RECENT DEVELOPMENTS IN FARM ESTATE AND BUSINESS PLANNING

Roger A. McEowen*

* Roger A. McEowen is an assistant professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University, Manhattan, Kansas. He is a member of the Kansas and Nebraska Bars.

I. OVERVIEW

This Article reviews the major case law, Internal Revenue Service (Service), rulings, and legislative developments affecting farm and ranch estate and business planning for the calendar year 1996. The Article begins with a survey of 1996 developments concerning available techniques to provide liquidity in an estate after death. Then, attention is focused on significant recent cases concerning the federal estate tax treatment of marital joint tenancies. Federal estate tax developments are addressed next, including implications for marital deduction planning and drafting. Also covered are 1996 developments in the areas of federal gift tax, generation skipping transfer tax (GSTT), and estate planning for long-term health care. The article concludes with a discussion of recent developments directly impacting farm and ranch business planning.

II. POST-DEATH LIQUIDITY OPTIONS

A. *Installment Payment of Federal Estate Tax*

1. *Eligibility Requirements*

In Technical Advice Memorandum (TAM) 96-35-004,[1] the Service allowed an estate to pay federal estate tax in installments where the decedent owned land outright that was used by a cattle ranching partnership owned two-thirds by the decedent and one-third by the decedent's son.[2] The partnership conducted most of the decedent's cattle ranching business.[3] The decedent actively participated in all partnership operations.[4] The decedent owned outright two-thirds of the land used in the cattle ranching business.[5] While the land was essential to the operation of the partnership, it was never transferred to the partnership.[6] The son also owned land outright that was never transferred to the partnership, but was essential to the partnership.[7] The partnership paid to maintain fences on the land, paid the real estate taxes, and paid for casualty and liability insurance.[8]

The Service ruled that the decedent's land qualified for I.R.C. § 6166 because the decedent was involved in the cattle ranching business as a partner and as a sole proprietor.[9] The Service reasoned that the land was essential to the overall operation of the decedent's cattle ranching business even though the partnership did not own the land because the land was used in the active business enterprise and produced income.[10] Likewise, the income from the land was dependent upon the profitability of the cattle ranching enterprise, rather than being a fixed amount.[11]

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1. Tech. Adv. Mem. 96-35-004 (May 15, 1996).
2. *See id.*
3. *See id.*
4. *See id.*
5. *See id.*
6. *See id.*
7. *See id.*
8. *See id.*
9. *See id.*
10. *See id.*
11. *See* Priv. Ltr. Rul. 96-21-007 (Feb. 13, 1996). The Service ruled that the decedent's interests in certain commercial rental properties were not interests in a closely-held business. *See id.* While the decedent (or the decedent's daughter) performed certain activities in managing the properties including interviewing prospective tenants, enforcing lease terms, collecting rent payments, conducting

2. *Miscellaneous Developments*

In *Estate of McKee v. Commissioner*,[12] an estate was allowed to deduct interest on loans taken out to pay the estate tax obligation in a single payment.[13] Interest expense was allowed as a deductible administration expense even though the estate could have elected to pay the estate tax in installments pursuant to stock restriction agreements.[14] The decedent's will incorporated a statutory power authorizing the executors to borrow funds without court approval, did not require the executors to pay the estate tax in installments, and did not contain a provision incorporating the stock restriction agreements by reference.[15] The court also noted that by borrowing funds, the estate avoided the necessity of forcing a redemption of the decedent's stock that would not have provided sufficient funds to pay all of the death taxes and other liabilities.[16] Instead, borrowing funds allowed the estate to meet more easily its burdens by taking advantage of the increasing stock value.[17]

B. *Special Use Valuation*

1. *Interest Rates*

For farmland valued under the "rent capitalization" approach,[18] the interest rates for decedents dying in 1996 are set forth in Revenue Ruling 96-23.[19]

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various bookkeeping and regulatory functions, and making or contracting for the maintenance of properties, the Service ruled that those activities were outweighed by the tenants' activities in providing landscaping, snow and trash removal, air conditioning, plumbing, painting, electrical maintenance, and fire insurance. *See id.*

12. Estate of McKee v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,362, at 2556.

13. *See id.* at 2568.

