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Charitable remainder trust (CRT) trustees and trust beneficiaries are asking about ways to accelerate distributions of trust principal to charitable organizations as part of the wave of philanthropy that is sweeping the country after the terrorist attacks on America. Several recent letter rulings provide solutions.6

Planning With Spendthrift Trusts

By Gideon Rothschild and Daniel S. Rubin

The management, preservation, and distribution of wealth are the primary goals of estate planning. Since the 17th century, trusts have been viewed primarily, if not exclusively, for the purpose of tax minimization. Trusts can provide additional significant benefits, including the protection from predators and creditors.

Today, spendthrift trusts, which are practically universally accepted in the United States, provide the basis for such protection. Notwithstanding the general acceptance of spendthrift trusts, public policy exceptions have developed. One such exception relates to claims by a beneficiary's spouse or for child support. Another exception relating to tort creditors was recently addressed in *Sligh v. First*

National Bank of Holmes County, 704 So. 2d 1020 (1999).

Sligh Litigation

On January 30, 1993, William B. Sligh was seriously injured in an automobile accident with Gene A. Lorange, an uninsured motorist driving under the influence of alcohol. Mr. Lorange was without any assets of his own but was a beneficiary of two spendthrift trusts established by his mother before her death earlier that year. It was alleged that Mr. Lorange's mother knew that he was a habitual drunkard who...

- Regularly drove while intoxicated,
- Had been involved in numerous

See Spendthrift Trusts on page 2 ➤

The Surviving Spouse's Tax: Complications and Unfairness With Carryover Basis

By Keith Schiller

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act) establishes modified carryover basis, concurrent with the year 2010 elimination of the estate tax, repealing the "death-value" basis rule on property received from a decedent. This article addresses the hidden complexities and implications that may leave many taxpayers preferring the estate tax system that will be in effect in 2009 to the carryover basis plan of 2010 and possibly beyond.

The carryover basis plan makes the new transfer tax (capital gains tax from reduced

basis adjustment) the problem of the surviving spouse. Before, a husband and wife could choose to defer estate tax until the death of the surviving spouse — making such tax the children's problem.

In addition, the modified carryover basis scheme will impose significant recordkeeping burdens on taxpayers and their estate planning team. Those burdens alone may rekindle reminders of the failed effort to impose carryover basis with the 1976 Tax Act, which was

See Spouse's Tax on page 12 ➤



► *Spendthrift Trusts from page 1*

automobile accidents, and

- Had been arrested and convicted on numerous prior occasions for driving under the influence.

It was further alleged that Mr. Lorange's mother established the two trusts as part of an intentional plan to enable her son to continue to lead his

"... intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trusts from the claims of his involuntary tort creditors" [*Sligh v. First Nat'l Bank*, 704 So. 2d 1020 (1999).]

Notwithstanding that sympathetic background, however, the trial court dismissed Mr. and Mrs. Sligh's complaint,

ruling that the assets of spendthrift trusts may not be garnished to satisfy the claims of tort judgment creditors. The Mississippi Supreme Court, in a split decision, reversed the trial court's hard-hearted but legally well-grounded decision, holding that as a matter of public policy, a beneficiary's interest in a spendthrift trust is not immune from claims arising out of a beneficiary's

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intentional or gross negligence [see Gideon Rothschild, Daniel S. Rubin, and Jonathan G. Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?" 32 *Vand. J. Transnat'l L.* 763 (1999)].

Public Policy Exceptions

Restatement (Second) of Trusts Section 157 (1959), which sets forth the few exceptions that exist to spendthrift trust protections, contains no express "public policy" exception. Nevertheless, comment "a" to Section 157 does provide that "[t]he enumeration in this Section of situations in which the interest of the beneficiary of a spendthrift trust ... can be reached is not necessarily exclusive. The interest of the beneficiary of a spendthrift trust ... may be reached in cases other than those herein enumerated, if considerations of public policy so require. Thus, it is possible that a person who has a claim in tort against the beneficiary of a spendthrift trust may be able to reach his interest under the trust."

As an aside, it is the authors' frequently stated contention that in the area of asset protection planning, "public policy" is often used to justify a ruling in favor of an emotionally compelling fact pattern that is not otherwise favored by the law.

Aftermath of the *Sligh* Case

Within six months of the decision, the Mississippi legislature negated any future implications from that decision by passing the Family Trust Preservation Act of 1998. The *Sligh* case, when considered in conjunction with its legislative aftermath, is legally significant because it demonstrates how deeply rooted spendthrift trust protections are in the United States. Although a majority of the Supreme Court of Mississippi ultimately ruled against the trustee in the *Sligh* case, it would be almost impossible to conceive of a set of facts in which the plaintiff was more worthy of our empathy or the trust beneficiary more worthy of our enmity.

Even so, the spendthrift trusts in *Sligh* came within a hairsbreadth of serving their intended purpose of pro-

tecting their assets from the beneficiary's creditors. Because of the Mississippi legislature's swift and decisive action, the next time the issue arises in Mississippi, the spendthrift trust will serve its intended purpose of protecting its assets from the beneficiary's creditors. In most other states, the issue would never even have been in doubt in the first place.

In light of the almost absolute protections afforded by spendthrift trusts, why are trusts frequently considered solely as a device to minimize transfer taxes? Arguably, our highly litigious society requires every planner to consider a beneficiary's potential exposure to creditor risk and, therefore, trusts should almost always be employed. The writers have seen all too many instances when the contemplated transfer of wealth is thwarted by the appearance of creditors or ex-spouses. By suggesting ways in which trusts can be structured for maximum protection, this article endeavors to promote trusts for the purpose of wealth preservation.

Planning Considerations

The very essence of a "spendthrift" trust is the inalienability of its beneficial interests; the inclusion of certain provisions within the trust agreement can maximize the protection afforded by the trust. At the very least, for example, ...

1. The trust should be situated in a jurisdiction that recognizes the validity of spendthrift trusts without significant qualitative or quantitative exception, and
2. The trust agreement should actually include an express spendthrift provision.

That express trust provision applies irrespective of the fact that a spendthrift trust can be created by a mere demonstration of the settlor's intent that the beneficiary's trust interest should not be subject to alienation. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted [see, e.g., Texas Property Code, Title 9, Section 112.035 (2000)]. Those provisions apply even in those jurisdictions where the spendthrift nature of a trust is effected by default.

As a general matter, the right of a beneficiary of an express trust to receive the income from property and apply the income to the use of any person or pay the income to any person may not be transferred by assignment or otherwise. Nevertheless, the beneficiary of an express trust may transfer that right by assignment if that power is conferred upon such beneficiary by the instrument creating or declaring the trust [see, e.g., *New York Estates, Powers and Trusts*, § 7-1.5(a)(1) (McKinney, 1999)]. Additional factors can, however, enhance the spendthrift protection. A discussion of but a few of those additional factors follows.

Discretionary Versus Vested Interests

Where a spendthrift trust provides for the beneficiary's interest to terminate at a certain time, courts have held such interest to be a property right that is available to the beneficiary's creditors. Recently, in a divorce proceeding, the Colorado Supreme Court held that a

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wife's remainder interest in a family trust constituted "property" and determined further that since her interest became certain during the marriage, subject only to the condition of surviving the income beneficiary, any appreciation on her interest during the marriage constituted marital property. The court distinguished such an interest from interests in discretionary trusts in which a beneficiary's mere expectancy does not rise to be a property interest [see *In re Marriage of Balanson*, 25 P.3d 28 (Colo. 2001)]. Accordingly, providing a trustee with discretion to distribute income and principal will provide significantly greater protection.

