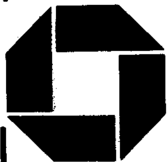

Financial Planning Thoughts

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SELECTED PLANNING AND DRAFTING ASPECTS OF GENERATION-SKIPPING TRANSFER TAXATION

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INTRODUCTION

Unless falling under an exception, exclusion or special rule, a generation-skipping transfer tax is imposed by IRC §2601 whenever property is transferred through or around one younger generation (such as the generation of the transferor's children) in favor of an even more remote generation (such as the generation of the transferor's grandchildren) unless an estate or gift tax is imposed at the generation around which or through which the property is transferred. (Descendants more remote than children, and others assigned to the generations of these more remote descendents, are known as "skip persons"; all others are called "non-skip persons".) As indicated, the tax may be imposed even if a gift or estate tax is imposed on the transferor or the transferor's estate. More than 80 percent of property exposed to both estate and generation-skipping transfer tax can be eroded by those taxes.

Technically, the generation-skipping transfer tax is imposed upon any generation-skipping transfer, which is defined as consisting of direct skips, taxable terminations or taxable distributions. The meaning of those terms is set forth in the Code and the recently promulgated final regulations. (See T.D. 8644, 1996-7 I.R.B. 16, issued December 26, 1995).[1]

OVERVIEW OF PLANNING

Although the generation-skipping transfer tax, in many ways, is a much more "tight" tax regime than the estate and gift tax, planning can significantly reduce the impact of the tax in some cases. Usually, planning will occur by using the exclusions, exceptions or special rules which are available under the generation-skipping transfer tax system. Failure to use those effectively can result in a significant loss of protection from the tax.

ANNUAL EXCLUSION

As an analogue to the gift tax annual exclusion of up to $10,000 allowed for present interest transfers under IRC § 2503(b), IRC § 2642(c), in effect, allows certain transfers to pass free of generation-skipping transfer tax to the extent the transfers fall under the protection of the gift tax annual exclusion. This means, for example, that a grandparent can make present interest gifts each year to each grandchild of up to $10,000 (or $20,000 if the grandparent is married and the spouse elects "gift splitting" under IRC § 2513) free of both gift tax and generation-skipping transfer tax.

IRC § 2642(c)(2) contains a special rule, however, where the transfer is in trust. In such a case, the annual exclusion generation-skipping transfer tax analogue applies only if the trust is structured so that (i) only the skip person (e.g., the grandchild) for whom the transfer is made is permitted to receive distributions from the trust during his or her lifetime, and (ii) the trust will be includible in the skip persons's (e.g., the grandchild's) estate if it does not terminate prior to the time he or she dies. That means, for example, that the trust must be structured so that if it is still in existence at the death of the skip person it will terminate in favor of his or her probate estate or he or she must hold a general (taxable) power of appointment under IRC § 2041.[2] However, income is not required to be distributed to the skip person beneficiary. Rather, income can be accumulated or may be distributable (as may corpus) to the skip person beneficiary in the discretion of a trustee.

A person is treated as holding a general (taxable) power of appointment under IRC § 2041 even if it is exercisable with the consent of a non-adverse party (that is, someone other than one whose interest would be adversely affected by the exercise of the power; an example of someone adversely affected would be a taker-in-default of the exercise of the power). Treas. Reg. § 20.2041-3(c)(2). Therefore, a transfer to a trust may qualify for both the gift tax annual exclusion and the generation-skipping transfer tax analogue under IRC §2642(c)(2) if (1) the skip person beneficiary (e.g.,

the grandchild) for whom the transfer is made has the immediate right to withdraw an amount equal to the annual exclusion when the transfer to the trust is made which lapses **in full** after at least 30 days (i.e., a so-called "Crummey power of withdrawal"), (2) the trustee is permitted to accumulate trust income or distribute it (and corpus) to the skip person beneficiary and (3) the skip person beneficiary holds a testamentary general power of appointment even if it is exercisable only with the consent of a non-adverse trustee. (It may be noted that because the skip person beneficiary has a general power of appointment, the lapse of the Crummey power of withdrawal even in excess of the non-taxable lapse limit of 5% and $5,000 ("5 and 5") contained in IRC §2514(c) will not be a taxable gift; the gift is incomplete on account of the testamentary power.[3]) Making the testamentary general power exercisable only with the consent of a non-adverse trustee tends to insure that the skip person beneficiary will not exercise it in a way which would be incompatible with the wishes of the grantor of the trust. Such a provision, perhaps, should be considered for inclusion in instruments creating such trusts.[4]

The strict requirements of IRC § 2642(c)(2) also mean that transfers to a "standard" irrevocable life insurance trust will not qualify for the "annual exclusion" allowable under that section. An irrevocable life insurance trust almost always has beneficiaries in addition to one skip person.[5] The final regulations provide that a transfer to a trust which is not itself a skip person (because it has at least one current non-skip person beneficiary) will not be subject to generation-skipping transfer tax even if skip person beneficiaries of the trust are given Crummey powers of withdrawal which lapse under the so-called "5 and 5" limit under IRC § 2514(e). Treas. Reg. § 26.2612-1(f), Example 3. That means, however, that a generation-skipping transfer tax will be imposed when property from the trust is distributed to a skip person or when the interests of all non-skip person beneficiaries end (e.g., upon the death of the survivor of the beneficiaries of the trust who are non-skip persons), unless another exception or special rule applies to protect the transfer from generation-skipping transfer tax.

CASCADING CRUMMEY POWERS℠[6]

An irrevocable life insurance trust can be an excellent tool to avoid estate and gift tax, especially if it results in the effective use of annual exclusions which the insured otherwise would not use by granting each beneficiary a so-called "hanging Crummey power of withdrawal," See, generally, Slade, "Personal Life Insurance Trusts," BNA Tax Mgt. Portfolio No. 836. However, as noted, such trusts usually do not avoid generation-skipping transfer tax on the transfer of trust assets to skip persons except to the extent GST exemption is allocated to the trust. Hence, as interests in the irrevocable life insurance trust "move down" to grandchildren or more remote descendants, generation-skipping transfer tax will be payable, unless some exemption or exception applies.

Of course, a preferable result from the perspective of the beneficiaries would be to avoid the generation-skipping transfer tax (as well as estate tax) as children die and their interests in the irrevocable life insurance trust terminate in favor of grandchildren. It appears that can be accomplished, in significant part in some cases, through Cascading Crummey Powers℠ if there are skip person beneficiaries (e.g., grandchildren) and non-skip person beneficiaries (e.g., children) of the trust.

When a Crummey power lapses, the powerholder is treated as making a gift if and to the extent the amount of the lapse each calendar year exceeds the greater of $5,000 or 5% of the property over which the power could have been exercised. IRC § 2514(e). Suppose, for example, an insured (whose spouse will "gift split" under IRC § 2513) creates a trust and transfers $30,000 to it, giving each of her two children the immediate right to withdraw $15,000 from the trust. The trust provides that after 30 days each child's power of withdrawal lapses in full. Because the amount of the lapse exceeds the $5,000 "no transfer" threshold under IRC § 2514(e) by $10,000, each child is deemed to have made a gift of $10,000. Hence, together there have been "excess" lapses of $20,000 (i.e., $10,000 as to each child). However, the trust further provides that a grandchild of the insured has the immediate right to withdraw the excess lapse amounts (i.e., $20,000) from the trust. This means that the $10,000 gift deemed made by each child to the grandchild (i.e., $10,000 of the $15,000 amount which lapsed) now should qualify for the gift tax annual exclusion. (Note that the child is not "using up" the parent's annual exclusion with respect to the grandchild. The child is simply using his or her own annual exclusions with respect to the grandchildren.) In addition, no excess lapse amount should be includible in a child's estate if the child is not entitled to income from the trust but is only eligible to receive it in the discretion of an "independent trustee" (*see* IRC § 2036), and the child holds no power (e.g., a special power of appointment) to control the beneficial enjoyment of the excess lapse amount (*see* IRC § 2038). That, of course, probably is the same result that would have been achieved if the annual lapse had been limited to the 5 and 5 threshold.

What is different, however, is what has happened for generation-skipping transfer tax purposes: Each child has become substituted for the insured parent as the

transferor for generation-skipping transfer tax purposes of the excess lapse amount. Hence, each child has become the transferor of one-third of the $30,000 the insured parent contributed to the trust. That means that no generation-skipping transfer will occur when a child dies with respect to two-thirds of the trust (assuming the property is transferred "down" to a generation no younger than that of the insured's grandchildren). Of course, if additional contributions are made, the number of children or grandchildren is different, or annual exclusions are used elsewhere, the ratio of the trust attributed to the insured and to each child, as transferors for generation-skipping transfer tax purposes, may be different.

The final generation-skipping transfer tax regulations confirm that contributions by different transferors are treated as separate trusts for generation-skipping transfer tax purposes and can be divided at any time. Treas. Reg. §§ 26.2654-1(a)(2)(i) and 26.2654-1(a)(3). Hence, the instrument should authorize the trustee to divide any trust into separate trusts with respect to different transferors. Whether the trustee divides the trust or not, the trustee probably should maintain separate records (if not accounts) showing which part of the trust assets is attributable to each transferor. The trustee should make distributions to the children (and exempt transfers to the grandchildren, such as certain transfers for medical care and tuition under IRC § 2642(c)(3)(B)) first from the trust of which the insured parent is the transferor, and make distributions to the grandchildren (not otherwise falling under an exemption or exception) first from the trusts of which the children are treated as the transferors. As a result, over time, significant property may escape estate and generation-skipping transfer tax as property "moves down" to the grandchildren's generation.[7]

GST EXEMPTION

Each person has a $1 million GST exemption. IRC § 2631(a). The GST exemption is not a true exemption but rather a rate reducer. The generation-skipping transfer tax is imposed at the "top" stated estate and gift tax rate, currently 55%. IRC § 2641, § 2001(c)(1). The real or effective generation-skipping transfer tax rate, called the "applicable rate", is based upon the portion of the transfer which is subject to tax and the portion which is not subject to tax because it falls under a special rule, exemption or exclusion. For example, a woman transfers $5 million to a trust and allocates her entire $1 million GST exemption to it. The allocation reduces the effective generation-skipping transfer tax rate of 55% by one-fifth to 44%. In other words, allocation of GST exemption does not mean a distribution of up to one-fifth of the value of the trust can be made to a skip person (such as a grandchild) free of generation-skipping transfer tax. Rather, each distribution from the trust to a skip person will be subject to a 44% tax, unless it falls under another exception or special rule.

