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Subject: **General Estate and Gift Tax Developments: January 2006**

1. **Assets Withdrawn From QTIP Trust Are Includible In Gross Estate**

Major References: [TAM 200602033](#)

2. **Grantor's Power of Substitution Exercisable in Fiduciary Capacity Will Not Cause Estate Tax Inclusion**

Major References: [PLR 200603040](#)

Prior AALU Washington Reports: 94-37;

3. **Surviving Spouse's Nonqualified Disclaimer of Income Interest in QTIP Trust Will Be Subject to Gift Tax In Amount Equal to Value of Disclaimed Property, Less Gift Taxes Paid by Donees**

Major References: [PLR 200604006](#)

Prior AALU Washington Reports: 02-109

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 2006, 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. TAM 200602033

The National Office of the Internal Revenue Service has determined, in technical advice, that assets withdrawn from a QTIP trust by a surviving spouse, in apparent violation of the terms of the trust, are includible in the surviving spouse's gross estate. The surviving spouse did not dispose of his income interest in the QTIP trust prior to death, nor was a constructive trust imposed on the withdrawn assets.

Under the facts of TAM 200602033, "Decedent" and his wife, "Spouse," who predeceased him were residents of Virginia. Prior to her death, Spouse had established a revocable trust, of which Decedent was the trustee.

The terms of Spouse's revocable trust established a marital (QTIP) trust, under which Decedent was entitled to income for life, and such principal as was required to maintain his standard of living and for his medical or other emergency needs, and a residuary credit shelter trust. Both trusts were further divided into an exempt and non-exempt portion to facilitate the allocation of Spouse's GST exemption. Upon the death of Decedent, any remaining principal of the QTIP trust was to become part of the residuary credit shelter trust. After Decedent's death, the residuary credit shelter trust (including the corpus of the QTIP trust) was to be divided into four equal shares, one share for the benefit of each of Spouse's and Decedent's four children, Child 1, Child 2, Child 3, and Child 4.

Child 4 was appointed as successor trustee. In the event Child 4 refused to serve, resigned, or became incompetent, "Executor" would become the successor trustee.

After Spouse's death, her executor elected to treat the property passing to the marital trust as qualified terminable interest property (QTIP), and an estate tax marital deduction was claimed for the date of death value of the trust.

Sometime after Spouse's death, Decedent, as Trustee of both the exempt and non-exempt shares of the QTIP trust, signed two letters authorizing the transfer of all assets held in those trusts to Account Z, which was held in the name of Decedent individually. Decedent issued 2 personal notes payable to the QTIP trust exempt share, and 2 personal notes payable to the QTIP trust non-exempt share. Each note was marked "Cancelled" two days later. The QTIP assets in Account Z were subsequently co-mingled with Decedent's other personal assets.

The assets continued to be held in Account Z until Decedent's death approximately eight months after the transfer of the assets to Account Z. A letter from Decedent's physician contained in the administrative file states that based on an examination of Decedent's medical records, as of the letter authorizing the transfer of the assets in the QTIP trusts to Account Z, Decedent had a progressive and "eventually terminal" medical illness, such that there was at least a 50% probability that Decedent would not survive one year.

In accordance with Decedent's will, Executor was appointed as personal representative of his estate. Decedent's will provided that the estate residue was to be distributed to Decedent's Trust, a revocable trust established by Decedent prior to his death. Under the terms of Decedent's Trust, the trust residue was to be distributed to 6 non-family members, one of which was Executor, who received approximately 75 percent of the total.

Subsequent to Decedent's death, a "Debts and Demands" procedure was commenced under Virginia law, requiring, "creditors and all other persons interested in the estate of the decedent to show cause on some day to be named in the order against the payment and delivery of the estate of the decedent to his legatees or distributees." Virginia law states that the personal representative who has in good faith complied with this provision is fully protected against the demands of creditors and all other persons. None of Decedent's children appeared in opposition to Executor's plan of distribution. The Probate Court therefore issued an order authorizing distribution of the estate to Decedent's Trust, to be distributed in accordance with the terms of that trust. Executor took the position that the court order applied to all assets in his possession including the assets Decedent withdrew from the exempt and non-exempt QTIP trusts. Accordingly, Executor distributed those assets to Decedent's Trust. Subsequently, these assets were distributed to the non-family member beneficiaries designated in the trust.