Independent Trustee

The trust should have at least one objectively independent trustee whose consent is required under the trust agreement before distributions can be made to the beneficiaries. That limitation applies because a restraint on alienation is ineffective where the same person is given both the entire legal and beneficial interest in the property. A trust generally cannot exist where there is no separation of the legal and equitable interest in property [see, e.g., Austin W. Scott and William F. Fratcher, *The Law of Trusts*, vol 2A, 4th ed (Boston: Little, Brown & Company 1989) § 99].

Conversely, where the trustee is one of several beneficiaries, a valid trust is held to exist as to both the trustee's interest as well as the other beneficiaries' interests. For example, if A holds upon a spendthrift trust for A and B, A's interest, being an interest under the trust and not a legal interest, cannot be assigned to A or reached by A's creditors [see, e.g., Austin W. Scott and William F. Fratcher, *supra*, § 99.3 at 57; see also *Avera v. Avera*, 253 Ga. 16 (1984)]. An independent trustee would, nevertheless, remain advisable in order to foreclose a creditor arguing that the trust is somehow a "sham."

Eliminating the Rule Against Perpetuities

The trust agreement should provide that the trust property remain in trust for the longest possible period so as to

continue the spendthrift trust protections. Where an extended term is desired, the settlor should create the trust in a jurisdiction that allows the perpetual existence of trusts. Fourteen domestic jurisdictions, to date, have repealed the Rule Against Perpetuities as it applies to trusts:

- Alaska
- Arizona

- Delaware
- Florida (allowing trusts created after December 31, 2000, to continue for a maximum period of 360 years)
- Idaho
- Illinois
- Maine
- Maryland

Spendthrift Trust Background Information

By Gideon Rothschild and Daniel S. Rubin

What exactly is a spendthrift trust? The Restatement (Second) of Trusts (1959) provides that a spendthrift trust is "[a] trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed" [Section 152(2)].

The maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited as the underlying legal justification for spendthrift trusts. In 1875, the U.S. Supreme Court, in establishing the modern rule validating spendthrift trust protections, stated that "[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate We also admit that there is a just and sound policy ... to protect creditors against frauds upon their rights But the doctrine, that the owner of property ... cannot so dispose of it, but that the object of his bounty ... must hold it subject to the debts due his creditors ... is one which we are not prepared to announce as the doctrine of this court" [*Nichols v. Eaton*, 91 U.S. 716, 725 (1875); see also, *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (1999) at 1028 ("Perhaps the most important policy consideration in favor of enforcing spendthrift trust provisions is the right of donors to dispose of their property as they wish.")].

Exceptions nevertheless do exist to the protections afforded by a spendthrift trust. According to the Restatement (Second) of Trusts, for example, although a trust is a spendthrift trust, the interest of the beneficiary can nevertheless be reached in satisfaction of an enforceable claim against the beneficiary ...

1. By the wife or child of the beneficiary for support, or by the wife for alimony;
 2. For necessary services rendered to the beneficiary or necessary supplies furnished to the beneficiary;
 3. For services rendered and materials furnished which preserve or benefit the interest of the beneficiary;
 4. By the United States or a State to satisfy a claim against the beneficiary.
- [Restatement (Second) of Trusts, Section 157 (1959)]

As a general matter, however, those excepted creditor claims are usually not of significant concern to most clients.

Additionally, the self-settled trust rule, followed in all states except Alaska, Delaware, Nevada, and Rhode Island, denies spendthrift protection where the settlor retains a beneficial interest in the trust. A detailed discussion of self-settled trusts is beyond the scope of this article and will be presented in a future issue. ■

- New Jersey
- Ohio
- Rhode Island
- South Dakota
- Virginia
- Wisconsin

In that regard, it is notable that a grantor's designation of controlling law will govern the administration of the trust provided that certain minimum contacts exist between the trust and the designated jurisdiction. A settlor domiciled in one state may create an *inter vivos* trust by conveying property to a trust company of another state as trustee and delivering the property to the trustee to be administered in that state [see, e.g., Austin W. Scott and William F. Fratcher, *supra*, § 626 at 419; see also Restatement (Second) of Conflict of Law § 270]. In conjunction with continuing the trust for the maximum possible period, the trust agreement should encourage the trustee to acquire assets for the use of the beneficiary in lieu of making distributions to the beneficiary. Similarly, the trustee should be empowered to make loans to the beneficiary (whether those loans are secured or unsecured) or equity investments in the beneficiary's business entities.

For some clients, it is not desirable to continue the trust, in perpetuity or otherwise. For example, the client may wish to give the beneficiary the right to withdraw principal upon attaining a certain age. Where the beneficiary allows property to which the beneficiary is entitled to remain in trust, the beneficiary has most likely thereby created a "self-settled" trust, which would be ineffective to protect the beneficiary's beneficial interest from the beneficiary's creditors [see, e.g., *In re Doris L. Morris*, 151 B.R. 900 (C.D. Ill. 1993); *Hartsfield v. Lescher*, 721 F. Supp. 1052 (E.D. Ark. 1989)]. In that event, the trustee or another independent party can be granted the right to extend the term of the trust where a creditor problem exists at a time the trust would otherwise terminate. A slight variation on that concept is a "hold back" provision, allowing the trustee to withhold an otherwise mandatory distribution in the

event that a creditor issue exists at the time of distribution.

Termination

In more extreme cases, the trust agreement can provide for the termination of the beneficiary's trust interest upon the occurrence of an event that calls into question the protection of the trust fund. For example, the trust agreement may provide that the beneficiary's interest terminates in favor of another beneficiary in the event that the first beneficiary is at any time deemed insolvent. The trust agreement may provide that an attempted alienation by the trust beneficiary or an attempted attachment by the beneficiary's creditors will cause the beneficiary's beneficial trust interest to be forfeited in favor of another beneficiary.

The Ninth Circuit has held such a termination provision effective to withstand even a federal tax claim on the basis that such provision left no property interest remaining that could be attached by the beneficiary's creditors [see *In re Fitzsimmons*, 896 F.2d 373 (9th Cir. 1990)]. A less drastic alternative might involve the conversion of an absolute spendthrift trust interest into a discretionary trust interest. The court in *Domo v. McCarthy*, 66 Ohio St. 3d 312, 317 (1993), determined, "It is obvious to us that when appellant filed his original creditor's bill in 1988, he triggered the spendthrift provision, converting James, Jr.'s interest from an absolute right in income and principal to an interest in which the trustee must administer the trust as a purely discretionary trust for James, Jr., James, Jr.'s dependents, and the settlor's lineal descendants. As such, the newly created discretionary trust cannot be reached by appellant as a creditor of James, Jr." Alternatively, the trustee can be given the power to exclude beneficiaries at the trustee's discretion by revising the trust's beneficial interests.

Finally, consideration might be given to including the beneficiary's spouse (or significant other) as an additional discretionary beneficiary of the trust. There may exist a creditor issue that prevents distributions from being made directly to the beneficiary. In that event, distribu-

tions can instead be made to the beneficiary's spouse, which can benefit that individual as well as the beneficiary (e.g., the distributions can be used for a family vacation or rental payments on the family residence).