As a general rule, it will be much better to have two funds or trusts, one entirely exempt from generation-skipping transfer tax (i.e., where the applicable rate will be zero) and another fund entirely subject to the tax (i.e., where applicable rate will be 55%), rather than (as in the above example) one trust where the amount of GST exemption allocated to it is less than the amount transferred to the trust.[8]

Not infrequently, the GST exemption will be allocated to a lifetime irrevocable life insurance trust (or similar trust even if it holds assets other than insurance). For instance, a man creates a trust with $1 million cash, which the trustee uses to acquire a single premium cash value life insurance policy, and allocates his entire $1 million GST exemption to the trust. Usually, it is anticipated that the single premium will "carry" the policy "forever" (i.e., no additional premiums need be paid in order to maintain the policy). However, for a variety of reasons (sometimes attributable to investment performance of the policy which turns out to be less than that projected), additional premiums may have to be paid in order to maintain the death benefit and cash value levels originally forecast. If the man makes additional contributions to the trust (directly or by payment of additional premiums on the policy) the trust will loose its "purity" of exemption from generation-skipping transfer taxation (i.e., zero applicable rate). It may be appropriate to consider that when determining whether to allocate GST exemption to a trust. One potential strategy is to have the trust provide that any contributions made to the trust (directly or indirectly, such as by the payment of premiums on a life insurance policy owned by the trust) in excess of the GST exemption amount must be held in a separate, although identical, trust under the instrument. That should allow one trust to maintain its generation-skipping transfer tax exemption purity.[9] The following sample language might be used:

> Unless the Trustees receive written instructions to the contrary prior to or simultaneous with the transfer, any property assigned, conveyed, transferred or delivered to the extent constituting a direct or indirect transfer by gift for Federal gift tax purposes, whether by gratuitous transfer, bargain sale, purchase or otherwise (the "transferred property"), by the Grantor to the Trustees shall be divided into two (2) portions to be known as Portion I and Portion II, such portions to be constituted and disposed of as follows:

1. Portion I shall consist of that fractional part (not in excess of the whole) of the transferred property of which (i) the numerator shall be an amount equal to the sum of the Unused GST Exemption (as hereinafter defined) of the Grantor, if the Grantor is then living, and the Unused GST exemption of the Grantor's spouse, _______________ (the "Grantor's spouse"), if the Grantor's spouse is then living,[10] and (ii) the denominator shall be the greater of (a) the sum of the Unused GST Exemption of the Grantor, if the Grantor is then living, and the Unused GST Exemption of the Grantor's spouse, if the Grantor's spouse is then living, and (b) the value of the transferred property as finally determined for Federal gift tax purposes. As used in this paragraph, Unused GST Exemption means the maximum exemption from the generation-skipping transfer tax allowed per transferor under section 2631(a) of the Internal Revenue Code of 1986, as amended (the "Code"), currently $1 million ("GST Exemption") reduced by the GST Exemption which such transferor has allocated, is deemed to have allocated, or advises the Trustees in writing prior to or simultaneous with the transfer that such transferor intends to allocate to transfers of property other than property forming a part of Portion I passing pursuant to this Article. Portion I shall be held by the Trustees in a separate trust in accordance with the terms and conditions set forth in Article [refer to Article with dispositive provisions] hereof.

2. Portion II shall consist of the balance, if any, of the transferred property. Portion II shall be held by the Trustees in a separate trust in accordance with the terms and conditions set forth in Article [refer to same Article as above] hereof.

LEVERAGING THE GST EXEMPTION

"Leveraging" the GST exemption means being able to protect more than $1 million from tax. One of the simplest and most effective ways to do that is to use the exemption as early in life as possible. For instance, a woman transfers $1 million to a trust for the benefit of her descendants 30 years before her death and the trust grows at 8% a year. The trust will be worth $10 million at her death. By using her GST exemption as early in life as possible, she has increased its "power" tenfold.

The benefits of early use of the GST exemption may be enhanced if the trust is structured as a "grantor trust" with respect to the grantor for income tax purposes under IRC § 671 et. seq., but still as a completed gift by the grantor upon creation of the trust and not included in the grantor's estate. Because the grantor will continue to be taxed on all of the trust income, the trust will, in effect, grow on a pre-tax basis as long as the grantor trust status continues (which can be until the death of the grantor). There are several ways to cause a trust to be a grantor trust for income tax purposes and yet be a completed gift for gift tax purposes and not included in the grantor's estate. For example, an independent trustee can be given the power to add to the class of beneficiaries and/or the grantor can hold the power to substitute property of equivalent value for the trust property (although such a power may, perhaps, not be advisable in certain cases, for example, if IRC § 2036(b) type stock is held by the trust). *See* IRC §§ 674(c) and 675(4). It would appear that the grantor trust powers can also be released during the grantor's life, thereby causing the trust to cease to be a grantor trust, if that should become appropriate.

In Private Letter Ruling ("PLR") 9444033, the IRS had suggested that the payment of income tax by the grantor on income of a grantor trust may result in an additional gift to the trust; however, in PLR 9543049 the IRS reissued PLR 9444033 to delete the discussion of that issue.[11] However, unless the grantor has a right to be reimbursed under state law (which can be expressly negated in the trust agreement), it does not appear that any additional gift should be made when the grantor pays tax on the income and gain of a grantor trust.

Whether or not the trust is structured as a grantor trust, the benefits of the GST exemption are maximized if the GST exempt property is held in a long-term trust for the benefit of descendants. In many states, that is a period measured by lives in being plus 21 years. However, in some states, such as Delaware, a trust can be perpetual (except with respect to real property in some cases). Even if the grantor is not a resident of those states, it appears the law of those states (including the ability to make a trust perpetual) can be caused to apply to the trust if the trust has a co-trustee resident in one of those states, such as Chase's Delaware affiliate. The duties of such a co-trustee might even be limited to administrative matters, such as keeping custody of trust assets, maintaining books and records, and preparing tax returns, if appropriate.

The trustees of such a trust are typically given broad authority to use the income and principal of the trust for the benefit of the grantor's descendants. The corpus of the trust is usually invested, especially in early years, for maximum appreciation, and income and gain are normally not paid out to beneficiaries but retained in the trust and reinvested for many years. It is not expected that the trustees will make distributions

to the beneficiaries in early years. Even later, such a trust can be drafted to preserve wealth inside the trust rather than to dissipate it.[12] For example, rather than distributing money to a beneficiary to enable the beneficiary to buy a home, the trustee can purchase the home inside the trust and permit the beneficiary and members of his or her family to live there. Or if a beneficiary wishes to acquire a work of art, the trustees of the trust could purchase the artwork and allow the beneficiary to use the artwork (e.g., display the artwork in his or her home). The home, artwork, etc., however, could always remain an asset of the trust and, therefore, any appreciation in its value would inure to the benefit of the trust. Moreover, if funds are not distributed, the assets would not be includible in the beneficiary's estate on his or her death or subject to the claims of his or her creditors.

Another potential way of leveraging the GST exemption is through a charitable lead trust. The gift and estate rules allow a deduction for the actuarial value of the leading interests in a charitable lead trust committed to charity.[13] The value of the remainder constituting a taxable gift or bequest is determined by subtracting the actuarial value of the annuity or unitrust interest committed to charity from the fair market value of the property transferred to the charitable lead trust.

The tax rules relating to charitable lead trusts for generation-skipping transfer tax purposes are somewhat different than they are for estate and gift tax purposes. Under IRC § 2642(a), the applicable rate of generation-skipping transfer taxation is usually determined by comparing (i) the amount of GST exemption (which can be as great as $1,000,000) allocated to the trust to (ii) the amount of property transferred to the trust. This ratio is known as the "Applicable Fraction" and determines, in effect, what percentage of the trust is exempted from the tax. For this purpose, the amount of property transferred to the trust is reduced by (a) the amount of the estate or gift tax (if any) actually payable from the property transferred and, (b) as a general rule, by the amount of any charitable deduction allowed for estate or gift tax purposes with respect to the trust. If the charitable deduction is sufficiently large to reduce the net amount of the property transferred to the amount of the GST exemption allocated to the trust, the effective rate of generation-skipping transfer tax generally is zero. That means the trust will be totally exempt from generation-skipping transfer tax.

However, IRC § 2642(e) and Treas. Reg. § 26.2642-3 provide a special rule for determining the Applicable Fraction when property is transferred to a charitable lead **annuity** trust. For a charitable lead annuity trust, the Applicable Fraction is not determined until the charitable interest ends. During the charitable lead annuity term, the amount of GST exemption allocated to the trust is annually compounded by the IRC § 7520 rate and this "adjusted" GST exemption is then applied to the value of the trust at the end of the charitable lead annuity term. If the amount of adjusted GST exemption equals or exceeds the then value of the trust, the trust will be exempt from generation-skipping transfer tax. However, if the value of the property then exceeds the adjusted GST exemption, the trust will not be exempt from generation-skipping transfer tax (although the rate of the tax will be reduced).

