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AALU Bulletin No: 05-93

September 27, 2005

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

1. **Investment Advisory Fees Paid By Trust Are Subject to 2% Floor**

Major References: [\*William L. Rudkin Testamentary Trust v. Commissioner, 124 T.C. \\_\\_\\_, No. 19 \(2005\)\*](#)

2. **Spouse's Contemporaneous Disclaimers of Interest in IRA and Trust Are Qualified**

Major References: [\*PLR 200521033\*](#)

3. **Redemption of Foundation's Stock in Closely-Held Corporation Is Not Self-Dealing**

Major References: [\*PLR 200521028\*](#)

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

**SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE  
CONCLUSION OF THIS WASHINGTON REPORT.**

**Cases**

**1. William L. Rudkin Testamentary Trust v. Commissioner, 124 T.C. \_\_, No. 19 (2005)**

*The Tax Court, in accordance with a prior decision which has been reversed on appeal, has determined that investment advisory fees paid by a testamentary trust are deductible only to the extent that they exceed 2 percent of the trust's adjusted gross income.*

Henry A. Rudkin, a member of the family involved in the foundation of Pepperidge Farm, died on April 14, 1967, establishing, in his will, a testamentary trust for the benefit of his son, his son's spouse, and further descendants.. Pepperidge Farm was sold to Campbell Soup Company in the 1960s, and the trust was initially funded primarily with proceeds from that sale.

The trust terms provided Mr. Rudkin's executors and trustees with broad authority "to invest and reinvest the funds of my estate or of any trust created hereunder in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel."

The trustee paid Warfield Associates, Inc. a total of \$22,241.31 to provide investment management advice for the trust during the taxable year 2000. On its return for that year, the trust reported total income of \$624,816, and deducted the full \$22,241 on the line for "Other deductions not subject to the 2% floor," further described on an attached statement as "INVESTMENT MANAGEMENT FEES." It claimed no deduction on the line for "Allowable miscellaneous itemized deductions subject to the 2% floor."

On audit, the Internal Revenue Service permitted a deduction of only \$9,780, the amount by which \$22,241 exceeded 2 percent of adjusted gross income of \$623,050 (*i.e.*, \$12,461). As a result, the trust was assessed a tax deficiency of \$4,448 for the year.

The so-called "2% floor" limits the "miscellaneous itemized deductions" of individual taxpayers to the amount of such deductions that exceed 2% of adjusted gross income. Miscellaneous itemized deductions of trusts and estates are similarly limited except with respect to "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate \* \* \*." (Emphasis supplied.)

Mr. Rudkin's trustee maintained that the fees paid to Warfield Associates were (i) paid in connection with administration of the trust and (ii) would not have been incurred if the property were not held in trust. He argued that, while an individual may make a voluntary and personal choice to seek investment advice, fiduciary duties imposed on a trustee render such professional advice a necessary and "involuntary" component of trust administration.

The IRS responded, and the Tax Court, in a unanimous decision that was reviewed by the full Court, agreed, that (i) because investment advisory fees are commonly incurred by individual investors outside the

context of trust administration, the fees fail to satisfy the requirement that they would not have been incurred if the assets were not held in trust, and (ii) neither State law nor the governing trust instrument imposed a legal obligation on the fiduciary to obtain professional investment management services.

In ruling in favor of the government, the Tax Court adopted the reasoning of its prior opinion in *O'Neill v. Commissioner*, 98 T.C. 227 (1992). That decision subsequently was reversed - in favor of the taxpayer - by the U.S. Court of Appeals for the Sixth Circuit. Two other Circuit courts of appeal - the Fourth Circuit and the Federal Circuit - have decided this issue in favor of the government, however, thus creating a split in the circuits. *See*. Scott v. United States, 328 F.3d 132 (4th Cir. 2003) and Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001).

Appeal in the instant case would be to the Court of Appeals for the Second Circuit, which has not ruled on this issue.

### **Private Letter Rulings**

#### **2. *PLR 200521033***

***The IRS has ruled, in PLR 200521033, that a surviving spouse's disclaimers of her interest in her husband's IRA after his death, followed, within the requisite time period, of disclaimers of her interest in a marital trust and her testamentary right to appoint the property of a family (credit shelter) trust are qualified, and serve to make the family trust the designated beneficiary of the disclaimed portion of the IRA. Required minimum distributions from the family trust with respect to the disclaimed portion of the IRA must be made based on the surviving spouse's life expectancy as the oldest beneficiary of that trust.***

Under the facts of *PLR 200521033*, "Decedent" died prior to his required beginning date (*i.e.*, before April 1 of the calendar year following the calendar year in which Decedent attained age 70-1/2) owning an individual retirement account (IRA). Decedent was survived by his spouse ("Spouse") and two children.

Sometime prior to his death, Decedent executed two irrevocable trusts, "Marital Trust" and "Family Trust," and thereafter executed a beneficiary designation with respect to his IRA, naming Spouse as the primary beneficiary. The designation provided that, if Spouse disclaimed any part or all of the benefits of the IRA, then the beneficiary of the disclaimed portion would be the trustee of Marital Trust. In the event that spouse disclaimed her interest in Marital Trust, the beneficiary of the disclaimed portion of the IRA would be Family Trust. Finally, if Spouse disclaimed her interest as a beneficiary of both Marital Trust and Family Trust, Decedent's daughters would become the beneficiaries of his IRA.