Where it may be desirable to include the beneficiary's spouse as a beneficiary of the trust, consider naming the beneficiary's spouse by reference to a defined term rather than by name. For example, "Spouse of the Settlor shall refer to the person to whom the Settlor is married at the time a distribution is made." In that manner, the beneficiary's spouse will be automatically excluded as a beneficiary upon a divorce, and the beneficiary's new spouse will be automatically included upon the beneficiary's remarriage.

Conclusion

For as long as estate plans are developed under a regime that imposes transfer tax at rates as high as 50 or 55 percent, the use of trusts to minimize those taxes will remain undeniably important. Those same estate plans are developed in a society where the adage "love thy neighbor" often seems to have been supplanted by the adage "sue thy neighbor." The judicious use of those same trusts must also look to first obtaining, and then enhancing, the spendthrift trust protections that they can also provide. The law surrounding spendthrift trust protections is, however, an iceberg, and this article exposes merely the tip. Therefore, the diligent estate planner will dig further to discover the myriad creative ways that exist to protect his clients' interests through the use of spendthrift trusts.

For more information, see Gideon Rothschild's presentation to the 35th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Protecting the Estate From In-Laws and Other Predators (Matthew Bender).

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How to Accelerate Charitable Remainder Trusts Benefits to Charity

By George B. Jewell

Charitable remainder trust (CRT) trustees and trust beneficiaries are asking about ways to accelerate distributions of trust principal to charitable organizations as part of the wave of philanthropy that is sweeping the country after the terrorist attacks on America. Many charitable organizations are looking for additional sources of funding for capital programs, equipment needs, and ongoing projects as taxpayers are expending current dollars for relief efforts and charitable causes related to the September 11 terrorist attacks.

In addition, recipients of annuity or unitrust amounts who no longer need the cash flow or who desire to support a particular program are asking how to make gifts from their CRTs. Several recent letter rulings provide solutions. The circumstances surrounding the essential facts of the rulings discussed below are fictional.

Sale of a CRT Income Interest

Letter Ruling 200127023 discusses the termination of a charitable remainder unitrust prior to the expiration of the trust term by selling the income interest to a charitable organization. Jeff established a charitable remainder unitrust for a 20-year term. If Jeff died before the end of the 20-year trust term, the unitrust amount was to be paid to whomever Jeff appointed by his Will. If he did not make such an appointment, the unitrust amount would be paid to Jeff's estate for the duration of the trust term.

The trust assets, along with some of his other investments, had significantly appreciated since Jeff established the trust, and Jeff no longer needed the unitrust amount. Jeff decided that he would like to terminate the trust before the end of the 20-year term and trans-

fer the trust assets to his alma mater to participate in a capital campaign to build a new field house. He and the university agreed to terminate the trust by Jeff's sale of his income interest to the university.

Under the facts of the ruling, the value of Jeff's and the charity's interests were to be determined under the provisions of Code Section 7520. Upon trust termination, Jeff (as trustee of the trust) was to distribute trust assets representing their respective interests in the trust to the university and to himself.

The IRS discussed in Letter Ruling 200127023 the proper characterization of the cash and property that Jeff would receive. Code Section 664(b) provides that amounts distributed to the beneficiary of the unitrust payment are characterized in the hands of the recipient in the following manner:

- First as ordinary income
- Second as capital gain income
- Third as "other income" (e.g., tax-free income)
- Fourth as trust corpus

The ruling raised the question whether those ordering rules applied to the cash and property to be received by Jeff upon early termination of the trust. In response, the IRS addressed three issues:

1. The receipt of cash and property as a distribution amount
2. Jeff's basis in the unitrust interest and the character of the gain
3. The question of self-dealing

Treatment of Cash and Property Received

The IRS stated that cash and property received upon early termination of the trust did not represent a distribution of an annual unitrust amount and that, therefore, the transaction would be

governed by Code Section 1001. Citing Rev. Rul. 72-243, the IRS ruled that the sale of an income interest in a trust is the sale of a capital asset. The determination of whether the gain realized on the sale of the asset would be long-term or short-term gain would be determined by the date on which Jeff first held the unitrust interest. Based on the facts of the case, the IRS concluded that the gain that Jeff would realize from the sale of his unitrust interest would be long-term capital gain.

Basis in Unitrust Interest

The IRS discussed Jeff's basis in his unitrust interest to determine whether the full amount of the sale proceeds should be considered long-term capital gain. The IRS said that under Code Section 1001(e)(1), the portion of the adjusted uniform basis of the trust assets assigned to Jeff's interest was to be disregarded. For purposes of the sale of Jeff's unitrust interest, Jeff had no basis in his unitrust interest. Therefore, under Code Section 1001(c), the total amount of cash and property Jeff was to receive in the transaction was to be recognized as long-term capital gain income.

That finding as to capital gain meant that Jeff would be subject to capital gain tax on the full amount he received from the transaction. Assume, for example, that Jeff established the trust 10 years ago by contributing property worth \$200,000. Also, assume a unitrust amount of 5 percent of the annual value of the trust assets and that the assets were invested at a 2 percent yield and 5 percent appreciation for a total return of 7 percent.

Under those assumptions, the value of the trust assets at the end of year 10 is \$243,799. The value of Jeff's unitrust interest is \$94,979, and the value of the university's remainder interest is

\$148,820. Since the full value of the sale proceeds will be treated as long-term capital gain taxed at 20 percent, Jeff will be subject to capital gain tax of \$18,996 and will net \$75,983 from the transaction. The university will receive a net benefit of \$148,820 from the transaction.

The Question of Self-Dealing

The IRS discussed whether Jeff's sale of his unitrust interest to the university would constitute an act of self-dealing under Code Section 4941. Jeff was a disqualified party because he was a "substantial contributor" to the trust under Code Section 4941(a)(1)(A). The IRS stated that under an exception in Treas. Reg. Section 53.4947-1(c)(2)(i), the annual distribution of the unitrust amount to Jeff is not an act of self-dealing.

The IRS then reasoned that the amount of cash and property to be received by Jeff upon early termination of the trust was based upon the Code Section 7520 value of Jeff's interest. The amount of cash and property was derived from Jeff's legal right to the unitrust amount under the terms of the trust agreement. The IRS concluded, therefore, that no act of self-dealing resulted from the early termination of the trust and the distribution of trust assets to Jeff and to the charitable remainderman.

Exchange of a Unitrust Interest for a Gift Annuity

Letter Ruling 200152018 discusses an interesting proposal that combines both a gift and a sale through the exchange of a unitrust interest for a charitable gift annuity issued by a charitable organization.

In that case, Ellen executed a trust agreement establishing a charitable remainder unitrust with a bank as trustee. Under the terms of the trust agreement, Ellen is to receive a 5 percent unitrust payment in quarterly installments during her lifetime. At the end of the trust term, the trustee is to distribute the remaining trust assets to an educational organization ("Academy").

Academy launched a capital cam-

paign to obtain funds for a new academic building. Ellen wanted to participate and proposed to transfer her *entire* unitrust interest to Academy. In consideration for Ellen's transfer of her unitrust interest, Academy proposed to pay Ellen an annuity for Ellen's life. It was represented to the IRS that the annuity would be paid from Academy's general funds and not from the specific property Academy would receive due to Ellen's transfer of her unitrust interest.