It is not possible, in most cases, to forecast whether the adjusted GST exemption will fully protect a charitable lead annuity trust from generation-skipping transfer tax because usually it will not be possible to know what growth the trust will experience during the charitable lead term. (Also, it may turn out that "too much" GST exemption was allocated — i.e., it would be exempt from the tax even if less GST exemption had been allocated.) As a consequence, in the judgment of many practitioners, a charitable lead unitrust rather than an annuity trust is the more appropriate tool to use if the client's objective is to prevent the imposition of generation-skipping transfer tax. Of course, whether that is the most appropriate method of using all or a portion of any given client's GST exemption depends upon the client's particular circumstances. Nonetheless, in some cases, skip persons will receive more property after-tax through a charitable lead trust when the charitable term ends, than they would have if the property had been fully exposed to estate or gift taxes initially, and all income and appreciation on the net amount had then accumulated until the charitable term of the lead trust would have ended.[14]

GENERATION JUMPING

Although the generation-skipping transfer tax acts as a supplement or substitute for the estate or gift tax as property passes through or around one younger generation in favor of an even younger one, many important differences exist. In some cases, an estate or gift tax may be lower. That may be the case, for example, when the property if subjected to an estate or gift tax would be exposed to tax at less than a 55% rate of taxation, which may occur because taxable transfers are less than $3 million (where the rate reaches 55%) or credits are available. (No credits are available against the generation-skipping transfer tax.) In other cases, generation-skipping transfer tax will be lower than estate or gift tax would be. That may occur if state death taxes exceed the maximum amount allowable under IRC § 2011 as a state death tax credit or if taxable transfers are between $10 million and

$21,040,000, when the effective Federal gift or estate tax rate will be 60%. Federal generation-skipping transfer tax cannot exceed 55%.

Even if the estate or gift tax is as great as the generation-skipping transfer tax, it usually will be best to expose property to estate and gift tax if it thereby becomes exempted, in whole or in part, from generation-skipping transfer tax by reason, for example, of the availability of otherwise unused GST exemption. That means that as the property passes through or around even younger generations in favor of even more remote ones, generation-skipping transfer tax (as well as estate and gift tax) may be avoided.

However, there are other cases where it will be preferable to expose property to generation-skipping transfer tax. One is where the property is not transferred "down" to a younger generation but only "over" to the same generation. For example, a mother creates a trust for her son providing for the property upon the son's death to pass outright to the son's then living descendants or, if he has none, to his sister, if living. If the property were exposed to estate or gift tax, the tax would be imposed if the son died whether the property passed to his descendants or his sister. If the property were exposed to a generation-skipping transfer tax, there would be no tax due if the assets passed to his sister because no generation-skipping transfer would have occurred.

Another case where it may be appropriate to expose property to generation-skipping transfer tax rather than estate or gift tax is where "generation jumping" can occur. "Generation jumping" means jumping over at least one intermediate younger generation, at least temporarily, but paying only one generation-skipping transfer tax. For example, when a transferor's daughter dies, property in trust for her passing to her descendents will be subject to generation-skipping transfer tax (if it is not subjected to estate or gift tax at her generation and another exception, exemption or special rule does not apply). One generation-skipping transfer tax will be due whether the property is transferred to her children, grandchildren or even more remote descendants. For example, if the property is subject to generation-skipping transfer tax and is transferred to the daughter's grandchildren, only one generation-skipping transfer tax will be due even though two generations have been "jumped" or "skipped" (her generation and her children's generation). If the property were subject to estate or gift tax in the daughter's hands and the property passed to her grandchildren both estate tax and generation-skipping tax would be due.

Of course, one effect of generation jumping is to provide for the property to benefit the generation two (or more) below that of the beneficiary whose interest terminates, rather than one below. However, the denial of benefits to the intermediate generation(s) need, perhaps, only be temporary. The determination of the generation which is treated as receiving the property depends upon those who have a current interest in the trust, as a general rule. Treas. Reg. § 26.2612-1(e) and *see* Treas. Reg. § 26.2653-1. Hence, if upon a daughter's death, the property is held in trust only for her grandchildren for a time, but thereafter (perhaps after five years or so) also for her children if then still living, the property should be treated as having passed to her grandchildren's generation. *Cf.* Treas. Reg. §26.2653-1(b), Example 1. As a consequence, even after her children become beneficiaries, it would seem that no generation-skipping transfer tax should be due when the interests of her children in the trust property terminate.

However, an interest which is used primarily to postpone or avoid generation-skipping transfer tax is ignored for such tax purposes. Treas. Reg. § 26.2612-1(e)(2)(ii). An interest is considered as used primarily to postpone or avoid the tax if a significant purpose for the creation of the interest is to postpone or avoid the tax. *Id.* Because the daughter's grandchildren could have been current beneficiaries at the same time the daughter's children are current beneficiaries, it is difficult to see how the interest of the grandchildren is being used to postpone or avoid tax. Nonetheless, it is possible that creating an interest for the generation for which the property has been initially transferred when the generation-skipping transfer has occurred (i.e., for the daughter's grandchildren in the foregoing example) might be viewed as using their interest to postpone or avoid the tax at the generation of descendants which has been initially jumped (i.e., the daughter's children in the example). That possibility might be reduced if the grandchildren were granted an interest in the trust (e.g., by being eligible to receive income — *see* Treas. Reg. § 26.2612-1(e)(1)(ii)) while the daughter is still living — that way, the grandchildren's interest in the trust would exist before the generation-skipping transfer to their generation occurs on their grandmother's death. Perhaps, a "safer" route is to grant someone (e.g., a grandchild of the daughter in the foregoing example) who has no fixed entitlement to property in the trust a special power of appointment which could be exercised to create an interest for the generation which was jumped. The "safest" route of all would be to jump over the intermediate generation permanently. That may be a practical option only for the wealthiest of families.

Many trusts are drafted to pass to or for the benefit of descendants (including children) upon the death of the income beneficiary. If that occurs, there will be no generation jumping. Hence, it may be appropriate to grant the income beneficiary a special (non-general) testamentary power of appointment over the trust. In that way, the income beneficiary can put generation jumping into effect upon his or her death if and to the extent that makes sense. If appropriate, the power could be made exercisable among a narrow class (such as descendants of the transferor) and/or made exercisable only with the prior consent of a non-adverse person (for example, a trustee who would not be adversely affected by the exercise of the power).

A practical question that arises is how a non-adverse person grants consent to the exercise of a power which is exercisable only by will. One possibility is for the instrument creating the power to provide that the beneficiary may exercise the power only in a manner in which the non-adverse person has agreed in writing prior to the beneficiary's death. The instrument creating the power could further provide that the non-adverse person may revoke the consent, at any time, also in writing, prior to the beneficiary's death. Hence, only if the non-adverse person has granted consent in writing, and has not revoked it in writing prior to the beneficiary's death, will the exercise be effectual.

WAYS TO DECIDE WHETHER TO EXPOSE PROPERTY TO GST OR ESTATE/GIFT TAX

As explained, sometimes it is better to expose property to estate or gift tax and other times it is better to expose the property to generation-skipping transfer tax. Often, it will be difficult to determine well in advance of the taxing event which tax regime will be preferable. There are several ways in which property can be made subject to estate or gift tax rather than generation-skipping transfer tax.

Invading So Property Is Directly Held. The first is to have the property be directly owned by someone at the time it is transferred (such as at that person's death). A non-adverse trustee, for example, could be permitted to invade the trust for any reason, or for specified reasons including to facilitate estate planning, and the trustee could distribute property outright to the beneficiary prior to the event (e.g., the beneficiary's death) which would have caused the generation-skipping transfer tax to occur. Of course, it may not always be possible to arrange for such a distribution to be made prior to a beneficiary's death.

Grant By Trustee of General Power. Another way in which property can be subjected to estate or gift tax rather then generation-skipping transfer tax is by having the beneficiary hold a general (taxable) power of appointment. There are several ways to accomplish that. The first is to authorize the trustee to grant the beneficiary a general power. It seems unlikely that the beneficiary would be treated as having a general power in such a case if the trustee does not, in fact, grant one. The argument for contending that the beneficiary holds the power even if it is not granted is that a circumstance where a general power is exercisable with the consent of a non-adverse trustee is in substance no different from one where the non-adverse trustee can grant the beneficiary the general power. However, although no substantive difference may exist, a legal difference does. Where the beneficiary has the power only if the trustee grants it, the beneficiary never had a general power to begin with and will not have one unless or until granted. It seems likely that legal distinction would be respected.

Thus, an independent trustee could be authorized, for example, to grant a testamentary general power and the trustee also could be authorized to expunge the general power before the beneficiary dies. Moreover, the trustee could be empowered to grant the general power but make it exercisable only with the trustee's prior written consent.

Exercise of Special Power to Spring the Delaware Tax Trap. Another option is to grant the beneficiary a special power of appointment which may be exercised so as to trigger what is known as the "Delaware Tax Trap." Under IRC §§ 2041(a)(3) and 2514(d), a person who exercises a special power by granting someone else another power of appointment which may be exercised without regard to the normal rule against perpetuities relating back to the creation of the first power, is subjected to tax as if it were a general power. (Note that it is not that the original power need be exercised or exercisable without regard to the rule against perpetuities relating back to the date it was created. Rather, it is that the "newly" created power must be exercisable without regard to the date the first or "original" power was created or granted.)

The Delaware Tax Trap is a complex concept. It can apply, apparently, in any state, even one which has the "standard" rule against perpetuities. To spring the trap (and make the special power a taxable one), the "original" special power is exercised by having the property remain in trust but granting a beneficiary (such as a child of the powerholder) a presently exercisable general power of appointment. It appears that in all (or virtually all) jurisdictions, a presently exercisable general power may be exercised under the rule against

perpetuities without regard to the date upon which the property was originally placed in trust and the original (special) power of appointment granted. In those states which do not have a rule against perpetuates (such as Delaware and South Dakota) exercising a special power by granting someone else another special power (and not a presently exercisable general power) appears to be sufficient to spring the trap.

