propose to execute qualified disclaimers of their respective interests under Trust 2 within 9 months of Decedent's death. In the case of three beneficiaries who are minors, a guardian will be appointed for purposes of executing their disclaimers.

Under State law, the disclaimants will be treated as if they had all predeceased Decedent, and the estate residue (which includes the proceeds of the retirement plans), after the payment of debts and expenses, will become distributable to Decedent's heirs at law.

Daughter 1, Daughter 2, Grandchild 1 and Grandchild 2 further propose to execute qualified disclaimers, also within 9 months of Decedent's death, of each of their intestate interests in the residue of Decedent's estate. These disclaimants also will be treated as predeceasing the Decedent under State law, with the result that Spouse will receive the decedent's entire estate. Accordingly, Spouse will become the sole beneficiary of Decedent's residuary estate, including the interests in the retirement benefits.

Within 60 days of receipt of the distributions from these plans, Spouse will roll over the distributions into an individual retirement account (IRA) set and maintained in her name.

On these facts, the Service ruled that:

- The proposed disclaimers will be qualified disclaimers;
- The amount passing to Spouse by intestacy as a result of the disclaimers will qualify for the estate tax marital deduction;
- As a result of the disclaimers, Spouse will be treated as having received Decedent's interest in both plans directly from Decedent; and
- Spouse is eligible to roll over the distributions received under both plans into an individual retirement account (IRA) set up and maintained in her name; and will not have to include in her Federal gross income for the year of distribution and rollover (2004) any portion of the distribution from either plan.

The complex approach reflected in this ruling and the trouble and expense it represents, although illustrative of creative post-mortem estate planning, could have been avoided if Decedent had remembered to change his beneficiary designation when he revised his estate plan. The creativity which is shown in the ruling and which brings credit to the estate planner would not have been necessary to preserve the Spouse's income recognition-avoiding rollover rights if Decedent had been more prescient and simply consulted with his estate planner prior to death.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Bulletin may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Jeff Lavine at lavine@aalu.org and include a reference to this *Washington Report*.



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