Under the terms of the proposal, the annuity would be either nonassignable or assignable only to Academy. Ellen would be the only annuitant. Ellen's right to receive annuity payments from Academy would become effective on the date that she transferred her unitrust interest to Academy. It was represented to the IRS by Ellen and Academy that the annuity payable to Ellen would provide for a specified sum, payable not less often than annually for Ellen's life. The annuity would terminate on Ellen's death, and no additional payments would be due. The terms of the annuity would prohibit any commutation, prepayment, or refund.

Ellen represented to the IRS that she did not divide her interest in the property transferred to the trust in order to avoid the partial interest rule.

Amount of Charitable Contribution Deduction

The IRS considered whether Ellen would be entitled to a charitable contribution deduction. In its discussion

of that issue, the IRS pointed out that in the case of an annuity purchased from a qualified charitable organization, the donor was allowed a charitable contribution deduction for the amount by which the total value of the property transferred to the organization exceeded the value of the annuity at the time of the gift.

Accordingly, the IRS ruled that Ellen would qualify for a charitable contribution deduction for the amount by which the value of Ellen's unitrust interest exceeded the value of the annuity at the time of the gift.

Again, using the same assumptions that were used for Jeff's trust, the value of Ellen's 5 percent unitrust interest is \$94,979. If Ellen, assumed age 72, transferred her entire unitrust interest worth \$94,979 to Academy in exchange for a 7.4 percent gift annuity, the value of the annuity would be \$56,730, and Ellen's charitable contribution deduction would be \$38,249. The IRS ruled that Ellen would be entitled to a gift tax charitable contribution deduction of the same amount.

Amount of Long-Term Capital Gain Realized

Another question considered by the IRS was the amount of long-term capital gain Ellen would realize as a result of the transfer. Consistent with Letter Ruling 200127023, the IRS ruled that Ellen's unitrust interest was a capital asset. For purposes of Ellen's transfer of her unitrust interest, she had no basis in the unitrust interest.

Pretax Annuity Payments				
Years	Capital Gain Portion	Tax-Free Principal Portion	Ordinary Income Portion	Total Pretax Annuity Payment
2001	\$1,372.32	0	\$1,091.45	\$2,463.77
2002 to 2015	\$3,914.85	0	\$3,113.60	\$7,028.45
2016	\$ 549.79	0	\$6,478.66	\$7,028.45
2017 onward	\$ 0.00	0	\$7,028.45	\$7,028.45

Accordingly, Ellen would have long-term capital gain in an amount equal to the total value of the annuity. Under the assumptions above, therefore, Ellen would have long-term capital gain in the amount of \$56,730.

The sale of a unitrust interest would have required Ellen to pay tax on long-term capital gain of \$94,979 in the year of the sale. The tax at the 20 percent capital gain rate would be \$18,996. In contrast, under a gift annuity Ellen is permitted to report the gain ratably over the period of her life expectancy of 14.5 years. Over that 14.5-year period, each annuity payment will comprise a portion of capital gain and a portion of ordinary income. Since Ellen had no basis in the unitrust interest, no portion of the annuity payment would comprise a tax-free return of principal, as is the case in most gift annuities. If Ellen lives longer than 14.5 years, each annuity payment will comprise only ordinary income.

Using the same assumptions that were used for Ellen's trust, the table entitled, "Pretax Annuity Payments" (on page 7), shows how the capital gain portion of each annual annuity payment would be reported over Ellen's life expectancy.

Assuming that the capital gain portion of each annuity payment will be taxed at the 20 percent capital gain tax rate and that Ellen is in the 30 percent income tax bracket for ordinary income, she will realize an after-tax benefit of approximately \$5,358. The amount will fluctuate due to the phased-in reduction in the tax rate under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the sunset provision that restores pre-EGTRRA rates beginning in 2011. Ignoring the time value of money, the after-tax payments would total approximately \$77,691 at the end of 14.5 years. Since Academy will have to make an annuity payment of approximately \$2,464 in the year of the transaction, the net benefit for Academy will be approximately \$241,335 in the year of the transaction (again, making the same assumptions as in the case of Jeff's trust).

Outright Gift of a Unitrust Interest

Letter Ruling 7743027 discusses an outright gift of a unitrust interest to a charitable organization.

Under the facts of that ruling, the income beneficiary (Scott) received a lifetime unitrust interest in a testamentary unitrust established under Article IV of his rich uncle's Will.

Scott did not need the cash flow from the unitrust. He decided to terminate the trust by giving his unitrust interest to qualifying charitable organizations that were to be named by the trustee. Scott and the trustee agreed that the next quarterly payment of the unitrust amount to Scott would represent the final payment of any amount due to him. Scott would consent to the termination of his unitrust interest and the transfer of all remaining trust assets to qualified charitable organizations. The trustee would then distribute all the remaining trust assets.

The IRS ruled that, since Scott proposed to contribute his entire interest in the charitable remainder unitrust to the remaindermen, he would be entitled to an income tax charitable contribution deduction under Code Section 170 and to a gift tax charitable contribution deduction under Code Section 2522.

Making the same assumptions about Scott's trust as we did about Jeff's trust, the value of the unitrust interest that Scott plans to contribute to the charitable remainder beneficiaries would be \$94,979. Assuming that Scott is in the 30 percent income-tax bracket, Scott's income tax on that amount would be \$28,494. Because of his outright contribution of his unitrust interest to charity, therefore, Scott would receive an income tax deduction of \$94,979 and would realize income tax savings of \$28,494. The charity would receive all of the trust assets, then valued at \$243,799.

Transfer of Trust Principal to A Charitable Organization

Letter Ruling 9442017 discusses the transfer of principal from a charitable remainder unitrust to a charitable orga-

nization under provisions in the trust's governing instrument that permitted such a transfer.

Under the facts of that ruling, the governing instrument of Vicki's charitable remainder unitrust provided for the distribution of trust assets at any time to qualified charitable organizations. If trust assets were distributed in kind, the adjusted basis of that property was required to be fairly representative of the adjusted basis of all trust property available for distribution at the time of distribution. Vicki no longer needed the unitrust payments and advised the trustee that she would consent to the trustee exercising its discretion to distribute the trust principal to a local community foundation where Vicki had established a donor-advised fund.

The IRS stated that those governing instrument provisions comply with Section 1.664-3(a)(4) of the Treasury Regulations. The IRS ruled that the additional requirement of the trust's governing instrument that any such distribution could be made only with Vicki's consent was not in conflict with those regulations. No income-tax charitable contribution deduction is permitted, however, for such a distribution of principal.

Under that plan, therefore, Vicki received no economic benefit. She received no income-tax deduction, and received neither a lump sum for the value of her unitrust interest nor lifetime annuity payments. However, since the trust assets were transferred to a donor-advised fund, Vicki and other family members who were fund advisors (under the agreement with the community foundation) would regularly experience the joy of giving by making grant recommendations to the foundation's governing board. Since Vicki did not need an income-tax deduction, cash, or lifetime annuity payments, the joy of giving she experienced was more than a sufficient reward.

Summary

Each of the options discussed in this article presents a range of benefits to the donor (or seller) and the charitable organization(s) involved. The best

option is the one that best balances everyone's interests under all the circumstances surrounding the transaction:

- Jeff sold his unitrust interest for \$94,979 and netted \$75,983 after payment of capital gain tax of \$18,996. The university received a net benefit of \$148,820.