Tax Driven Formula Grant of General Powers. Another, and, perhaps, very effective way to expose property to estate or gift tax rather than generation-skipping transfer tax is to grant the beneficiary a general power to the extent it will reduce taxation. The IRS has "approved" the concept. *See* PLR 9527024 (April 7, 1995). The trust grants each beneficiary a general power of appointment, such as one exercisable in favor of the estate of the beneficiary, to the extent that the aggregate of the federal estate tax and generation-skipping transfer tax due as a result of the beneficiary's death can be reduced. This tax driven formula general power of appointment presumably could also be made exercisable only with the consent of a non-adverse person, such as a non-adverse trustee.

One "problem" with the tax driven formula general power is that, as explained above, it may be preferable to subject the property to estate or gift tax even if it is higher than the generation-skipping transfer tax would be because of an opportunity to use an otherwise unused GST exemption of a beneficiary. On the other hand, as also explained above, it might be better to subject property to a higher generation-skipping transfer tax rather than to a lower estate tax because of the ability to generation jump under the generation-skipping transfer tax regime which would not be possible if the property were subject to estate tax.

Tax Driven Exercise of Delaware Tax Trap. Perhaps, therefore, the greatest flexibility would be available by giving the beneficiary the special power which can be used to spring the Delaware Tax Trap. Indeed, a person with a special power might attempt to exercise or spring the Delaware Tax Trap through a tax driven formula similar to the tax driven formula "okayed" in PLR 9527024.[15]

ALLOCATION OF GST EXEMPTION AND ESTATE TAX INCLUSION PERIOD

As indicated above, allocating GST exemption as early as possible is usually beneficial: the property retains its exemption regardless of how large it becomes. However, IRC § 2632(a)(1) provides that the GST exemption may not be effectively allocated during the period when the property would be includible (other than by reason of the transfer-within-three-years-of-death rule of IRC § 2035) in the gross estate of the transferor or the transferor's spouse.

Treas. Reg. § 26.2632-1(c)(2)(ii)(B) provides, in part, that transferred property is not considered as being subject to inclusion in the transferor's spouse's gross estate by reason of a power to withdraw property if the spouse possesses with respect to any transfer to a trust the right to withdraw no more than the greater of $5,000 or 5% of the trust corpus and such withdrawal right terminates no later than 60 days after the transfer to the trust. This also means that, if the transferor intends to allocate GST exemption to a trust (for example, an irrevocable life insurance trust) and wishes it to qualify for the gift tax annual exclusion by granting the beneficiaries so-called "Crummey" powers of withdrawal, the transferor's spouse should be granted a power of withdrawal at any time of only 5%/$5,000, which power should lapse in full in 60 days. Other beneficiaries could receive the "standard" $10,000/$20,000 Crummey powers, lapsing each calendar year at a rate of the greater of $5,000 or 5% of the amount subject to withdrawal, with the balance of the withdrawal rights "hanging."

REVERSE QTIP ELECTION

IRC § 2652(c) provides that if the qualified terminable interest property (QTIP) election is made for estate or gift tax purposes, this election can be reversed for generation-skipping transfer tax purposes so the spouse who creates the trust, rather than the beneficiary spouse, is treated as the transferor of the property for generation-skipping transfer tax purposes. It is important in drafting Wills (and Will substitutes, such as revocable trusts) to fully use the decedent's unused GST exemption, and because of the prevalent use of QTIP marital trusts, a reverse QTIP trust may be required to accomplish that. Thus, a "typical" Will for a married person might provide for a "tripartite" disposition, consisting of a credit shelter trust (to pick up any remaining unified credit amount) to which the decedent's GST exemption will likely be allocated, a reverse QTIP marital trust to which the balance of the decedent's GST exemption will be allocated, and a second QTIP trust to hold the balance of the decedent's property.[16] The Will (and the Will of the surviving spouse) should also provide that any taxes on the "GST exempt" QTIP will be paid from the non-exempt QTIP, to preserve as much property as possible in the exempt QTIP.[17]

The reverse QTIP election may also provide an opportunity to be able to use GST exemption during life. Treas. Reg. § 26.2632-1(c)(2)(ii)(C) indicates that the estate tax inclusion period (ETIP) rule does not apply to a QTIP trust if the so-called "reverse" QTIP election has been made even though the trust will be includible in the

estate of the transferor's spouse under IRC § 2044. In addition, although normally, on account of the ETIP rule, the transferor cannot retain an interest (such as a secondary income interest) in the trust as that would cause estate tax inclusion in his or her estate, there should be no estate tax inclusion of a QTIP trust in the transferor's estate if he or she retains an income interest to take effect when the beneficiary spouse dies. *See* Treas. Reg. § 26.2523(f)-1(f). Example 11.

The foregoing strongly suggests that a property owner may (1) create a lifetime QTIP trust (equal to his or her unused GST exemption), and retain a secondary income interest in it (2) make the reverse QTIP election so as to be treated as the transferor of the trust for generation-skipping transfer tax purposes, (3) immediately and effectively allocate his or her GST exemption to the trust, and (4) pay no gift tax. This allows the GST exemption to be used early in life without gift tax and also permits retention of an interest in the trust property.

For example, a woman creates a $1 million QTIP trust for her husband 40 years before she dies. She makes the reverse QTIP election, and allocates her $1 million GST exemption to it. If the trust grows at 10 percent per year, it will be worth over $45 million when she dies and protect that much from generation-skipping transfer tax. Although the beneficiary spouse must be entitled to all of the trust's income and be able to force the trustee of the QTIP trust to make the trust reasonably productive of income, there is no requirement that it, in fact, be productive. Treas. Reg. § 20.2056(b)-5(f)(4). By keeping income production low, less is distributed to the spouse and, therefore, more kept in the trust to provide more protection from generation-skipping transfer tax. Of course, the trust property will ultimately be subject to estate tax (although, if funds are available, that tax would presumably be paid from other sources, and that payment from other sources should not be considered an addition to the GST exempt fund, *see* Treas. Reg. § 26.2652-1(a)(3)). In the case of a non-QTIP irrevocable inter vivos trust, after the initial payment of gift tax upon funding ($153,000 if the trust is funded with $1 million and the full unified credit is available) no later gift or estate tax should be due.

SPECIAL REGULATORY MOVE-UP-A-GENERATION RULE

A generation-skipping transfer tax, as mentioned above, is imposed by IRC § 2601 on any generation-skipping transfer including a "direct skip" which is a transfer, subject also to estate or gift tax, to a skip person, such as a grandchild or more remote descendant. For purposes of determining if a transfer is a direct skip and, therefore, subject to the tax, a grandchild is treated as a child (so transfers are not subject to tax) if the child's parent, who also is a descendant of the transferor, predeceased the transfer. IRC § 2612(c)(2). A similar rule applies for more remote descendants of the transferor and descendants of a spouse or former spouse of the transferor. This is known by several names including the "predeceased child" and "move-up-a-generation" rule.

Bills have been introduced in the Congress to expand this rule to others, such as nieces and nephews. In addition, the application of the current rule has been liberalized by Treas. Reg. § 26.2612-1(a)(2)(i), so it applies when a descendant dies within 90 days of the event which would have caused the "predeceased child" rule to apply if the descendant had, in fact, died prior to the event (e.g., a child dies within 90 days after the transferor's death). However, this regulation applies only if local law or the terms of the governing instrument so provide.[16] Some states (e.g., those that have adopted the Uniform Probate Code survivorship provision) have a default survivorship rule. Usually, it is relatively short (e.g., 120 hours). It is worth considering having instruments which have generation-skipping "potential" contain a provision making dispositions conditioned upon a 90 day survivorship requirement where the "predeceased child" rule would be triggered if the descendant had, in fact, died before the event. Although this may reduce or eliminate the tax, it may also have significant impact on the disposition of property. For example, a bequest to a child (with a gift over to a grandchild if the child does not survive) who survives for fewer than 90 days will be "voided" if the provision is adopted. If the special 90 day survivorship provision did not apply, the bequest to the child would have been effective and the child could have left the property subject to the bequest to the child's spouse, for example. By putting the 90-day survivorship provision in the document, the bequest will instead go to a grandchild or grandchildren.

The following provision is drafted for Wills and tries to take into account any further expansion of the rule if enacted (it would be modified for other instruments, such as revocable trusts). This could include having it apply to descendants of a parent of the transferor and to generation-skipping transfers other than direct skips.

> If any person dies within ninety (90) after my death, the termination of any trust created hereunder or any other event covered by Treas. Reg. § 26.2612-1(a)(2), as the case may be, and if had such person not, in fact, survived my death, the trust termination or the other event, as the case may be, such failure to survive would have caused the special rule relating to a predeceased child or

other descendant under section 2612(c)(2) of the Code to apply to any property passing under this Will, then I direct that such person shall be treated with respect to such property as having predeceased me, the termination of the trust or such other event, as the case may be, so that in accordance with Treas. Reg. § 26.2612-1(a)(2), the special rule under section 2612(c)(2) of the Code shall apply with respect to such property.

CONCLUSION

The generation-skipping transfer tax represents a major challenge in estate planning. In many ways, it is a more onerous tax system than the estate and gift tax systems which it supplements. Nonetheless, opportunities to reduce tax substantially are available. Often, these opportunities are best effected as early in the property owner's life as possible.

FOOTNOTES

[1]The IRS has recently issued some corrections to these regulations. See 96 TNT 115-12. In addition, the IRS has proposed to delete Treas. Reg. § 26.2652-1(a)(4) and Examples (9) and (10) of Treas. Reg. § 26.2652-1(a)(6) addressing the exercise of non-general powers of appointment. 96 TNT 115-13. As to the latter change, the IRS states the rule was intended to apply the generation-skipping transfer tax when it might not otherwise have applied, and not to prevent the application of the tax to the original taxable transfer, but to remove any uncertainty, it proposes the deletions described above.

[2]It may be possible to have the trust assets includible in other ways.

[3]The gift also will be incomplete if the trust terminates in favor of the estate of the skip person even though he or she holds no power of appointment over the property in the trust.

[4]Although a transfer to a trust described in IRC § 2503(c) and a transfer to a Uniform Gift (or Transfer) to Minors Act account would also qualify for the annual exclusion for gift and generation-skipping transfer tax purposes, the property must be distributed or made payable to the beneficiary at age 21, an age many believe is too young to receive substantial property.