Under the terms of Family Trust, Spouse has the power to appoint by her will all or any part of the assets of Family Trust to or for the benefit of any issue of the Decedent as Spouse may determine. If Spouse does not exercise her "testamentary special power of appointment," the assets of Family Trust will be distributed on her death to Decedent's children or their descendants.

Spouse proposes to execute a disclaimer of a fractional interest (defined by a formula) in IRA, plus any post-death income earned that is attributable to the disclaimed portion. Spouse also proposes to disclaim any and all interest in Marital Trust. Finally, Spouse will disclaim her power to exercise her limited testamentary power of appointment under the Family Trust with respect to that portion of the Family Trust

attributable to the portion of the IRA that passed to the Family Trust as a result of the foregoing disclaimers. Spouse represented that she has not accepted any interest or any benefit from the IRA.

Taxpayers asked for and received the following rulings:

1. The proposed disclaimers that will be executed by Spouse will be qualified disclaimers under Code Section 2518(b). Significantly, Spouse disclaimed her special testamentary power of appointment over the IRA assets passing to Family Trust as the result of her previous disclaimers of her outright interest and her interest in Marital Trust. This was necessary because Section 2518 of the Code prohibits a disclaimant from being able to direct the disposition of the property that is the subject of a qualified disclaimer. Spouse also satisfied the other requirements of a qualified disclaimer, including that the disclaimer be valid under State law, that the disclaimer be in the form of a writing executed within 9 months of the decedent's death, and that the disclaimant not have accepted any benefits of the disclaimed property.

2. Family Trust is a qualified beneficiary within the meaning of applicable Treasury regulations. Generally, a person who is not an individual, such as a trust or an employee's estate, may not be a designated beneficiary. However, Treasury regulations provide that beneficiaries of a trust with respect to the trust's interest in an employee's benefit may be treated as designated beneficiaries if the following requirements - which render the trust a "see-through" trust - are met:

- The trust must be valid under state law;
- The trust must become irrevocable upon the death of the participant;
- The beneficiaries of the trust must be identifiable from the trust instrument; and
- The trust indenture and other required documentation must be timely provided to the plan administrator.

We note that a designated beneficiary, whether determined pursuant to a disclaimer or otherwise, must also be determinable by September 30 of the year following the year of the IRA participant's death, a requirement that was met in this case.

3. Since Family Trust is a "see-through trust," with respect to the portion of IRA payable to the Family Trust, required minimum distributions may be calculated based upon the life expectancy of Spouse, as the oldest beneficiary of that trust, using the single life table found in the final minimum required distribution regulations.

*PLR 200521033* provides a road map for using serial disclaimers to direct a decedent's IRA, or a portion thereof, to a desired beneficiary or beneficiaries.

3. *PLR 200521028*

*The Revenue Service has determined that a closely-held corporation's redemption of its common stock held by a private foundation, with respect to which the corporation is a disqualified person, is not an act of "self-dealing."*

In general, Section 4941 of the Code strictly prohibits sales between a private foundation exempt from tax under Section 501(c)(3) and “disqualified persons” with respect thereto, including foundation managers, substantial contributors and persons and entities related to them.

**PLR 200521028** illustrates an exception to the foregoing rule whereby, under Revenue Code Section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all the securities of the same class held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

In the ruling, “C” is a for-profit corporation that is a disqualified person with respect to private foundation “F.” Since C’s assets consist entirely of publicly listed securities, and all of its gross income is from passive sources (dividends, interest, and sale of securities) C, which is effectively controlled by F and other disqualified persons, would appear to be a personal holding company.

It is proposed that C, pursuant to an offer made to all four of its common shareholders, will redeem F’s common stock in C for cash in the amount of the stock’s fair market value. C is the only one of the four common shareholders accepting the redemption offer. The others have declined because they would incur large taxes from capital gains. The value of C’s stock will be based on the market quotations of the securities held by C – calculated within a month of the redemption - and will *not* be discounted for lack of marketability or for F’s minority ownership status.

The Service noted that it is critical to the exception to self-dealing set forth above that the foundation receive no less than the fair market value of its interests. For this purpose, “fair market value” is determined pursuant to the regulations under Section 4942 of the Revenue Code. These regulations provide, with respect to the valuation of a holding company, as follows:

If . . . a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer . . . , then to the extent that the issuer’s assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations. . . . Thus, for example, if a private foundation and a disqualified person together own all of the unlisted voting stock of a holding company which in turn holds a portfolio of securities of issues which are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues . . . .Such determination may be made by employees of the private foundation or by any other person, without regard to whether such person is a disqualified person with respect to the foundation.

Because C will pay F the full fair market value of F’s shares of common stock in C, objectively determined by the use of quotes for the publicly traded securities and cash-type investments of C, and since the valuation will occur within a month of the redemption, C’s redemption of F’s shares of stock in C will not constitute an act of self-dealing under section 4941 of the Code.

We note that, although a redeeming corporation must make a bona fide offer on a uniform basis to the foundation and every other person who holds its securities, the transaction with the foundation will pass

muster under the self-dealing rules even if the foundation is the only party that accepts the corporation's offer.

Any AALU member who wishes to obtain a copy of any of the items discussed in this *Washington Report* 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](http://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](mailto:lavine@aalu.org) and include a reference to this *Washington Report*.

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