- Ellen exchanged her unitrust interest for an annuity that would pay \$7,028.45 per year for her life (after the partial payment in the year of the transaction). The total approximate after-tax benefit she will receive over her life expectancy of 14.5 years will be \$77,691. Academy received a net benefit in the year of the transaction of \$241,335. Although Academy will be

required to make annual annuity payments from its general funds, it will benefit from the immediate use of \$241,335.

- Scott contributed his unitrust interest valued at \$94,979 to charity, received an income tax deduction of \$94,979, and realized tax savings of \$28,494. The charitable remainder beneficiaries received \$243,799.

- Vicki asked the trustee of her charitable remainder unitrust to exercise its discretion to make gifts of trust principal to qualified charitable organizations. In its discretion, the trustee transferred the trust assets to a community foundation that managed a donor-advised fund that Vicki had established.

Jeff, Ellen, Scott, and Vicki all benefited, although in different ways, from the options they selected. Also, in each case, a qualified charitable organization received a benefit earlier than expected, thereby enabling it to make immediate use of the funds for its exempt purposes. The rulings cited provide a range of solutions for your clients who want to make immediate transfers of charitable remainder trust assets to organizations and causes they want to support.

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Federal Estate Tax Returns

Procedure for Filing an Estate Tax Return

By Frank S. Berall

Estate tax practitioners ordinarily handle IRS audits of estate returns only if they prepared the return.

Occasionally, however, estate tax practitioners may be retained to represent a fiduciary in an audit of a Form 706 or a Form 1041 that they did not prepare. The malpractice risk of estate tax practitioners increases when they become involved in the audit process or in handling other matters that may have already been mishandled.

The Engagement Letter

To minimize the risk of a malpractice claim, the first thing to do in any new matter is to send the client an engagement letter. The engagement letter should briefly describe the work for which the practitioner is being retained and should address any related issues that may require attention, such as income tax controversies and nontax disputes. The letter should clearly set forth all the following:

1. The party being represented
2. The scope of the engagement

3. An evaluation of the situation
4. What the practitioner hopes to accomplish
5. Fee arrangements

The estate tax practitioner should give no commitment about the results.

Many State Bar Associations require attorneys to send each client an engagement letter at the start of any new representation. The attorney might not be paid if a subsequent fee dispute develops and there was no such letter.

Due Date and Extensions For Form 706

A federal estate tax return, together with payment of estate and generation-skipping transfer taxes, is due nine months after the death of the decedent. Where state law provides that an absentee is presumed dead if not heard from after a specified time, the absentee's date of death for estate tax filing purposes is at the end of the state's presumptive period, rather than any date of death set by the state court [Rev. Rul. 66-286, 1966-2 CB 485,

clarified and modified by Rev. Rul. 80-347, 1980-2, CB 342; see also PLR 8526007].

Automatic Six-Month Extension

Estate tax practitioners can secure an automatic six-month extension for filing Form 706 by filing Form 4768, "Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes" (August 2001). Form 4768 must be filed with the Cincinnati Service Center and postmarked on or before the due date of Form 706 [Treas. Reg. § 20.6081-1(b), as amended by TD 8957 of July 24, 2001]. All federal estate and gift tax returns, extension requests, and related matters have been handled by the Cincinnati Service Center since January 1, 2002.

Discretionary Extensions

The IRS may give a discretionary filing extension in the following circumstances:

1. When a fiduciary of the estate did not request an automatic extension to file Form 706 prior to its due date;

2. When forms other than Form 706 are required; or

3. When the executor is abroad and requests an additional extension of time for six months.

Good and sufficient cause must be shown to secure the discretionary extension. Unless the executor is abroad, the extension may not be for more than six months.

A practitioner who desires to secure a discretionary extension needs to provide a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date. The practitioner must file that explanation sufficiently early to permit the IRS time to consider the matter and reply before what otherwise would be the return's due date. Failure to file Form 4768 before that date may indicate negligence on the part of the practitioner and may constitute sufficient cause for denial of the extension.

If an estate did not request an automatic extension, such an extension may still be obtained from the IRS. The executor must file Form 4768, showing good and sufficient cause for not having requested the extension on time [Treas. Reg. § 20.6081-1(c), as amended by TD 8957 of July 24, 2001]. That extension will be determined on a case-by-case basis and will require the executor to submit a statement of facts with the Form 4768.

Validity of Elections On Late-Filed Returns

The following elections are valid on late-filed returns:

1. Qualified terminable interest property (QTIP)
2. Qualified domestic trust (QDOT)
3. The alternate valuation date
4. Special use valuation

In contrast, the Section 6166 extended payout election is valid only if that election is made on a timely filed estate tax return, including a timely filed estate tax return filed pursuant to an extension.

Filing and Paying Extension Requests Are Handled Separately

The fiduciary may request both a filing extension and a paying extension. If so, separate Forms 4768 (filed in duplicate) should be used for each request. Filing both forms will expedite the granting of the filing extension even if the paying extension is delayed.

The paying extension can be either for a hardship (under Section 6161) or where the value of a reversionary or a remainder interest is involved (under Section 6163). Both filing and paying extension requests will be processed in the Estate and Gift Tax Office of the Cincinnati Service Center [§ 6163(2) and Internal Revenue Manual (IRM) 4398.2 and IRM 5477.1 (October 13, 1993), as updated verbally by the IRS]. The executor should request an extension to pay if unsure of the exact amount of tax and when the executor is also requesting an extension of time to file.

The estate may be required to post a bond because of the delay in payment. That bond cannot exceed double the amount for which the extension is granted [IRM 4398.3(2), which cites § 6165]. Estate and Gift Tax Office personnel may investigate cases involving requests for extensions of time to pay and make appropriate recommendations to the Collections Office [IRM 4398.3(3)]. However, for initial requests that involve over \$500,000 in tax, recommendations whether or not to grant an extension of time to pay are not binding on the Collections Office.

The maximum allowable paying extension for hardship for estates with certain closely held businesses is 12 months. Additional extensions can be applied for and granted a year at a time, up to a maximum of 10 years, or up to 4 years for a deficiency assessment [IRM 5477.1(4)].

Reasonable Cause Statement

A request for an extension of time to pay must be timely filed on or before the due date of the return, and the request must be accompanied by a check for the balance due [see Part VI of Form 4768]. The request must contain a

statement setting forth reasonable cause [for examples of reasonable cause, see IRM 5673.1, Collection of Estate Tax (Form 706) Assessments] and give one of the following four reasons:

1. While there are sufficient liquid assets to pay the tax when otherwise due, those liquid assets are located in several jurisdictions and are not immediately subject to the executor's control. Thus, liquid assets cannot readily be marshalled by the executor, even with the exercise of due diligence.

2. Substantial assets of the estate consist of rights to receive future payments (i.e., annuities, copyright royalties, or contingent fees for accounts receivable) without present cash. Borrowing against those assets can only be done on terms that would cause loss to the estate.

3. There is a claim for substantial assets, which cannot be collected without litigation. Thus, the gross estate's size is not yet determined or ascertainable, nor can the tax be paid when due.

4. Insufficient funds exist with which to pay the taxes when otherwise due, to provide a reasonable allowance for the widow and dependent children, and to satisfy claims.

The IRS does not expect the estate to borrow at interest rates higher than those generally available. Furthermore, the executor should have made a reasonable effort to convert assets into cash. However, if a closely held business interest is involved, a Section 6166 extension can be obtained.

More Complex Issues And Their Resolution

An incomplete extension request is likely to lead to correspondence between the executor and the Estate and Gift Tax Office of the Cincinnati Service Center about the requirements for completing the extension. If a complete request meets the criteria of IRM 5477.23, the Cincinnati Collections Office will handle the case.