14. *See id.*

15. *See id.* at 2560.

16. *See id.* at 2568.

17. *See id.*

18. *See* I.R.C. § 2032A(e)(7) (West 1997).

19. Rev. Rul. 96-23, 1996-15 I.R.B. 11. The rates by Farm Credit Bank district are as follows: Columbia - 8.98%; Omaha - 8.38%; Sacramento - 9.28%; St. Paul - 8.73%; Spokane - 8.48%; Springfield - 8.59%; Texas - 8.86%; Wichita - 8.44%. *Id.*

Jurisdictions located in each district are as follows: Columbia - Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia; Omaha - Iowa, Nebraska, South Dakota, Wyoming; Sacramento - Arizona, California, Hawaii, Nevada, Utah; St. Paul - Arkansas, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, North Dakota, Ohio, Tennessee, Wisconsin; Spokane - Alaska, Idaho, Montana, Oregon, Washington; Springfield - Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont; Texas - Alabama, Louisiana, Mississippi, Texas; Wichita - Colorado, Kansas, New Mexico, Oklahoma. *Id.*

2. *Minority Discounts and I.R.C. § 2032A*

No significant court decisions or Service rulings were issued in 1996 involving the combination of a minority discount and a special use valuation.[20]

3. *Filing of the Recapture Agreement*

In *Estate of Lucas v. United States,* [21] the court ruled that the estate's special use valuation election was not in substantial compliance with the I.R.C. § 2032A requirements because a recapture agreement did not accompany the estate tax return.[22] On the estate tax return, the estate did not check either the "yes" or "no" box with respect to whether a special use valuation election was being made.[23] The estate, nevertheless, attached Schedule N, attempting to elect special use valuation.[24] The estate also attached affidavits of the decedent's two sons that purported to serve as the estate's notice of election.[25] The Service held the election defective for failure to attach a recapture agreement.[26] The estate furnished the agreement within ninety days, but the Service denied the election asserting that the initial submission did not substantially comply with the regulations.[27] While the court held that the estate did make a special use valuation election because it expressed the clear intent to make the election,[28] the court concluded that the estate failed to provide substantially all of the "information" required.[29] The court ruled that the phrase "information with respect

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20. However, in a late 1995 decision, *Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995), the Tenth Circuit Court of Appeals reversed a Tax Court decision that disallowed the estate from taking both a 30% minority interest discount and a special use valuation election to value the decedent's 26% interest in a New Mexico limited partnership (*see* Hoover v. Commissioner, 102 T.C. 36 (1994)). *See id.* at 1047. On appeal, the Tenth Circuit held that the maximum reduction in the qualified real property's value under I.R.C. § 2032A(a)(2) had to be subtracted from the true fair market value of the property, which was not properly determined without considering a discount for the decedent's minority interest in the partnership and the interest's lack of marketability. *See id.* The court held that the statute did not alter the concept of fair market value and that the estate was not attempting to take the reduction in "special use value." *See id.* For a more complete discussion of the *Hoover* case, *see infra*note 197 and accompanying text.

21. Estate of Lucas v. United States, 97 F.3d 1401, 1413 (11th Cir. 1996), *cert. denied*, 65 U.S.L.W. 3531 (U.S. Jan 21, 1997)(No. 96-1157).

22. *See id.* at 1403.

23. *See id.*

24. *See id.*

25. *See id.*

26. *See id.* at 1404.

27. *See id.*

28. *See id.*

29. *See id.* at 1408, 1413.

to such election" contained in §1421 of the Tax Reform Act of 1986 included the recapture agreement.[30]

4. *Extension of Time to Make the Election*

In Private Letter Ruling (PLR) 96-12-010,[31] the decedent died owning property for which a special use valuation election could have been made. The estate did not, however, make such an election. The Service ruled that the estate was entitled to an extension of time for making an election, but noted that the estate bears the burden of establishing that all of the I.R.C. § 2032A requirements are met.