[5]Of course, any trust may be structured for more than one beneficiary even if it does not hold life insurance.

[6]Cascading Crummey Power is a service mark of Jonathan G. Blattmachr.

[7]Of course, Crummey powers, as well as Cascading Crummey Powers[sm], can be used even if the trust receives and holds assets other than life insurance policies or amounts to pay premiums on them.

[8]See generally, J. Blattmachr, "Getting It Clean and Keeping It Clean (Another Generation-Skipping Adventure)," *8-1 49th Annual Institute on Federal Taxation* (1991), reprinted as "Another Generation-Skipping Adventure," *¶472 Macmillan, Inc. - Tax Ideas* (7-19-91).

[9]Another possibility is to create a new trust, fund it with the amount needed to pay the additional premiums, and have the two trusts enter into a form of split-dollar (split-ownership) agreement with respect to the policy under which the newer trust will pay the additional premiums. Cf. Rev. Rul. 64-328, 1964-2 C.B. 11. Or, another person, such as the original transferor's spouse, might transfer the necessary additional funds to the trust.

[10]This contemplates that the Grantor's spouse will agree pursuant to IRC § 2513 to "split" the gift to the trust, permitting application of both the Grantor's and the Grantor's spouse's GST exemptions (and credit-shelter amounts). If that is not the case, or if the Grantor is unmarried, delete reference to the Grantor's spouse's exemption both here and below. Also, if the Grantor's spouse is a beneficiary (even one merely eligible to receive distributions in the discretion of an independent Trustee), the spouse cannot "split" the gift.

[11]Neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent. IRC § 6110(j).

[12]See R. Oshins and J. Blattmachr, "The Megatrust[sm]: An Ideal Family Wealth Preservation Tool, Trusts and Estates 20, (November, 1991)

[13]IRC §§ 2055(e)(2)(B) and 2522(c)(2)(B); Treas. Reg. §§ 20.2055(e)(vi) and 25.2522(c)-3(c)(vi) and (vii).

[14]See J. Blattmachr, "A Primer On Charitable Lead Trusts: Basic Rules and Uses" Trusts & Estates 56 (April 1995), for an example and explanation as to why that may occur.

[15]See J. Blattmachr & J. Pennell, "Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes," 68 J. Tax'n., 243 (April 1988).

[16]See "The Tripartite Will: A New Form of Marital Deduction," 127 Trusts & Estates 47 (April 1988).

[17]See Treas. Reg. § 26.2652-1(a)(3).

[18]Although it is possible that if a death occurs within 90 days, a subsequent disclaimer would "work" to take advantage of the regulation, it seems doubtful that such a result was intended.

UPDATES[1]

IRS ISSUES PROCEDURE ALLOWING TAXPAYERS TO REQUEST ART VALUATION STATEMENT

The Internal Revenue Service ("IRS" or "Service") in Revenue Procedure 96-15, 1996-3 I.R.B. 1, sets forth the procedure by which taxpayers can request from the IRS a statement of value for the gift of an object of art which can be used to substantiate the object's value for income, estate or gift tax purposes. A taxpayer who has received a statement of value for an object of art from the IRS in compliance with the provisions of Revenue Procedure 96-15 can rely on that value in completing the tax return that reports the transfer of the object.

The Revenue Procedure applies to an item of art that has been appraised at $50,000 or more and has been transferred as (1) a "charitable contribution" within the meaning of I.R.C. § 170(c), (2) by reason of a decedent's death or (3) as an *inter vivos* gift. The Service also has the authority to issue a statement of value for items appraised at less than $50,000 if the request for the statement of value includes a request for appraisal review for at least one item appraised at $50,000 or more and the Service determines that the issuance of such statement would be in the best interest of efficient tax administration.

For purposes of the Revenue Procedure the term "art" includes paintings, sculpture, water colors, prints, drawings, ceramics, antique furniture, decorative art, textiles, carpets, silver, rare manuscripts, historical memorabilia and other similar objects.

In order to obtain a statement of value, the taxpayer (which includes an executor or administrator acting on behalf of an estate and a donor of a gift) must submit a request for a statement of value prior to the filing of the return that reports the charitable contribution or the transfer of the item. In addition to a user fee in the amount of $2,500 (for a request for a statement of value for up to 3 items of art plus an additional $250 for each additional item of art), the request for a statement of value must include among other items an appraisal of the item of art. The appraisal must include the following: (1) a complete description of the item of art including the name of the artist or culture, the title or subject matter, the medium, the date created, the size, any marks, signatures or labels on the items of art, the history (provenance) of the item, a record of any exhibitions at which the item was displayed, any reference source citing the item, and the physical condition of the item. The appraisal must be made no earlier than 60 days prior to the date of the contribution of the item of art in the case of the determination of the value of the item for purposes of an income tax charitable contribution deduction or 60 days prior to the valuation date (e.g., date of death, the alternate valuation date or the date of the gift) in the case of a transfer at death or by gift of the item of art. In addition, the appraisal must contain a statement by the appraiser which includes, among other requirements, a representation that the appraiser is not the beneficiary or donee receiving the item of art, the appraiser is not a person who is employed by the decedent or employed by the taxpayer, and the appraiser is not an appraiser who is regularly used by the decedent or who is regularly used by the taxpayer or the beneficiary or donee.

If the Service agrees with the value reported on the taxpayer's appraisal, the Service will issue a statement of value approving the appraisal. If the Service disagrees with the value reported on the taxpayer's appraisal, the Service will issue a statement of value with the Service's determination of value, and the basis for its disagreement with the taxpayer's appraisal. A copy of the statement of value, regardless of whether the taxpayer agrees with it, is required to be attached to and filed with the taxpayer's income, estate, or gift tax return that reports the transfer of the item of art valued in the statement of value or, if the return is due prior to receiving a statement of value, the taxpayer must indicate on the return that a statement of value has been requested and attach a copy of the request to the return. Upon receiving the statement of value, the taxpayer is required to file an amended income or gift tax return or supplemental estate tax return. The taxpayer may rely on a statement of value received from the IRS for an item of art except the taxpayer may not rely on the statement of value issued to another taxpayer or on a statement of value if the representations upon which the statement was based are not accurate statements of the material facts.

DONOR'S LOANS TO SONS ARE RECHARACTERIZED AS GIFTS

I.R.C. § 2501(a) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual. If property is transferred for less than adequate and full consideration, the amount by which the value of property transferred exceeds the value of consideration received is treated as a gift.

[1] Under I.R.C. § 6110(j), a private letter ruling ("PLR") or national office technical advice memorandum may not be used or cited as precedent.

Treas. Reg. § 25.2511-1(g)(1). Transfers between family members are subject to special scrutiny and there is a presumption that such a transfer is a gift.

In *Miller v. Commissioner,* T.C. Memo 1996-3, a mother had transferred $100,000 to each of her sons. On each of the checks representing the transfers, the mother had written the word "loan". In connection with each of these loans, each son had signed a non-interest bearing note which was not secured. Each note was payable by the son on demand or on a date certain which was 3 years after the date of the loan. The mother did not demand payment of any of the notes prior to the date certain nor thereafter. Although one of the sons had made a partial payment on the note, the other son had made no payments. In addition, on various dates after the notes were executed, the mother forgave annually various portions of the loans. The IRS took the position that the transfers were gifts by the mother to her sons.

In determining whether the transfers at issue were loans or gifts, the Tax Court stated that the focal question was whether the mother had entered into a bona fide creditor-debitor relationship with her sons. The Tax Court stated that the mother had to rebut the presumption that the transfer which was between family members was a gift by an affirmative showing that at the time of the transfer she had a real expectation of repayment of the loans and an intention to enforce the debt. In order to determine whether the transfer was made with a real expectation of repayment and an intention to enforce the debt depended on all the facts and circumstances, including whether: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for payment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

Reviewing the foregoing factors, the Tax Court concluded that the transfers at issue were gifts rather than loans. Although the sons had executed promissory notes, the notes did not bear interest and were not secured. Although each note had a fixed maturity date, the Tax Court noted that the mother had stated that she did not view the maturity date as a fixed date and had no intention of demanding payment on that date or any other date. Moreover, the mother never demanded repayment of either of the notes. Except for one small payment on one of the notes by one of the decedent's sons, no repayment had been made on the notes. Moreover, neither son had the ability to repay the respective notes. In addition, the Court noted that there were inconsistencies in the evidence concerning the treatment of the transfers and loans by the mother. Accordingly, the Court concluded that the mother had not established that she had entered into a bona fide creditor-debitor relationship with either of her sons at the time the transfers were made and, therefore, the transfers were gifts by the mother to her sons.

BENEFICIARIES OF TRUST DO NOT POSSESS INCIDENTS OF OWNERSHIP OVER INSURANCE POLICIES ON SUCH BENEFICIARIES' LIVES

Under I.R.C. § 2042(2), the value of a decedent's gross estate includes the proceeds of all life insurance policies on the decedent's life to the extent that the decedent possessed at death any incidents of ownership exercisable either alone or in conjunction with any other person. The term "incident of ownership" means the right of the insured or the insured's estate to the economic benefits of a policy. Treas. Reg. § 20.2042-1(c)(2). Under Treas. Reg. § 20.2042-1(c)(4), a decedent is considered to possess an incident of ownership in an insurance policy on his life held in trust if, under the terms of the trust, the decedent, either alone or in conjunction with another person or persons, has the power as trustee or otherwise, to change the beneficial ownership of the policy or its proceeds or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

In PLR 9602010 (September 29, 1995), a taxpayer requested a ruling that neither of the taxpayer's daughters would possess any incidents of ownership over life insurance policies on each of their lives held by trustees of separate irrevocable trusts created for their respective benefits. The taxpayer proposed to establish two separate irrevocable trusts, one for the benefit of each of his two daughters. During each daughter's lifetime, the net income of her separate trust was to be distributed to the daughter annually and the trustees were also authorized to distribute principal to the daughter. In addition, during each daughter's lifetime and upon a daughter's death, the trustees were directed to distribute the principal of the daughter's separate trust to such beneficiaries (other than the daughter, her creditors, her estate or the creditors of her estate) as the daughter may appoint. These powers of appointment were not effective if the daughter's separate trust held any insurance policies on the life of the daughter. The trustees of each separate trust were authorized to purchase life insurance policies on the life of the daughter. If such a policy of insurance was purchased, the trustees were not entitled to distribute to the daughter any portion of such life insurance policy. Neither the Grantor nor his daughters were authorized to serve as Trustee.