Although Decedent's Executor originally included all of the assets in Account Z in Decedent's gross estate, he subsequently filed a claim for refund, arguing that the property held in the QTIP exempt and non-exempt trusts that was withdrawn by Decedent and deposited in Account Z were not includible in his gross estate under section 2044 (relating to the inclusion in the gross estate of a surviving spouse of property for which a QTIP election has been made), or any other Code section. The estate contended that Decedent disposed of his qualifying income interest for life in the property in the QTIP trusts when he withdrew the assets from the QTIP trusts and transferred them to his personal investment account (Account Z). The estate also argued that, because Decedent's withdrawal of funds was not authorized under the trust instrument, the withdrawal constituted a breach of Decedent's fiduciary duty. Therefore, a constructive trust was imposed on the assets. Further, under constructive trust principles, because Decedent commingled his assets with the assets of the QTIP trusts, at some point in time it became impossible to determine which assets were attributable to the QTIP trusts and which were attributable to Decedent, and as a result, Decedent's interest in the assets of the QTIP trusts terminated and a disposition of Decedent's life estate under section 2519 occurred. Therefore, the portion of Account Z attributable to the property previously held in the QTIP trusts should not be includible in his gross estate for estate tax purposes. Rather, Decedent (as a result of the disposition of his life estate) made an inter vivos gift subject to gift tax. The estate proposed to pay the gift tax as an offset to the estate tax refund.

In addition, the estate argued that, because Decedent commingled the QTIP trust assets with his own assets held in Account Z, Decedent's interest in his own assets held in Account Z also terminated in accordance with constructive trust principles. Accordingly, the amount attributable to his own asset held in Account Z also should not be includible in his gross estate.

The Revenue Service understandably disagreed with the estate's analysis, noting 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 estate of the surviving spouse." Under either IRC Sections 2519 or 2044, the property for which a deduction was allowed will be subject to either a gift tax (if the spouse disposes of the income interest) or an estate tax (if the spouse retains the income interest until his or her death).

The Service found that, in TAM 200602033, Decedent continued to possess, at a minimum, the right to receive the income from the assets withdrawn from the QTIP trusts. Thus, his transfer of those assets did

not constitute a disposition that would trigger a gift under section 2519. Therefore, the property was includible in Decedent's gross estate under Section 2044.

The Service also rejected the estate's constructive trust argument, noting that Child 1, 2, 3, and 4 as the remainder beneficiaries of the QTIP trusts, had not sought any relief in a court of equity in order to claim their interests under the terms of the trusts, and no court has ordered that any constructive trust be imposed on the property. Either or both of these conditions would be necessary to the establishment of a constructive trust.

Finally, the Revenue Service stated that it was not addressing the gift tax consequences with respect to Child 1, Child 2, Child 3 and Child 4 regarding the "relinquishment" (presumably by failing to object to the distribution of those assets to non-family members) of their respective interests in the QTIP trusts.

2. *PLR 200603040*

The Revenue Service has ruled that the retention of a power to substitute assets of a trust by the grantor won't cause trust's property to be included in grantor's gross estate; and that the exercise of that power won't constitute a gift to the trust by the grantor.

"Grantor" established an inter vivos, irrevocable trust (Trust) which was funded with cash and marketable securities. "Trustee" is an independent party - *i.e.*, not a descendant of Grantor and not otherwise related or subordinate to Grantor within the meaning of Internal Revenue Code Section 672(c).

During Grantor's life, Trustee may distribute as much income and principal of Trust to Grantor's spouse ("Spouse") and Grantor's issue as Trustee determines. Grantor thus is treated as the owner of the trust for income tax purposes by reason of Section 677(a), which provides that the grantor shall be treated as the owner of any portion of a trust whose income, "without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse." At Grantor's death, Trustee shall distribute the trust property to Grantor's issue per stirpes, or, if no issue survives, to Foundation.