IRM 5477.22 deals with second and subsequent extension requests. Those requests involving amounts under \$500,000 will be handled by the

Cincinnati Estate and Gift Tax Office. Larger amounts will go to the Collections Office. All requests for estate tax filing and paying extensions will be processed in the Cincinnati Service Center.

In view of the above-described procedure, a considerable delay will occur in processing an extension to pay. Furthermore, practitioners should keep in mind that additional changes may be made to some of the above procedures during the current IRS reorganization.

Requests for extensions of time to pay are to be approved for a period of only 12 months and for the amount of cash shortage in the estate. Apparently, approval of that extension occurs after the case has come back from the Cincinnati Collections Office.

Denial of Requests

Following denial of a request for an extension to pay, IRM 5477.25(1) requires that the IRS provide a reason for the denial. The IRS must notify the taxpayer that a written appeal may be made to the Regional Commissioner within 15 days from the mailing of the denial.

Approval of Requests

The IRS approves extensions to file Form 706, other than automatically granted requests that do not ask for extensions to pay, only when the taxpayer's explanation shows good and sufficient cause. As a practical matter, as long as reasonably sound grounds are given on a filing extension request that cannot be automatically granted, the IRS will grant the extension request even if the latter is made on the due date. But it would be unwise for an executor to rely on that procedure if the executor could have requested an extension previously.

Since an audit is not more likely where an extension has been requested, whether or not the extension is automatic and whether or not the extension is granted, an extension should always be requested. The beneficiaries may have to be convinced of the wisdom of requesting an extension to obtain an extra six months to observe the surviving spouse's health or other develop-

ments that might affect the desirability and amount of the QTIP election or could affect the handling of various other items on the estate tax return. The estate tax return can be filed before the extension period ends.

Where and How to File An Estate Tax Return

When the return is ready to be filed, it should either be hand-carried to what used to be the District Director's office or mailed to the Cincinnati Service Center. The return should not be sent to the Service Center for the state of domicile [§ 6091(b)(3), Treas. Reg. § 20.6091-1(a) and Ann. 2001-74, 2001-28 IRB 40]. The latter's Service Center was the prescribed place to mail estate tax returns until January 1, 2002. Nonresident citizen decedents' estate tax returns should still be mailed to the Philadelphia Service Center [§ 6091(b)(3), Treas. Reg. § 20.6091-1(a) and Ann. 2001-74, 2001-28 IRB 40]. The returns for decedents domiciled in American Samoa, Guam, the U.S. Virgin Islands, Puerto Rico, and those with a foreign address or with an APO or FPO address should also be mailed to Internal Revenue Service Center, Philadelphia, PA 19255.

Use the Cincinnati Service Center

Unless the estate tax return is hand-carried, it should be sent to the Cincinnati Service Center. Otherwise, the return will not be considered as filed until the earliest date it could have been received (via transfer) by the Cincinnati Service Center [*Winette v. Commissioner*, 96 TC 802 (1991)]. In practice, the transfer may not necessarily occur.

Hand Filing

When hand filing an estate tax return, obtain proof of filing and payment by requesting that the IRS stamp the practitioner's copy of the return, "Received with remittance attached," with the date of receipt. If possible, obtain a receipt for all pages and exhibits of the return. The receipt can be made up in advance and given to the IRS to stamp.

Filing by Mail

When filing an estate tax return by mail, use registered or certified mail, return receipt requested. The filer should be sure the post office hand stamps both the envelope and the registered or certified mail receipt with a legible mailing date. The registration

What to Do When Not All Data Is Available to Complete a Return on Time

By Frank S. Berall

The fiduciary may have insufficient data available to file a complete return by its prescribed or extended due date. In that situation, the fiduciary must file as many of the schedules and attachments as possible, estimating unavailable values. While filing only the first three pages (properly signed) using estimated values on Form 706 may create problems, the IRS will probably accept the return without imposing either a late or a nonfiling penalty.

However, if a return is incomplete when filed, the preparer should include an attached statement saying that the return will be supplemented when further information, such as a missing appraisal, is available. At that time, supplemental information should be mailed to the IRS, with a request that the new information be associated with the return. In any case, the preparer should retain an extra copy of whatever is sent so that in the event of an audit, the material can be shown to the estate tax attorney, if the supplemental material has not yet caught up with the return. Eventually, that material will catch up under the IRS's loose documents procedure. ■

or certification number should be copied onto the accompanying cover letter to the IRS. Then, the cover letter should contain a request that the IRS date stamp "Received with remittance." Alternatively, the cover letter should request that the IRS stamp the letter "Received," if no check is attached, on an enclosed extra copy either of the first page of the return, the cover letter itself, or both.

Proof of Filing

The reason for obtaining IRS acknowledgment on a copy of the cover letter is that if the return is lost, either by the Post Office or the Cincinnati Service Center, a registered or certified mail receipt merely proves that something was mailed, but it does not prove the contents. Thus, the receipt might not be acceptable evidence, and the practitioner might have to spend an inordinate amount of time and effort making out affidavits that the mailing contained a tax return, all its attachments, and a check.

The need for obtaining clear proof of timely filing is illustrated by *Estate of Leonard A. Wood v. Commissioner*, 90-2 USTC ¶60,031 (8th Cir. 1990), which held that an estate had timely filed a federal estate tax return that the IRS alleged it had never received. While the post mistress testified that she had hand canceled the envelope containing the return on the date in question, the IRS produced no evidence of its nonreceipt.

The court held that neither actual delivery nor proof thereof by the taxpayer was required. But the presumption of delivery, with the postmark date deemed the date of delivery, can never be used to

satisfy the requirement of actual delivery. Thus, that presumption can be overcome if the IRS can prove the return was lost in the mail and never delivered.

Since proving a postmark without either the document or a receipt is very difficult, when mailing an estate tax return (or any document or payment to the IRS), it is best to use certified or registered mail. Section 7502(c)(1) provides that the date of registration is *prima facie* evidence of the postmark date. Treas. Reg. Section 301.7502-1(c)(2) provides that the date on the sender's receipt, postmarked by the postal employee to whom the document is presented, is treated as the postmark date. However, no such provision exists for a certificate of mailing. That proof of mailing is insufficient evidence to rebut an untimely postmark [see *D.A. Haaland v. Commissioner*, which involved a late-filed tax court petition, 48 TCM 378, TCM 1984-355 (1984), and the *Wood* case].

Private Delivery Services May Be Used

Section 7502(f) expands the timely mailed, timely filed and paid rule to designated private delivery services, namely Airborne Express, DHL Worldwide Express, Federal Express, and United Parcel Service. For applicable criteria, see Rev. Proc. 97-19, 1997-1 CB 644, modified by Notices 97-26, 1997-1 CB 413; 97-50, 1997-2 CB 305; and 99-41, 1999 IRB 35, 325. Notice 97-26, note 22, contains a lengthy description of special rules for determining the date treated as the postmark date for purposes of the Section 7502 timely filed rule when private delivery services are used.

Registered mail and private delivery services are the safest ways of sending a return since a signature is required of everyone handling a registered letter, thus enabling a tracing of the return if the IRS claims it has not arrived. Private carriers have a similar tracking procedure, but certified mail requires signing only upon delivery to and then by the post office.