5. *Disposition of Elected Land*

In PLR 96-04-018,[32] the taxpayer was the beneficiary of elected land.[33] The land was adjacent to a landlocked college that wanted to acquire a portion of the elected farmland for access to the college.[34] The college held other unimproved tracts of farmland and wanted to exchange one of those tracts with the taxpayer's tract, which was subject to the I.R.C. § 2032A election.[35] The taxpayer would use the land acquired from the college for farming and no cash or other property was to be involved in the exchange.[36] Because the exchange qualified under I.R.C. § 1031 as a tax-free exchange, the Service held that no recapture tax would be triggered.[37]

Likewise, in PLR 96-42-055,[38] a qualified heir's sale of elected land did not cause a disqualifying disposition where the qualified heir's interest was sold to two other qualified heirs who were brothers of the qualified heir and the decedent's lineal descendants.[39]

6. *Miscellaneous I.R.C. § 2032A Developments*

In *Sass v. Hanson*,[40] the qualified heirs filed suit alleging that recapture tax would not have been assessed had proper legal advice been given.[41] The court of

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30. *See id.* at 1412-13; *see also* Estate of Hudgins v. Commissioner, 57 F.3d 1393 (5th Cir. 1995).

31. Priv. Ltr. Rul. 96-12-010 (Dec. 18, 1995).

32. Priv. Ltr. Rul. 96-04-018 (Oct. 30, 1996).

33. *See id.*

34. *See id.*

35. *See id.*

36. *See id.*

37. *See id.*

38. Priv. Ltr. Rul. 96-42-055 (July 24, 1996).

39. *See id.*

40. Sass v. Hanson, 554 N.W.2d 642 (Neb. Ct. App. 1996).

41. *See id.*

appeals upheld the trial court's finding that the lawsuit was barred by the statute of limitations, and dismissed the lawsuit.[42] The decedent died in early 1980 and the defendant sent a letter to the heirs, advising that they needed to maintain material participation in the farming operation if the elected land was leased to an unrelated third party.[43] However, the letter did not specifically state that cash leasing should be avoided.[44] A second letter was mailed to the heirs in conjunction with the decedent's federal and state income tax returns and the attorney reiterated the necessity of the heirs to maintain material participation with respect to the farmland subject to the election.[45] Again, no specific mention of the avoidance of cash leasing was included in the letter.[46] The court, in noting that the Nebraska statute of limitations for professional negligence utilized the "occurrence rule" rather than the "damage rule," held that the statute was triggered when the heirs knew of injury or damage and not when the heirs had a legal right to seek redress in court.[47] The court ruled that while the letters did not expressly state that cash leasing was to be avoided, the heirs understood the nature of the problem and that cash leasing would cause recapture.[48] As such, the cause of action accrued not when the Service assessed recapture taxes, but rather in late 1980 and early 1981 when the letters were sent to the heirs.[49]

In *LeFever v. Commissioner*,[50] upon the imposition of recapture tax against the estate, the qualified heirs argued that the special use valuation election was invalid because the land had never been put to a qualified use.[51] The heirs also claimed that the Service's determination of recapture liability was barred by the statute of limitations because the estate tax return put the Service on notice that the election was invalid.[52] The Tenth Circuit upheld the Tax Court in rejecting both arguments.[53]

In holding that the heirs could not disavow the special use valuation election, the court rejected the heirs' contention that the "duty of consistency doctrine" required a finding that the taxpayer made an intentional misrepresentation or wrongful misleading silence. Instead the court held that their representations in the election were conclusions of law.[54] The court also noted that the applicable statute

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42. *See id.* at 648.
43. *See id.* at 645.
44. *See id.*
45. *See id.* at 645-46.
46. *See id.* at 646.
47. *See id.*
48. *See id.*
49. *See id.* at 647-48.
50. LeFever v. Commissioner, 100 F.3d 778, 783 (10th Cir. 1996).
51. *See id.*
52. *See id.* at 783-84.
53. *See id.* at 789-90.
54. *See id.* at 786-87.