The IRS ruled that neither daughter will possess any incident of ownership over the life insurance policies on her life held by the trustees of her irrevocable trust and that the proceeds of the policies will not be includible in either daughter's gross estate under I.R.C. § 2042(2). The IRS noted that the trustees of the separate trusts were vested with all right, title and interest in and to the policies and were prohibited from distributing any portion of the life insurance policies or their proceeds to the insured daughter. In addition, neither daughter could serve as a trustee. Accordingly, the IRS held that neither daughter held a power over the life insurance policy in a fiduciary capacity and, accordingly, Treas. Reg. § 20.2042-1(c)(4) was not applicable.

The IRS next addressed the issue of whether each daughter's powers over the maintenance and distribution of the assets held in her separate trust gave her an incident of ownership over the life insurance policies on her life. The IRS noted that neither daughter could direct that corpus be distributed to herself and that each daughter's power of appointment was only effective if there was no life insurance policy on her life included in the trust assets. Therefore, the IRS concluded that neither daughter could exercise her special power of appointment to gain any economic benefit of the life insurance policy or its proceeds.

It should be noted that the IRS specifically stated that it is expressing no opinion with respect to the gift tax consequences to either daughter if the trustees of their separate trusts invest in a non-income-producing life insurance policy on their lives.

REAL ESTATE INTERESTS HELD INDIRECTLY BY DECEDENT QUALIFIED AS INTEREST IN CLOSELY-HELD BUSINESS ENTITLED TO ESTATE TAX DEFERRAL UNDER I.R.C. § 6166

Under I.R.C. § 6166, if the value of an interest in a closely-held business exceeds 35% of the decedent's adjusted gross estate, the decedent's executor may elect to pay part or all of the estate tax imposed in two or more (but not exceeding 10) equal installments, with the first installment to be paid no later than 5 years after the original due date of the payment of the tax. In determining the closely-held business amount, I.R.C. § 6166(b)(9) provides that the value of any interest in a closely-held business shall not include the value of that portion of such interest which is attributable to passive assets held by the business. In general, the term "passive asset" means any asset other than an asset used in carrying on a trade or business. In Rev. Rul. 75-365, 1975-2 C.B. 471, the IRS ruled that rental commercial property, rental farm property and notes receivables did not constitute an interest in a closely-held business where the decedent maintained a fully equipped business office because, under those facts, the decedent's relationship to the assets is merely that of an owner managing investment assets. See, *also*, Rev. Rul. 75-367, 1975-2 C.B. 472. Thus, the IRS looks at the level of activity that the decedent engaged in with respect to a closely-held business to determine whether the decedent's interest in the closely-held business is a passive asset or an asset used in carrying on a trade or business.

In PLR 9602017 (October 11, 1995), the taxpayer requested a ruling as to whether the executors of a decedent's estate may elect under I.R.C. § 6166 to defer and pay in installments the Federal estate tax attributable to certain real estate interests held indirectly by the decedent. The decedent had owned 100% of the stock of various corporations which held commercial and residential real estate. In addition, the decedent had held a 50% interest in a partnership which held residential and commercial real estate. The value of the decedent's real estate interest exceeded 75% of the decedent's gross estate. During most of his life, the decedent had operated, maintained and repaired all of the commercial and residential units. In addition, he had operated a real estate management corporation of which he was the sole operating officer and sole shareholder. Although the decedent employed and/or directly supervised 13 employees who performed a variety of functions at many of the buildings, the decedent supervised all aspects of their responsibilities with respect to the maintenance of the buildings. In addition, the decedent supervised the office where the records were maintained and all bookkeeping matters, including reviewing all bills and signing all checks. The decedent was also involved in all negotiations concerning the commercial leases and executed all leases for each of the residential units.

Several years prior to his death, the decedent suffered a major stroke which debilitated him. After his incapacitation, the management activities of the decedent were continued by his wife and son (who were also named as his co-conservators), his brother-in-law and his employees.

The IRS ruled that the decedent's interest in the corporations and the partnership were interests in a closely-held business because the corporations and partnership were engaged in a trade or business. The Service noted that the day-to-day operation and management of these properties were handled in whole or in part by the decedent, his wife and son, brother-in-law or employees employed and/or directly supervised by them. In performing these activities, the Service stated that these individuals were acting as agents on behalf of the corporations or partnership and, therefore, the activities of these individuals are attributed to

the corporations or partnership. Accordingly, the decedent's interests in the corporations and partnership were interests in a closely-held business and the decedent's executors may elect to defer the estate tax under I.R.C. § 6166.

INTEREST PAID ON LEGACY NOT DEDUCTIBLE FOR ESTATE TAX PURPOSES

A deduction from the value of the gross estate is allowed for amounts paid as administration expenses that are allowable under the laws of the jurisdiction under which the estate is being administered and that are actually and necessarily incurred in the administration of the estate. I.R.C. § 2053(a)(2); Treas. Reg. § 20.2053-3(a). Accordingly, interest incurred by an estate on tax payments deferred under I.R.C. § 6161 or 6166 or interest paid on an estate tax deficiency are deductible as an administration expense. In addition, interest paid on a loan from a bank is deductible if the loan is required to avoid a forced liquidation of estate assets. Rev. Rul. 84-75, 1984-1 C.B. 193.

In NOTAM 9604002 (October 6, 1995), the IRS addressed the issue of whether interest paid pursuant to state law on the delayed distribution of a pecuniary bequest is a deductible administration expense under I.R.C. § 2053. A decedent had provided a pre-residuary pecuniary disposition in trust for the benefit of the decedent's daughter, her husband and their issue. Under applicable state (Pennsylvania) law a pecuniary bequest in trust bears interest at the rate of 5% per year from the date it was to be set aside until it is set aside. Pursuant to the statute, interest was paid on the pre-residuary pecuniary distribution in trust. The estate sought to deduct the interest paid to the trust under I.R.C. § 2053. The estate contended that the interest paid is in the nature of interest paid on a loan of money from the trust since it is required to be paid under state law. The estate relied on Rev. Rul. 73-322, 1973-1 C.B. 44 which held that, for income tax purposes, statutory interest on a pecuniary legacy is deductible by the estate for income tax purposes under I.R.C. § 163(a) and includible in the beneficiary's gross income under I.R.C. § 61(a)(4). To support its conclusion, this Revenue Ruling had stated that interest required to be paid on a legacy is not part of a legacy but is, rather, an amount payable with respect to an indebtedness incurred by the estate.

The IRS in this NOTAM ruled, however, that these precedents did not govern the present case which raised the question regarding the characterization of a payment as an administration expense under the Federal *estate* tax. Revenue Ruling 73-322 focused on this issue for income tax purposes and the income tax and estate tax are not in pari materia. The Service stated that the Federal estate tax is a tax on the transfer of wealth and is imposed on the value of property passing at death without regard to the form of the property ultimately passing to the beneficiaries. According to the Service, the purpose of permitting deductions from the gross estate under I.R.C. § 2053 is to ensure that the Federal estate tax is only imposed on the net estate (*i.e.*, the net amount passing from the decedent to the beneficiaries of the estate.) Moreover, the IRS ruled that deductions under I.R.C. § 2053 are not available for transfers serving the decedent's donative intent.

Accordingly, the Service stated that it must scrutinize the nature of the payment and the nature of the beneficiary's right to receive the payment. The IRS concluded that the Pennsylvania statutory provision merely provides a mechanism to allocate estate income among the estate's beneficiaries to compensate pecuniary legatees for any delay during the administration of the estate in funding their bequest. Thus, the payment of statutory interest was viewed as a payment of estate income to estate beneficiaries. The origin of the trust's claim to the statutory interest arose as the result of the trust's status as a beneficiary of the decedent's estate. Moreover, the Service stated that it could not conclude that the interest payments were necessary to the administration of the estate because there was no liquidity problem or other evident need for the executors to borrow money (e.g., through their delay in funding of the trust) during the administration of the estate.

Finally, the Service noted that the decedent could have provided in the trust agreement that statutory interest not be paid on the pecuniary bequest and the fact that he did not do so confirms his intent that the interest passes with the bequest in trust rather than to the residuary beneficiaries. Accordingly, the IRS concluded that the interest payment is not deductible as an administration expense under I.R.C. § 2053.

TAX COURT HOLDS BUY-SELL AGREEMENT DOES NOT FIX ESTATE TAX VALUE

In *Lauder v. Commissioner,* T.C. Memo 1992-736, the United States Tax Court held that a buy-sell agreement did not fix estate tax value because, among other reasons, the price was not fair when entered into. The Tax Court recently applied the same reasoning to reach a similar result in *Gloeckner v. Commissioner,* T.C. Memo 1996-148. Although the case is factually somewhat unusual, several aspects of the Tax Court's reasoning are of interest. In *Gloeckner,*

the decedent owned 84.6% of the common stock of a corporation, an unrelated party ("P") owned 15%, and another unrelated party ("S") owned .4% which he had acquired by gift from the decedent. It was the decedent's intent that S (who was much younger than the decedent and P) inherit the company. In 1987, the decedent entered into an agreement restricting his right and the right of his estate to dispose of his stock. In addition, at death, the corporation was required to redeem sufficient stock to pay death taxes, and had an option to redeem the balance of the decedent's stock. The redemption price was to be the 1987 value which, as determined by an appraiser, was $440 per share for the common stock. It appears that "S", but not "P", was a party to this agreement; however, "P" was later bought out at a different price, before decedent died. When the decedent died, because his other assets had increased greatly in value, all of his stock had to be redeemed in order to pay death taxes, and the company negotiated with the estate to make that payment over time because it did not have the necessary liquidity to make that payment immediately upon death.