The Trust indenture provides Spouse with the right to withdraw an amount equal to the value of each contribution; provided, however, that in no event shall the aggregate value of property subject to this withdrawal right exceed the amount of annual exclusion from gift tax (currently \$12,000, per donee, per year) available to the Grantor with respect to Grantor's spouse for each such calendar year. The right to withdraw with regard to a contribution terminates upon the later of 30 days after the receipt of notice by Spouse and December 31st of such calendar.

Trust also provides that Grantor may acquire any or all property constituting Trust principal by substitution of other property of equivalent value to the property acquired, measured at the time of substitution. The instrument provides that Grantor's power to acquire Trust property under this section *may only be exercised in a fiduciary capacity*. Under the Trust indenture, action in a fiduciary capacity is defined as "action that is undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law."

Grantor proposes to exercise his power of substitution by transferring X shares of B stock, a publicly traded company, to Trust in exchange for Y shares of C stock (also a publicly traded company), that is currently held in Trust. Grantor will also either transfer to Trust, or withdraw from Trust, cash or cash

equivalents in an amount necessary such that the total value of the assets Grantor is transferring to Trust will be equal to the total value of the assets Grantor is acquiring from the Trust incident to the substitution.

Upon these facts, the Revenue Service issued the following rulings:

1. The retention by Grantor of the power of substitution will not cause the property of Trust to be included in Grantor's gross estate under Sections 2033, 2036(a), 2036(b), 2038 or 2039. The Service reasoned, relying on *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1, that the requirement in the Trust that the substituted property be equal in value to the assets replaced indicated (as did the explicit representation to that effect) that the substitution power was exercisable only in good faith and subject to fiduciary standards. Accordingly, Grantor could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.

We note that, in order to constitute a "grantor trust power" under Section 675(4), a power of substitution must be held, by the grantor or a nonadverse party, in a "nonfiduciary" capacity. Therefore, in this case, the Grantor was not relying on the power of substitution to create a grantor trust. The Revenue Service did not unequivocally state whether it was taking the position that a grantor trust power to substitute assets (albeit for assets of equivalent value) that states that it is exercisable solely in a nonfiduciary capacity would cause estate tax inclusion problems under any Revenue Code section. Nor did it unequivocally state that any power to substitute assets, if exercisable only upon the condition that the assets be of equivalent value, must be exercisable in a fiduciary capacity (which would vitiate the use of this power to create a grantor trust).

In our *Bulletin No. 94-37*, we described PLR 9413045, in which the Revenue Service refused to rule that the taxpayers who held a "power of substitution" would be treated as owners of a life insurance trust for Federal income tax purposes under Section 675, since that section was under study. Reportedly, the issue under study was whether a grantor who retains the power to substitute assets in an insurance trust is really acting in a "non-fiduciary capacity", or whether he or she, in fact, owes some fiduciary duty to the trust. We thus advised caution in using the power of substitution as the sole "defective power" in drafting a trust where the object is to make the trust a grantor trust. PLR 200603040 would seem to validate the use of caution in this regard.

2. The exercise by Grantor of the power of substitution as proposed will not constitute a gift to Trust by Grantor, for federal gift tax purposes. The exchange of property in the Trust for assets of equivalent value made this transaction an exchange for adequate and full consideration for money or money's worth, and thus not a gift.

3. Trust is a grantor trust under Section 671 in its entirety. In issuing this ruling, the Service noted that Spouse's right of withdrawal, which, absent Grantor's being treated as the owner of the entire trust for income tax purposes under Section 677(a), might result, under IRC Section 678 (a), in Spouse's being treated as the owner of that portion of the trust assets over which her withdrawal right was exercisable, was not sufficient in this case to make Spouse (a nongrantor) the owner of those assets.

4. Because Trust is a wholly grantor trust with respect to Grantor, neither Grantor nor Trust will recognize any income or loss by reason of the exercise of the power of substitution.

PLR 200603040 is an important explication of the Revenue Service's view of the power of substitution and the effect of annual exclusion withdrawal rights on the status of a grantor trust under Section 678. It remains to be seen, however, whether this ruling is meant to indicate that the Service regards the existence of power of substitution exercisable in a nonfiduciary capacity (which has been the means by which so many grantor trusts have attained that status in recent years) as a vehicle for estate tax inclusion.