However, tracking procedures add a new possible danger, namely that tracing a missing estate tax return could turn up evidence that it was transported by an airplane that crashed with all the mail destroyed. Thus, the IRS could prove nonreceipt, overcoming the presumption of delivery. The taxpayer will then be in the position of not having timely filed the return.

Electronically Filed Returns

The timely mailing, timely filing rule applicable to returns is proven by a postmark. Registered and certified mail is considered postmarked on the date of registration or certification. Similar rules apply to returns filed by designated private carriers. The IRS may have to devise a way of acknowledging electronically the receipt of a return filed in that manner immediately upon receiving the return. The electronic acknowledgment will have to be convertible to hard copy on the printer of the taxpayer transmitting the return.

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► Spouse's Tax from page 1

repealed retroactively with legislation in 1980.

Internal Revenue Code Section 1022, effective in 2010, provides generally for the recipient's basis to be the *lesser* of the following:

1. The decedent's adjusted basis, or
2. The fair market value at the time of the decedent's death.

Basis Adjustment Allowances

The Internal Revenue Code provides for a modified basis increase ("aggregate basis increase") in the sum of \$1.3 million plus the sum of any capital loss carryover, net operating loss carryover, and any losses allowable under Code Section 165. Those provisions apply if the property acquired from the decedent had been

sold at fair market value immediately prior to death. An additional basis increase of \$3 million is allowed for property acquired by a surviving spouse. That raises the potential combined basis adjustment total to \$4.3 million for the surviving spouse (i.e., \$3 million to the spouse plus \$1.3 million to the spouse or others). The aggregate basis adjustment allowances will receive Consumer Price Index (CPI) increases after 2010.

Exclusion Amount

The estate-tax applicable exclusion amount increases to \$3.5 million under the 2001 Act, enabling married couples to pass \$7 million estate-tax-free with an exemption/bypass trust. That tax-free sum may be increased to \$10.5 million (assuming a modest 33.33 percent in valuation discounts), or more, with appropriate living trusts coupled with a family limited partnership or limited liability corporation (LLC), controlled by the spouse or others, among other strategies [see *Estate of Bonner v. U.S.*, 84 F.3d 196, 198-199 (5th Cir. 1996); 1996 U.S. Lexis 13493(e); *Estate of Mellinger v. Comr.*, 112 TC No. 4 (1999); *Estate of Nowell v. Comr.*, TC Memo. 1999-15; *Estate of Lopes v. Comr.*, 78 TCM 46 (1999); *Estate of Strangi v. Comr.*, 115 TC 35 (2000); *Estate of Dailey v. Comr.*, TC Memo. 2001-263].

Before and After Comparison

Two case examples are presented to illustrate the following:

1. Income tax will arise in an estate-tax-free estate of \$3 million on the death of the unmarried person.
2. The surviving spouse will pay more income tax on the liquidation of a family business with significant appreciation under the carryover basis scheme.

Case 1

Anna dies in 2009 leaving her estate of \$3 million, adjusted basis of \$1.5 million, to her son, John. No estate tax is payable as a result of the \$3.5 million exemption allowance. However, the adjusted basis allowance to John is only \$1.3 million, so his total basis as adjusted is then \$2.8 million. That leaves him with a capital gain tax of \$60,000 (30 percent of \$200,000).

Case 2

A husband and wife own 100 percent of the stock in ABC, Inc., which has a 100 percent entity value of \$11 million, but a minority-interest value of \$6 million. The basis adjustment on the husband's death to \$6 million assumes that the business was owned either as community property or that the sole owner is the deceased spouse. Their basis is \$1

million. The balance of the estate is worth \$2 million, consisting of a home with a value of \$1 million [one half interest, \$400,000 net a 20 percent fractional interest discount], basis \$200,000, and \$1 million in other cash and bonds.

Scenario 1: The husband dies in 2009. His gross estate equals \$3.9 million, consisting of ...

- 50 percent of the stock (\$3 million value)
- One half of the home (\$400,000)
- \$500,000 in cash and bonds

The business plus \$500,000 in other assets is allocated to the exemption trust, with \$400,000 of remaining value going to the qualified terminable interest property (QTIP) trust. If the estate tax is not repealed, the taxable estate of the wife would be \$4.3 million (the wife's half of the estate [\$3.9 million] plus the \$400,000 QTIP trust), leaving \$800,000 subject to estate tax, and an estate tax liability of \$360,000 (at the 45 percent rate). Table 1, "Before Estate Tax Repeal," illustrates

the total income and estate taxes owed under scenario 1.

Scenario 2: The husband dies after estate tax repeal. His executor allocates \$4.3 million in basis adjustment (\$1.3 million plus the spousal property allowance of \$3 million) to the closely held business interest. The wife would then have a total basis of \$5.3 million in ABC, Inc., stock and \$1.71 million capital gains tax on the sale of the business for \$11 million, as illustrated in Table 2, "After Estate Tax Repeal."

Result: A total of \$1.71 million in tax is paid under the modified carry-over basis scheme, versus \$1,522,500 under the 2009 rules, or \$187,500 of additional tax liability. Moreover, the increased capital gains tax arises during the lifetime of the widow.

Planning Strategies

Estate planners possess an array of strategies to significantly reduce estate taxes yet allow the surviving spouse or other loved ones to retain control. Those strategies (often based on valuation prin-

Before and After Estate Tax Repeal Tables

Table 1. Before Estate Tax Repeal

Income tax on gain on husband's trusts ((\$5.5 million less \$3 million basis x 30%*)	\$ 750,000	
Income tax to wife on sale	\$ 750,000	
Total income tax:		\$1,500,000
Wife's revised taxable estate: ((\$4,300,000 - \$750,000 [net capital gain tax paid])	\$3,550,000	
Estate tax on wife's death		\$ 22,500
Total income and estate tax:		\$1,522,500

*The 30 percent rate assumes federal capital gains tax, California income tax, and possible alternative minimum tax (AMT), rounded.

Table 2. After Estate Tax Repeal

Proceeds of sale of business		\$11,000,000
Wife's carryover basis	\$ 500,000	
Wife's modified basis in husband's shares ((\$500,000 + \$4.3 million)	\$4,800,000	
Total basis		\$ 5,300,000
Gain on sale of business		\$ 5,700,000
Capital gains tax (30% of \$5.7 million)		\$ 1,710,000

ciples, as well as other discount and planning approaches) and many planning techniques are supported by cases cited herein. Of course, the amount of discounts should be supported by an appraiser. As a final point of reference in the context of the highly appreciated estate, the phased-down estate-tax rate of 45 percent, when applied to an estate that can achieve even a 33 percent valuation discount adjustment, amounts to an overall transfer tax of 30 percent on the

appreciation. That rate compares closely to the overall capital gains rate when all components of capital gains taxes (state, federal, and alternative minimum tax [AMT]) are considered.

Conclusion

The impact of carryover basis on the majority of taxpayers may cause Congress to reconsider estate-tax elimination, whether because of budgetary concerns, changes in the political cli-

mate, or heightened awareness that a broad base of taxpayers will be worse off under a carryover-basis scheme when compared to an estate-tax system with expanded tax-free allowances.

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Life Insurance

Is Life Insurance Still Important?

By Denis A. Kleinfeld

Life insurance is a favored financial product for estate planners. It is a unique wealth creation tool that is a complex mixture of legal, tax, and economic components. Historically, estate planners have used life insurance to solve a wide range of both personal and business problems and circumstances.