The IRS argued that the value of the common stock at the decedent's death was $965 per share. The Tax Court held that the agreement did not fix estate tax value because it was a testamentary substitute (although the court also found that the fair market value of the stock was somewhat less than the IRS contended). Based on *Lauder,* the court enunciated the following test for determining whether a buy-sell agreement fixes estate tax value: (1) the price must be fixed and determinable under the agreement, (2) the agreement must be binding on the parties both during life and at death, and (3) the agreement must be entered into for bona-fide business reasons and not as a testamentary substitute. As in *Lauder,* the Court found all elements satisfied except for the issue of testamentary substitute. Perhaps more significantly, as in *Lauder,* the Court stated that if the other parties are natural objects of the decedent's bounty, then an inference arises that the agreement is a testamentary substitute and, in order to rebut that inference, the estate must demonstrate that the price to be paid under the agreement reflected full consideration when the agreement was entered into. Although "S" and the decedent were unrelated, because of their personal friendship and certain provisions of the decedent's Will in favor of "S" the court treated "S" as a natural object of the decedent's bounty for purposes of its analysis.

For technical procedural reasons, it appears the estate was unable to admit its expert appraisal into evidence, with the result that the estate failed to carry its burden of proof. Interestingly, however, the court rejected the Service's contention that I.R.C. § 2703 applied because of the post-death amendment of the agreement permitting payment over time. The Court apparently reached that result because the amendment was made after the valuation date (which, in this case, was the alternate valuation date).

TRANSFERS IN TRUST FOR LESS THAN FULL AND ADEQUATE CONSIDERATION ARE INCLUDED IN DECEDENT'S GROSS ESTATE

A decedent's gross estate includes the value of all property transferred by a decedent during his life in which the decedent has retained for life the right to the possession, enjoyment or income from the property. I.R.C. § 2036. However, I.R.C. § 2036(a) does not apply where the transfer is a bona fide sale for an adequate and full consideration in money or monies worth. This "adequate and full consideration" exception to I.R.C. § 2036 is intended to prevent the depletion of a decedent's estate. In order to constitute adequate and full consideration, the value of what the decedent received must be measured against the total value of the property the decedent transferred. *See Estate of D'Ambrosio v. Commissioner,* 105 T.C. 252 (1995). Thus, where there is a transfer of property in trust in which the transferor retains a life interest, the adequacy of the consideration must be determined by comparing the value of the consideration received with the total value of the property the decedent transferred to the trust rather than just the remainder interest. *Id.* at 259-260.

In *Estate of Magnin v. Commissioner,* T.C. Memo. 1996-25, Joseph Magnin and his son, Cyril Magnin, entered into an agreement in 1951 which was aimed at addressing Joseph's concern that the business remain in the family and Cyril's concern of having control of the business upon his father's death. Under the 1951 agreement, Joseph agreed to bequeath all the stock in the family companies to Cyril as trustee for the benefit of Cyril and his children, giving Cyril the right to vote all of the stock for his life. In return, Cyril agreed to leave by his Will in trust all of his stock in the family companies for the benefit of his three children. Cyril also agreed not to otherwise transfer, assign or encumber any of his stock in the family companies. In 1952, Joseph and Cyril entered into a second supplementary agreement which confirmed that nothing in the 1951 agreement prohibited Cyril from selling stock of, or dissolving, the family companies in the event that any company received a fair purchase price and also provided that Cyril agreed to vote his shares of stock in the family companies so that his children would con-

stitute two of the five members of the Board of Directors of each company.

In 1953, Joseph died leaving all of the stock in the family companies for Cyril and his children and granting Cyril the power to vote the stock. (Under the 1951 agreement, Cyril was entitled to give the stock to his children during his lifetime as well.)

In 1971, in conformance with the 1951 and 1952 agreement, Cyril transferred the proceeds of sale of one of the family companies to three trusts which provided that Cyril retained an income interest for life and upon his death the trust property was distributable to Cyril's children.

The Tax Court addressed the issue of whether Cyril's 1971 transfers in trust with retained life estates are includible in Cyril's gross estate or whether they are excluded from the estate because they are bona fide sales for adequate and full consideration under I.R.C. § 2036(a). The Tax Court ruled that, in order for there to be adequate and full consideration to trigger the exception to I.R.C. § 2036, the value of the property which Cyril received must be measured against the total value of the property that Cyril transferred. Relying on *Estate of D'Ambrosio, supra,* and *U.S. v. Past,* 347 F.2d 7 (9th Cir. 1965), the Tax Court held that the consideration received by Cyril had to be measured against the total value of the property he contributed to the trusts, rather than the value of the remainder interests in the property contributed. The Court concluded that the consideration received by Cyril was not "adequate and full" within the meaning of I.R.C. § 2036(a), and, therefore, the value of the trusts that Cyril created in 1971 must be included in his gross estate.

However, the Tax Court noted that I.R.C. § 2043(a) provides some relief for potential double taxation. I.R.C. § 2043(a) provides that where a transfer is made for consideration but is not a bona fide sale for an adequate and full consideration the amount included in the decedent's gross estate is the excess of the fair market value at the time of death of the property otherwise to be included over the value of the consideration received by the decedent. The Court rejected the estate's argument that in valuing the consideration received by Cyril the Court should apply a proportional rule and reduce the includible value of the trust by the proportion of the value of the corpus at death that is attributable to the consideration received by Cyril under the 1951 agreement. The consideration that Cyril received was a life income interest and 50% of his father's stock in the family companies as well as the voting rights (as Trustee) with respect to all his father's stock. The Court stated that it is well settled that the consideration received is to be valued at the time of transfer (*i.e.,* at the time of the 1951 agreement) and then credited against the date-of-death value of the property subject to I.R.C. § 2036(a).

SURVIVING SPOUSE ALLOWED 100% STEP-UP IN BASIS FOR JOINT INTEREST CREATED PRIOR TO 1977

Prior to 1977, under I.R.C. § 2040, in all cases, the portion of property jointly owned with right of survivorship which was includible in the estate of the first joint owner to die was based upon the proportionate part of the purchase price provided by that owner. Moreover, there was a presumption that the co-owner dying first had provided all the consideration for the purchase of the jointly held property. However, for property jointly owned by spouses, after 1976, I.R.C. § 2040 has been amended to provide that one-half of the property is includible in the estate of the spouse first to die regardless of the actual respective contributions the spouses had made towards the cost of the property. To the extent the property is includible in the estate of the first spouse to die, an income-tax step up in basis, as a general rule, occurs under I.R.C. § 1014.

However, the inclusion rule based upon respective contributions as it existed prior to 1977 was held by the Sixth Circuit in *Gallenstein v. United States,* 975 F.2d 286 (6th Cir. 1992), to be applicable in determining the ownership of jointly held property between spouses if the property was acquired by the spouses before 1977, even if the first death occurred after 1976.

In *Patten v. United States,* 77 AFTR. 2d ¶96-731, the United States District Court for the Western District of Virginia followed the Sixth Circuit's decision in *Gallenstein v. United States, supra.* In *Patten* in 1955 the decedent had deeded real estate to himself and his wife as tenants by the entirety (a form of joint ownership with right of survivorship between spouses). The decedent subsequently died in 1989 and pursuant to local law the decedent's spouse became the sole owner of the real estate. In 1990, the surviving spouse sold the real estate. The issue arose as to whether or not she was entitled to a step-up in basis for the full value of the jointly held property as of the date of her husband's death in 1989 for purposes of determining the capital gains tax payable upon her sale of the property in 1990. If the rules in effect prior to 1977 for including jointly held property in a decedent's estate were effective, the surviving spouse would be entitled to a stepped-up date of death basis for the entire property. However, if the amendments to I.R.C. § 2040 with respect to property jointly owned between spouses (made by the Tax Reform Act of 1976 ("TRA") and the Economic Recovery Tax Act of 1981 ("ERTA")) apply for purposes of determining the portion includible in

the estate of the spouse who dies first, the surviving spouse would not be entitled to a step-up in basis to 100% of the date of death value of the real estate in the decedent spouse's estate but only to 50% of that value.

The Court addressed the issue of whether ERTA's amendments to I.R.C. § 2040 (which state that those amendments were "applicable to estates of decedents dying after December 31, 1981") replaced the effective date for TRA's amendments (which provides that the amendments shall apply to all joint interests created after December 31, 1976.) The Court held that, because the effective date of ERTA did not expressly or by implication repeal the effective date of TRA, for purposes of determining the portion of jointly held property includible in the gross estate of the spouse dying first who dies after December 31, 1981 (the effective date of ERTA) where the jointly held property was acquired prior to December 31, 1976, the contribution test as it existed prior to 1977 was applicable. Accordingly, the surviving spouse was entitled to a step-up in basis to 100% of the date-of-death value of the real estate she acquired as the surviving joint tenant on her husband's death.

TAX COURT REVIEWS METHODOLOGY FOR VALUING GIFT OF CLOSELY-HELD STOCK

A gift tax is imposed on the value of property transferred by gift during each calendar year. I.R.C. § 2501. The value of a gift of stock is the stock's fair market value on the date the gift is made. I.R.C. § 2512(a); Treas. Reg. § 25.2512-2(a). Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. Treas. Reg. § 25.2512-1.