of limitations gave the Service three years from the time of discovery of a disqualifying event to assert recapture tax rather than three years from the filing of the return.[55] In this case, recapture tax was asserted nine years after death, and the court found nothing in the estate tax return, election, or supporting documents that should have put the Service on notice that the election was invalid.[56]

C. *Life Insurance*

1. *Split-Dollar Arrangements*[57]

In TAM 96-04-001,[58] the Service ruled that a CEO in a collateral assignment equity split-dollar arrangement was required to include in gross income for each year that the arrangement was in effect not only an amount equal to the one-year term cost of the life insurance protection enjoyed, but also "any cash surrender buildup. . . that exceeds the amount that is returnable to the (employer)."[59] Even though a subsidiary corporation had purchased fully paid-up policies on the CEO's life and had attained fully paid up status within one premium payment, the Service ruled that this was not distinguishing where the cash value in the policies remained subject to the subsidiary's general creditors.[60]

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55. *See id.* at 789-90.

56. *See id.* at 790.

57. Split-dollar life insurance arrangements have become increasingly popular in recent years as a deferred compensation tool for highly paid employees. Under a split-dollar arrangement, an employer purchases life insurance for an employee and the employer and the employee agree to split the insurance premium on the employee's life, the cash value, and the death benefits. The employer provides the funds to pay part of the annual premium to the extent of the increase in the cash surrender value each year. The employee pays the balance of the annual premium. The employer receives, out of policy proceeds, an amount equal to the cash surrender value (or at least the amount of the premiums paid). The employee has the right to name the beneficiary of the balance of the proceeds payable at death. An employee is taxable on the value of the cost of the insurance protection benefit provided to the employee under the arrangement. *See* Rev. Rul. 64-328, 1964-2 C.B. 11.

58. Tech. Adv. Mem. 96-04-001 (Sept. 8, 1995).

59. *Id.*

60. *See id.* This memorandum signifies a change in the Service's position on the issue and has generated a great deal of protest. Earlier Service rulings did not require taxation of employees on the cash surrender values in excess of the employer's premium payments. *See, e.g.,* Rev. Rul. 64-328, 1964-2 C.B. 11; Rev. Rul. 55-747, 1955-2 C.B. 228. Estate planners and other tax practitioners may want to consider slowing the increase in cash value so that it accrues over a longer term and postpones equity attainment. Similarly, it may be possible to avoid a taxable transfer under I.R.C. § 83 (1996) by providing for a substantial risk of forfeiture on the employee's part. A taxable transfer does not occur if the interest has not vested. I.R.C. § 83(a) (West 1996). Practitioners can expect litigation on this issue in 1997 and further guidance from the Service, unless the Congress acts with legislation that changes the ruling's impact.

2. *Inclusion of Insurance Proceeds in the Estate*

In PLR 96-02-010,[61] the Service held that the estates of certain irrevocable trust beneficiaries would not include the proceeds of life insurance policies taken on their lives and held by the trustees because the beneficiaries did not possess incidents of ownership over the policies.[62] An indenture of trust limited the beneficiaries' powers over trust assets, trust distribution, and life insurance policies.[63] Likewise, the beneficiaries' rights to principal distributions were subject to the trustees' absolute discretion, the beneficiaries could not use personal assets to maintain the policy contained in the trust, and the beneficiaries' special powers of appointment were not effective while the trust held the insurance policies.[64] As such, the beneficiaries were unable to exercise any powers to gain economic advantage from the policies.[65]

In PLR 96-22-036,[66] three shareholders of a C corporation entered into a binding stock restriction agreement concerning their corporate stock.[67] The agreement was funded, in part, by a first-to-die life insurance policy on the lives of two of the shareholders.[68] A portion of the proceeds from the policy was payable to the survivor of these two shareholders, and a portion was payable to the third shareholder.[69] The beneficiaries were required to use the policy proceeds to purchase the decedent's stock in the corporation.[70] The redemption agreement was also funded by a second policy insuring the life of one shareholder.[71] The proceeds of the second policy were payable equally to the other two shareholders.[72] The beneficiaries were required to use the policy proceeds to purchase the decedent's stock.[73]

The shareholders proposed to transfer both policies to an irrevocable trust.[74] The trustee of the trust was to be an unrelated third party who would not be a