Private Letter Rulings**3. PLR 200604006**

The Revenue Service has ruled that a surviving spouse's nonqualified disclaimer of her entire interest in a qualified terminable interest property (QTIP) trust will result in a taxable gift. The amount of the gift will be determined under IRC Sections 2519 (relating to the disposition of income interests in QTIP trusts) and 2511 (relating to gifts, generally), and will be reduced in each case by the taxes required or agreed to be paid by the donees.

“Decedent” died in a community property jurisdiction on Date 1 survived by “Spouse” and eight children. Spouse and children are still living.

Upon Decedent’s death, the joint revocable trust established by Decedent and Spouse during their lifetimes is required to be divided into two separate shares, the Decedent’s Share and the Survivor’s Share. One-half of all community property comprising part of the trust or added to the trust by reason of Decedent’s death is to be allocated to each share. Decedent’s interest in any property which was the Decedent’s separate property passing to the trust by reason of Decedent’s death is to be allocated to Decedent’s Share. Survivor’s Share is to be distributed to Spouse’s Trust and administered in accordance with its provisions.

Decedent’s Share is to be further divided into a Marital (QTIP) Trust, and a Descendants Trust. Spouse is entitled to income for life from the QTIP trust, and, in the discretion of the trustee, the principal needed for Spouse’s reasonable support. Spouse also has the right to occupy, without rental or accounting to the trustee, any home, apartment, or condominium in which the Marital Trust has any interest and the right to direct the trustee to sell trust assets that produce little or no income and reinvest the proceeds in income-producing assets selected by the trustee. After Spouse’s death, the balance of the Marital Trust is to be distributed to Descendants Trust for the benefit of descendants of Decedent.

Spouse proposes to execute an irrevocable disclaimer of his entire interest in Marital Trust. The ruling stipulates that the disclaimer will not be a qualified disclaimer and, thus, will be subject to federal gift tax. However, for State law purposes, a disclaimer made more than nine months from the date of the decedent’s death may be timely, but the burden is on the disclaimant to demonstrate that the disclaimer was made within a reasonable time after the disclaimant acquired knowledge of the interest being disclaimed. On “Date 2,” State Court issued an order that a disclaimer made by Spouse within 30 days following the issuance of a favorable private letter ruling from the Internal Revenue Service will be a timely disclaimer under State law. As a result of such disclaimer, the assets of Marital Trust will pass to Spouse’s issue by right of representation as provided in Marital Trust.

Decedent’s children agree to pay all gift tax attributable to Spouse’s transfer.

The Revenue Service ruled that Spouse’s nonqualified disclaimer of his entire interest in Marital Trust will be treated as a disposition of Spouse’s qualifying income interest for life under Section 2519. That section provides that any disposition of all or a part of a qualifying income interest for life in property for which a QTIP election has been made is treated, for gift tax purposes, as the transfer of all interests in the property other than the qualifying income interest. The value of the remainder interest thus will be subject to gift tax.

Therefore, in PLR 200604006, the Service determined that Spouse’s nonqualified disclaimer will be treated as a disposition of his qualifying income interest in Marital Trust for purposes of Section 2519. The

amount of the gift made by Spouse under Section 2519 will be equal to the fair market value of the entire property subject to the qualifying income interest, less the value of the qualifying income interest in the property on the date of the disposition, less the amount Spouse is entitled to recover from Decedent's children under Section 2207A(b).

In addition, Spouse is treated as making a gift of the fair market value of his income interest in Marital Trust. The amount of the gift made by Spouse is equal to the fair market value of the income interest minus the amount of gift tax agreed to be paid by the donees.

As a result, Spouse will be deemed to have made a "net gift" of the entire value of the assets of Marital Trust - the value of the remainder interest under section 2519, and the value of the income interest under section 2511. Both gifts will be reduced by the gift tax obligation assumed by (or imposed on) the children. PLR 200604006 thus illustrates a rather tax efficient method of transferring QTIP assets to children in the absence of a timely qualified disclaimer. (*See also* PLR 200234047, discussed in our Bulletin 02-109.)

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