A Typical Case

A typical case our office has just handled involved a father who owns a fairly substantial family-owned business. During his life, he established several insurance plans as a means to provide liquidity in the event of his disability or death. When the father was diagnosed with terminal cancer, he understood that the hopes and dreams that had been his life would, because of the insurance, continue to be a reality.

The insurance that was in place would allow for the transition of his privately held company to his children, who are working in the business. The insurance proceeds allowed the children the financial wherewithal to pay off existing bank loans, provide capital so that key employees would continue to stay with the company, and provide some funding for the business to grow. In other words, for the small amounts of premium, a significant amount of financial assets were made available so that the vision the father wanted to leave as

his legacy would become the reality.

The Effect of Recent Tax Code Changes

Some tax planners and many people outside the profession feel that, because of recent changes in the tax code, life insurance is no longer needed. Those tax planners and lay people forget that Congress giveth and Congress taketh away. The repeal of the estate tax will itself be terminated in the year 2011, and the law will return to its current levels. Most commentators have expressed the view that it is likely that Congress will allow the marginal rates to drop to 45 percent and maintain the lifetime exemption at \$3.5 million, but the estate tax will not be terminated when all is said and done. The bottom line is that unless clients plan to die in the year 2010, they will have to continue doing estate planning, which includes dealing with nearly confiscatory levels of estate tax.

Benefits of Life Insurance

Life insurance is not just for paying estate tax. Life insurance provides an assured source of liquidity for a wide variety of financial needs. When the income owner dies, then the source of income generation terminates. The surviving family members and other dependents need to have a replacement source of income. It sounds cold, but it

is a fact of life. Life insurance serves as that income replacement generator.

College Expenses

Likely the greatest legacy that a parent can leave a child is the benefit of a good education. These days, funding college costs takes a great deal of money. A typical savings account is subject to annual reduction because of income taxes. Insurance, on the other hand, can build up investment income on a tax-free basis. In that manner, insurance has always been a popular financial investment vehicle to accumulate funds to pay for college education.

Some people even take advantage of a technique called "stuffing the policy" to put even more money under the insurance umbrella. Insurance, when used in that form of planning, is generally through an educational trust structure. During life, funds can be accessed for college expenses through policy loans from the cash surrender value. In the event of the owner's death, then the full value of the policy pays off into the trust, and the trustee can pay college expenses accordingly. Should the child not go to college but want to get involved in a business, then the funds may be available to help fund that activity instead.

Special Needs

Life insurance is the most effective means of solving special financial demands that arise because children

may be physically or mentally handicapped. By providing a separate insurance trust for those children or other dependents with physical or mental limitations, the entire family can be spared from being financially drained into destitution. Much of that planning takes the form of combining insurance planning with the Medicaid laws.

Business Continuity

For business purposes, having life insurance in place provides the ultimate in safety and security. In a closely held business where there are two, three, or more "partners," in the business, it may be extraordinarily difficult, if not impossible, for the remaining partners to actually buy out a disabled or deceased partner from remaining cash flow. By funding a buy/sell agreement, all the partners are assured that the business will continue without being dramatically dissipated by the need to buy out a partner who dies or becomes disabled. It is almost a universal fact that businesses may have a significant value, but the business does not have the ability to develop extra cash flow out of current earnings to pay off a large valuation of a deceased partner's share of the business.

A Key Employment Perk

A life insurance program is a key employment perk. Most business organizations, whether large or small, find that having a life insurance program is a key element in the business's ability to recruit, retain, and reward key employees. While it is always nice that employees feel psychologically loyal to a business, it is better to provide an effective means to assure that the employees will stay loyal.

Protection From Taxation And Creditors

When properly planned, life insurance proceeds will not be part of a probate estate. Essentially, there will be no public record of the amount of the death benefit or to whom it becomes payable. If properly structured in a life insurance trust, the death benefit pro-

ceeds are generally not subject to federal income taxes. During life, the increase in cash surrender value under the policy has the benefit of tax deferral from federal income tax. As a general rule, earnings on the policy cash surrender values are not taxable unless the policy is surrendered for cash.

Perhaps one of the most important aspects of life insurance policies and the cash surrender value is that under state laws, they may be protected from creditors. All states have some exemption provision for life insurance, but the amount of protection varies from state to state. Florida, for example, allows an unlimited amount of life insurance, cash surrender value, and annuities to be exempt from creditors. As a result, if the owner has the choice of investing in a financial product that earns a prudent rate of return, then it only makes sense to invest in the product that builds up on a tax-deferred basis and is protected from creditors rather than investing in a product that is subject to taxation and exposed to creditor liability.

Conclusion

Whether or not the federal estate tax law is repealed or continued in some form, the need for life insurance can be expected to grow dramatically. As the Baby Boomer generation grows older, the need for insurance to cover personal as well as business contingencies will become all the more important. Recently, one noted estate planning expert, in observing the need for insurance planning, stated, "Planning should continue as long as there is somebody or something you love." As has been widely observed, life insurance isn't for the people who die but for the people who continue living.

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S Corporation Status After the Shareholder Dies

By Sydney S. Traum

The death of an S corporation shareholder can present challenges to the tax advisor in attempting to retain the S corporation status. The nature of the problem depends on how the shareholder owns the stock. A shareholder may own S corporation stock directly or as a beneficiary of a trust.

Type of Ownership

If the shareholder owns the stock directly, then upon his or her death, the stock would be owned by the deceased person's estate. A decedent's estate is a qualified shareholder. A problem can arise, however, depending upon who is the ultimate beneficiary of the estate. If the beneficiary is a nonresident alien, the S corporation status would be lost upon distribution of the stock to such beneficiary. If the beneficiary is a trust, then there is a two-year grace period when the trust will be qualified as an S corporation shareholder. Prior to the end of that grace period, it is incumbent upon the tax advisor to determine what the trust must do to qualify as an

S corporation shareholder. Methods of qualification are discussed below.

If the individual owned the S corporation stock through a trust prior to death, then it will depend upon what kind of trust owned the S corporation stock. A trust that is treated entirely as owned by an individual who is a citizen or resident of the United States is called a qualified Subpart E trust and is a permitted shareholder. When the deemed owner dies, the trust also has a two-year grace period during which it will automatically qualify as an S corporation shareholder.

Methods of Qualification

In either of the above situations, the tax advisor should use the two-year grace period to prepare for qualifying the trust as an S corporation shareholder. If the trust provisions comply with Code Section 1361(d)(3) relating to qualified subchapter S trusts (QSSTs), the beneficiary of the trust can make a QSST election for the trust and be the deemed owner of that portion of the trust that consists of S corporation stock.

Alternatively, if the trust meets the

requirements of Code Section 1361(e) relating to electing small business trusts (ESBTs), the trustee can make an ESBT election to qualify the trust as an S corporation shareholder.

Unplanned Termination of S Corporation Status

Because S corporation status can be lost if appropriate action is not taken, S corporations should strongly consider utilizing stockholder agreements or buy-sell agreements to prevent the unplanned termination of S corporation status. However, if the S corporation status is terminated inadvertently, the corporation can apply to the IRS national office in Washington for a private letter ruling that would grant inadvertent termination status so that the terminating event would be ignored.

Additional information about S corporation status after the death of a shareholder may be found in Panel Publishers' loose-leaf tax service entitled The S Corporation Planning & Operation, written by Sydney S. Traum. ■

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