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61. Priv. Ltr. Rul. 96-02-010 (Sept. 29, 1995).
62. *See id.*
63. *See id.*
64. *See id.*
65. *See id.*
66. Priv. Ltr. Rul. 96-22-036 (Mar. 4, 1996).
67. *See id.*
68. *See id.*
69. *See id.*
70. *See id.*
71. *See id.*
72. *See id.*
73. *See id.*
74. *See id.*

corporate shareholder.[75] The trust was to be named the beneficiary of the proceeds of each policy and all policy rights were to be transferred to the trustee of the trust.[76]

Based on these facts, the Service ruled that the proceeds of the first policy would not be included in the gross estate of the first to die of the two shareholders after the transfer to the trust.[77] Likewise, the Service ruled that the proceeds of the second policy would not be included in the gross estate of the third shareholder after the proposed transfer of the policy to the trust.[78]

In PLR 96-23-024,[79] the taxpayer was a partner in a partnership that owned life insurance policies on the lives of all partners.[80] The partnership paid the premiums on the policies.[81] The policies were purchased to provide funds for payment of partnership obligations upon a partner's death.[82] Any proceeds not required to pay partnership obligations could be distributed to the remaining partners, but only in proportion to and to the extent of the aggregate amounts necessary to purchase the deceased partner's interests in the partnership.[83] The Service ruled that the taxpayer did not possess any incidents of ownership in the insurance policies.[84] As such, upon the taxpayer's death, the Service ruled that the policy proceeds would not be included in the taxpayer's gross estate under I.R.C. § 2042.[85]

In PLR 96-51-017,[86] an S corporation possessed no incidents of ownership in life insurance policies acquired by a trust.[87] The trust was created by a majority shareholder, who was also an employee, and another shareholder.[88] A split-dollar arrangement prohibited the corporation from borrowing against any part of the policies.[89] In addition, the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, and to pledge the policy for

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75. *See id.*

76. *See id.*

77. *See id.*

78. The Service also ruled that if the stock owned by a decedent/shareholder's estate was sold to the surviving shareholders at fair market value that I.R.C. § 2703 would not affect the value of the stock for federal estate tax purposes.

79. Priv. Ltr. Rul. 96-23-024 (Mar. 6, 1996).

80. *See id.*

81. *See id.*

82. *See id.*

83. *See id.*

84. *See id.*

85. *See id.* (Upon payment of the insurance proceeds to the partnership, the Service ruled that the value of the taxpayer's partnership interest would include the taxpayer's proportionate share of the proceeds of the insurance policies and the value of the taxpayer's partnership interest in the partnership would be included in the taxpayer's gross estate).

86. Priv. Ltr. Rul. 96-51-017 (Sept. 18, 1996).

87. *See id.*

88. *See id.*

89. *See id.*

a loan were vested in the trustees of the trust.[90] Thus, the Service ruled "that the proceeds of the policies payable to the trustees upon the death of the survivor of [either of the two shareholders would] not be included" in the survivor's gross estate.[91]

III. PROPERTY OWNERSHIP CONSIDERATIONS - FEDERAL ESTATE TAX ASPECTS OF JOINT TENANCIES

The major development in 1996 involved the estate tax treatment of marital joint tenancies created before 1976, but where the first spouse died after 1981.[92] In *Gallenstein v. United States*,[93] the Sixth Circuit Court of Appeals held that for marital joint tenancies created before 1977, the pre-Tax Reform Act of 1976 rules concerning joint tenancy contribution would apply.[94] In *Gallenstein*, the surviving spouse made no contribution to the purchase of farm property in the 1950s.[95] Under the pre-1976 rules, a decedent's gross estate included all of the value of property held in joint tenancy with another except the portion of that value contributed by the other person (the "consideration furnished" rule).[96] The surviving spouse argued that the legislation applying the 50% inclusion rule to pre-1977 joint interests did not apply, and that such interests were subject to the full marital deduction rule under the 1981 Act.[97]