In *Rabenhorst v. Commissioner,* T.C. Memo. 1996-92, the United States Tax Court reviewed the methodology for determining the fair market value of closely-held stock for gift tax purposes. In *Rabenhorst,* Mr. Rabenhorst had made gifts in 1988 of stocks in Rabenhorst Life Insurance Company, Inc. In calculating the fair market value of the stock for gift tax purposes, Mr. Rabenhorst relied on an appraisal prepared by Jerry Willis, the former chief examiner from the Louisiana Department of Insurance. Mr. Willis concluded that the discounted per-share value of the stock was $385. After the IRS indicated that it disagreed with Mr. Willis' appraisal, Mr. Rabenhorst hired David Chaffe to conduct a second appraisal. Mr. Chaffe concluded that the discounted per-share value of the stock was $167.98. The IRS also disagreed with this appraisal and concluded that the discounted per-share value of the stock was $445.

The Tax Court, in determining the value of the gifted stock, reviewed the appropriate approach for determining the fair market value of closely-held stock. The Tax Court stated that, in determining the value of unlisted stock, actual arms length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. In the absence of such sales, the Court noted that the value of the stock is to be determined by taking into consideration a variety of factors including: the company's net worth, the company's prospective earning power, the company's dividend paying capacity, the good will of the business, the economic outlook in a particular industry, the company's position in the industry and its management, the degree of control of the business represented by the block of stock to be valued, and the value of securities of corporations engaged in the same or similar lines of business that are listed on a stock exchange. In arriving at a value of $296 for each discounted share of stock transferred, the Tax Court first held that the values attributed to the gifts of stock on Mr. Rabenhorst's original gift tax returns constituted an admission of value and that lower values could not be substituted absent "cogent proof" that the reported values were erroneous. The Tax Court held that Mr. Rabenhorst had carried his burden in establishing that the IRS's determination was incorrect and that the values reported by Mr. Rabenhorst on his gift tax returns were erroneous (i.e., he overvalued the stock). However, in arising at a per share value between the two appraised values received by Mr. Rabenhorst, the Tax Court criticized the various appraisals that had been submitted by Mr. Rabenhorst to substantiate his values. The Court was critical of Mr. Willis' appraisal because the Court was troubled by his unfamiliarity with the relevant Treasury Regulations and Revenue Rulings. Particularly, the Court noted that Mr. Willis had testified that he was unfamiliar with the use of minority interest discount factors.

REFORMATION OF WILL DID NOT HAVE RETROACTIVE EFFECT FOR FEDERAL TAX PURPOSES

The IRS has ruled that retroactive changes of the legal effects of a transaction through judicial nullification of the transfer or judicial reformation of the document do not have retroactive effect for Federal tax purposes. Rev. Rul. 93-79, 1993-2 C.B. 269. In *American Nurseryman Publishing Co. v. Commissioner,* 75 T.C. 271 (1980), *aff'd,* 673 F.2d 1333 (7th Cir. 1982), the Court disregarded the effect of a state court order which had found that the transfer of S corporation stock to a trust was a mistake and void for purposes of determining the Federal tax status of the corporation and held that the

S election was terminated. The Court noted that, as a general rule, a reformation of an instrument has retroactive effect as between the parties to the instrument but not as to third parties who previously acquired rights under the instrument. However, in *Flitcroft v. Commissioner,* 328 F.2d 449 (9th Cir. 1964), the Ninth Circuit upheld a state court reformation of trusts which decreed that the trusts were irrevocable and held that the trusts were irrevocable for Federal tax purposes. (The Service did not acquiesce in the *Flitcroft* case to the extent it required the Service to give effect to a retroactive reformation.)

In PLR 9609018 (November 27, 1995), a decedent had executed a Will which the decedent's surviving spouse believed was inconsistent with the decedent's intent. The surviving spouse commenced an action in state court and obtained an order reforming the decedent's Will to provide that a specified amount be transferred to a trust and the remainder of the decedent's estate be transferred to the surviving spouse. The surviving spouse sought a ruling that the trust was a valid testamentary trust and that no part of the assets held by the trust, as reformed, as of the date of the decedent's death is includible in the surviving spouse's estate for Federal estate tax purposes.

Relying on Rev. Rul. 93-79 and the *American Nurseryman* case, the IRS concluded that, although the trust is a valid testamentary trust for Federal tax purposes, the reformation of the trust would not be recognized retroactively. Therefore, the original language of the decedent's Will as originally executed would be determinative for Federal tax purposes. Accordingly, only those assets transferred to the trust under the original language in the decedent's Will and held by the trust as of the date of death of the decedent are not includible in the surviving spouse's estate. To the extent assets beyond those originally set forth in the decedent's Will are held by the trust, part of the total assets held by the trust may be includible in the surviving spouse's estate. Although not elaborating on the reasons for the inclusion, it is assumed from the facts recited in this ruling that those assets beyond those originally set forth in the decedent's Will which were transferred to the trust would be treated for Federal tax purposes as having been transferred to the surviving spouse and then the surviving spouse having contribute them to the trust. Presumably, the surviving spouse has an interest in that trust and therefore a portion of the assets would be includible in the surviving spouse's estate under I.R.C. § 2036.

GIFT OF STOCK TO SPOUSE SUBJECT TO BUY-SELL AGREEMENT QUALIFIES FOR MARITAL DEDUCTION

Under I.R.C. § 2523(a) a donor is allowed a deduction for the value of property transferred to a donor's spouse. This deduction, however, is not allowed if the interest transferred is a "terminable interest" which is defined as an interest that will terminate or fail on the lapse of time or the occurrence or failure to occur of some contingency. Treas. Reg. § 25.2523(b)-1(a)(3).

In PLR 9606008 (November 9, 1995), the taxpayer proposed to make an outright gift to her spouse of stock in a closely-held corporation subject to a buy-sell agreement. The agreement placed restrictions on the spouse's ability to transfer the shares of stock received from the taxpayer. If the spouse wished to sell his shares, the corporation which had issued the stock and then the taxpayer had a right of first refusal to purchase the shares at the price offered by any third party purchaser. In addition, if the taxpayer and spouse divorce or if the spouse predeceases the taxpayer and the spouse's shares do not pass outright to the taxpayer, the corporation and then the taxpayer have the option to purchase the shares at fair market value as determined by an independent appraisal.

The IRS concluded that the proposed gift of stock from the taxpayer to the spouse qualified for the gift tax marital deduction under I.R.C. § 2523(a). The Service ruled that the buy-sell agreement did not convert the interest transferred into a terminable interest because the spouse would receive full value for his stock under the three circumstances covered by the buy-sell agreement (e.g., sale to a third party, divorce or death.)

GIFTS MADE BY ATTORNEY-IN-FACT ARE INCLUDIBLE IN DECEDENT'S ESTATE; NEGLIGENCE PENALTY IMPOSED FOR FAILURE TO INCLUDE GIFTS

Under I.R.C. § 2033, the amount of cash belonging to a decedent at the date of the decedent's death, whether in the decedent's possession or in the possession of another, or deposited with a bank, is includible in the decedent's gross estate. Treas. Reg. § 20.2031-5. In order for a transfer of property to constitute a valid gift, under New York law, the donor's intent, delivery and acceptance must be established. Moreover, where a gift is made pursuant to a power of attorney, under New York law, the power of attorney must specifically authorize the attorney-in-fact to make gifts.

In *Goldman v. Commissioner,* T.C. Memo 1996-29, the Tax Court ruled that the value of checks written on the decedent's account, shortly before she died, by her daughter who had a bank power of attorney over the account, were includible in the gross estate. After the decedent was diagnosed with breast cancer in late 1989, the decedent executed a power of attorney at her bank giving her two daughters the authority to conduct banking transactions. Although the decedent was severely ill with cancer, during November and December of 1990, the decedent wrote numerous checks on her checking account in order to pay bills and to make small birthday and Chanukah gifts to family members.

In mid-December 1990, one of the decedent's daughters wrote eight checks in the amount of $10,000 each to family members. Both before and after these checks were written by the decedent's daughter, the decedent wrote checks paying bills and making small gifts to family members. Subsequently, when the decedent became terminally ill in January, 1991, the decedent's daughter wrote eight additional checks in the amount of $10,000 each to family members and two checks in the amount of $25,000 each to herself and her sister allegedly to reimburse them for miscellaneous expenses. During the two days prior to the decedent's death, 14 of the $10,000 checks made to family members were deposited.

In determining whether or not the $10,000 gifts were includible in the decedent's gross estate, the Tax Court first addressed the issue of whether the decedent intended to make these transfers. The Tax Court stated that under applicable (New York) law, a gift is valid only if donor's intent, delivery and acceptance are established. The Tax Court held that the evidence and testimony of family members did not satisfy the estate's burden of establishing, by clear and convincing evidence, the decedent's intent to make the gifts. Moreover, the Tax Court concluded that the decedent's daughter did not have the authority to make those gifts under the power of attorney. The Court, based on *Semmler v. Naples,* 563 N.Y.S.2d 116 (App. Div. 1990), held that, if a power of attorney did not explicitly authorize gifts, a valid gift could not be made by an attorney-in-fact. Accordingly, the Court concluded that a New York court would invalidate the gifts made by the decedent's daughter, as attorney-in-fact, since the power of attorney executed by the decedent did not explicitly or implicitly authorize the attorney-in-fact to make gifts of the decedent's funds.

In addition, the Tax Court included the two $25,000 checks written to the decedent's two daughters by one of the decedent's daughters, as attorney-in-fact, to reimburse themselves for expenses paid on behalf of the decedent. The Tax Court stated that no records had been produced to substantiate the claim that the checks were for reimbursements of amounts expended by the decedent's daughters on the decedent's behalf.

Finally, the Tax Court imposed a penalty in the amount equal to 20% of the portion of the underpayment of tax under I.R.C. § 6662(a) on the basis that the estate was negligent in understating its tax liability. The Tax Court rejected the Estate's contention that given the size of the estate such an inadvertent omission should not justify the imposition of an addition to tax. The Tax Court stated that I.R.C. § 6662 does not have a de minimus exception. Moreover, the Tax Court rejected the argument that relying on an accountant to prepare the return was reasonable cause to avoid the negligence penalty.

THE CHASE REVIEW

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