The *Gallenstein* court reasoned that the 1976 Act applied only to joint interests created after December 31, 1976, and that the 1981 amendments, which resulted in one-half of the entire property value included in the estate of the first spouse to die (fractional share rule), expressly applied to decedent's dying after December 31, 1981.[98] The 1981 amendments did not repeal the January 1, 1977, effective date of the 1976 amendments, which did not apply to joint interests created before 1977.[99] Because the surviving spouse as joint tenant had made no contribution to the purchase of the property, the surviving spouse was entitled to a full step-up in basis with a resulting elimination of capital gain tax upon subsequent sale of the property.[100]

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90. *See id.*

91. *See id.* (The Service also ruled that the split-dollar arrangement did not create a second class of S corporation stock).

92. Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).

93. *See id.*

94. *See id.* at 292.

95. *See id.* at 287.

96. *See id.* at 288.

97. *See id.*

98. *See id.* at 292.

99. *See id.* at 290-91.

100. *See id.* at 290-92.

Two 1996 federal district court cases, both in the Fourth Circuit, followed the Sixth Circuit's approach.[101] In *Estate of Harden v. Commissioner*,[102] the Tax Court held that one-half of the value of a joint tenancy account was not excludable from the decedent's gross estate because the estate failed to prove that this amount originally belonged to the decedent's son, the surviving joint tenant.[103] Although the son received half of the funds in the account under his pre-deceased father's will, under applicable state law (California), a legacy is ineffective to the extent there are insufficient assets to fund the legacy, and creditors' claims have priority over legacies.[104] The decedent's estate failed to substantiate that the father's estate had sufficient assets in excess of liabilities to satisfy the legacy.[105] In addition, deduction of one-half of the value of the joint tenancy property without adequately determining the amount of the father's assets and liabilities constituted a failure to exercise due care and subjected the estate to an addition to tax for negligence.[106]

IV. FEDERAL ESTATE TAX

A. *Property Included in the Gross Estate*

1. *Property Subject to a Power of Appointment*

A number of significant developments concerning the federal estate tax treatment of powers of appointment occurred during 1996. In *Estate of Kurz v. Commissioner*,[107] the court held that the decedent's gross estate included a 5% interest in a family trust over which the decedent held a general power of appointment.[108] While the decedent could only exercise the power after exhausting

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101. *See* Patten v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,231, at 84,246 (W.D. Va. 1996); Anderson v. United States, 96-2 U.S. Tax Cas. ¶ 60,235, at 86,544 (D. Md. 1996).

102. Estate of Harden v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,488, at 3530.

103. *See id.* at 3534.

104. *See id.* at 3534-35.

105. *See id.* at 3535.

106. *See id.* at 3534-36. The court also held that the estate was entitled to deduct as a theft loss amounts the decedent paid as an investment in a business that turned out to be a sham. *See id.* at 3535. However, the estate was not entitled to an indebtedness deduction for a note the decedent issued pursuant to the terms of her pre-deceased husband's will. *See id.* at 3534-35. The pre-deceased husband's will made bequests to family friends, but stated that if the surviving spouse determined that immediate payment of the gifts would be burdensome to the surviving spouse that the surviving spouse could issue promissory notes to the friends instead. *See id.* at 3531-32. The surviving spouse did issue the notes, but the estate was not entitled to a deduction for the notes because the friends gave nothing of value in return for the notes and the indebtedness was not bona fide because the friends could not reject the notes. *See id.* at 3535. In addition, the court also held that assessment of the estate tax deficiency was not barred by the period of limitations because the notice of deficiency was mailed within three years after the Service received the estate tax return. *See id.* at 3533-34.

107. Estate of Kurz v. Commissioner, 68 F.3d 1027, 1029 (7th Cir. 1995).

108. *See id.*

the marital trust, the power was "exercisable" because the decedent had the ability to remove the exhaustion condition.[109] As such, the sequence of withdrawal rights did not prevent the power from being "exercisable."[110]

In PLR 96-07-008,[111] the Service followed Revenue Ruling 95-58,[112] and ruled that the right of a co-trustee/beneficiary to remove and replace a corporate trustee unrelated and not subordinate to the individual trustees under I.R.C. § 672(c) did not give the co-trustee a general power of appointment over the trust. The decedent executed an irrevocable deed of trust in 1966 and died in 1974. The trustees were decedent's daughter, her husband, and a bank. All three served as trustees until 1995, when the daughter died. The resulting vacancy needed to be filled, and the son-in-law planned to exercise his discretionary authority under the trust and appoint the decedent's granddaughters as co-trustees of the trusts established for their benefit and the benefit of their descendants. As co-trustees, they would have the right to remove and replace the corporate co-trustee of their respective trusts. The Service concluded that the granddaughters did not have a general power of appointment over the income and principal of their respective trusts by virtue of their power to remove and replace the corporate trustee.

In *Estate of Hyde v. Commissioner,*[113] the corpus of a testamentary trust created by the decedent's mother was included in the decedent's gross estate because the decedent's power to invade the principal "in her sole discretion" as was "necessary and desirable" constituted a general power of appointment.[114] Under New Hampshire law, there was nothing limiting or defining the terms to mean that the decedent could only use the proceeds to meet her personal needs for education, support, or maintenance.[115] The mother's will also indicated an intent to allow the decedent to use the trust assets for whatever purposes she might wish during her lifetime.[116] As such, the decedent's power was not limited by an ascertainable standard relating to her health, education, support, or maintenance.[117]

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109. *See id.*

110. *See id.*

111. Priv. Ltr. Rul. 96-07-008 (Nov. 9, 1995).

112. Rev. Rul. 95-58, 1995 I.R.B. 16. The Service issued this Revenue Ruling as a result of court decisions in *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992), and *Estate of Wall v. Commissioner* ,101 T.C. 300 (1993). With the Revenue Ruling, the Service conceded that a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) was not a reservation of a discretionary distribution power causing inclusion of trust property in the decedent/grantor's gross estate under I.R.C. §§ 2036 and 2038. *See id.* The Service ruled that the retained power is not equivalent to the power to affect beneficial enjoyment of trust property and is not a gift to the trust. *See id.*

113. Estate of Hyde v. Commissioner, 950 F. Supp. 418 (D.N.H. 1996); 96-2 U.S. Tax Cas. (CCH) ¶ 60,243 at 86,570, 86,572 (D.N.H. 1996).

114. *See id.*

115. *See id.*

116. *See id.*

117. *See id.*

In *Estate of Dietz v. Commissioner*,[118] the terms of a trust gave the decedent a noncumulative right to withdraw the greater of 5% or $5,000 from the trust principal each calendar year.[119] However, the decedent did not exercise this right at any time before death.[120] As a result, each failure to exercise the right of withdrawal for a year constituted a lapse of the power over the amount available to the decedent for that particular year.[121] Because the amount that lapsed at the end of each calendar year did not exceed the annual exemption under I.R.C. § 2041(b)(2)(1996), the lapse was not subject to gift tax.[122] However, the decedent's general power of appointment with respect to a right of withdrawal for the year in which she died did not lapse at the time of her death and, thus, the annual exemption did not apply.[123] As such, the decedent's gross estate included 5% of the value of the trust because she was deemed to have held a general power of appointment over the trust property at the time of death.[124]

118. Estate of Dietz v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,471, at 3439.
119. *See id.* at 3440.
120. *See id.* at 3441.
121. *See id.* at 3442.
122. *See id.* at 3443-43.
123. *See id.* at 3444.
124. *See id.* at 3443.

2. *Transfers Within Three Years of Death*

In PLR 96-01-002,[125] the Service ruled that withdrawals from a revocable trust made by the decedent's daughter within three years of the decedent's death were includible in the decedent's gross estate.[126] Under local law (Oregon), the withdrawals were unauthorized because the trust's terms expressly prohibited anyone other than the decedent from making withdrawals, and the powers of attorney that the decedent executed did not reference the revocable trust or permit the daughter to act for the decedent with respect to the trust.[127]

In TAM 96-34-004,[128] the decedent executed a durable power of attorney during life that named her daughter as attorney-in-fact.[129] The power granted the daughter the power to lease, grant, bargain, sell, and dispose of real or personal property at any price.[130] The power also authorized the daughter to "perform every act and thing whatsoever requisite and necessary to be done in and about the premises. . ." as the decedent might or could do if the decedent were present.[131] The power also gave the daughter authority to make contracts and conveyances in the decedent's best interest and the power to do any act necessary or desirable to properly conduct, manage, and control all of the decedent's business and property.[132] However, the power did not expressly authorize the daughter to make gifts.[133] The daughter made gifts of the decedent's property in 1993 and 1994 and claimed six annual exclusions each year.[134] Net gifts were reported for 1994.[135] The decedent died in 1994.[136] The Service ruled that the gifts were unauthorized because the power of attorney did not expressly grant the power to make gifts and could not be

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125. Priv. Ltr. Rul. 96-01-002 (Sept. 22, 1995).

126. *See id.*

127. *See id.* Transfers from a revocable trust within three years of death are generally not included in the decedent's gross estate if the decedent/beneficiary did not have the power to direct the trustee to make payments to persons other than the decedent/beneficiary. However, distributions from a revocable trust are included in the gross estate if the decedent/beneficiary had the power to direct the trustee to make payments to persons other than the decedent/beneficiary or if the distributions involve a relinquishment of the decedent/beneficiary's power to revoke the trust. *See, e.g.,* Priv. Ltr. Rul. 90-10-004 (Nov. 17, 1989). Thus, practitioners may want to draft language into revocable trusts that precludes direct gifts out of trust property from being made. One alternative is to have the gifts be made pursuant to the decedent's withdrawal power in accordance with the donor's written instruction rather than at the trustee's discretion. *See, e.g.,* White v. United States, 906 F. Supp. 24 (D. Mass. 1995); Kisling v. Commissioner, 32 F.3d 1222 (8th Cir. 1994); McNeely v. United States, 16 F.3d 303 (8th Cir. 1994).

128. Tech. Adv. Mem. 96-34-004 (May 2, 1996).

129. *See id.*

130. *See id.*

131. *Id.*

132. *See id.*

133. *See id.*

134. *See id.*

135. *See id.*

136. *See id.*

construed as authorizing gifts.[137] Consequently, the gifted property was includible in the decedent's gross estate under I.R.C. § 2038.[138]

In TAM 96-51-004,[139] the Service ruled that a decedent did not transfer during the three-year period ending with his death the incidents of ownership in two whole life insurance policies that insured his life.[140] The corporation of which the decedent was the chairman of the board and an employee obtained the policies.[141] The policies were transferred to the decedent who, more than three years before his death, transferred the policies to a trust.[142] Despite the fact that new policies were issued indicating that the decedent owned the policies within the three-year period, the incidents of ownership already had been transferred.[143] As a result, the policy proceeds were not includible in the decedent's gross estate.[144]

3. *Retained Interests*

In PLR 96-23-024,[145] the taxpayer was a general partner in a partnership that owned a life insurance policy on the taxpayer's life.[146] The partnership paid all premiums on the insurance policy.[147] The partnership agreement provided that upon the death of a partner, the life insurance proceeds of the policy on that particular partner were to be held by the partnership to the extent needed to cover partnership obligations, with the remainder distributed to other partners to the extent necessary to purchase the deceased partner's interest in the partnership.[148] The Service ruled that the taxpayer did not have any incidents of ownership in the policy and the taxpayer's partnership interest included in the gross estate would include the insurance proceeds to the extent of the taxpayer's proportionate share of the partnership.[149]

In PLR 96-38-036,[150] the Service ruled that the total value of a trust in which the decedent retained an annuity interest was includible in the decedent's gross estate under I.R.C. § 2036(a) because the decedent retained an interest in the entire trust corpus.[151] The amount of property transferred upon creating the trust was less

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137. *See id.*
138. *See id.*
139. Tech. Adv. Mem. 96-51-004 (Aug. 26, 1996).
140. *See id.*
141. *See id.*
142. *See id.*
143. *See id.*
144. *See id.*
145. Priv. Ltr. Rul. 96-23-024 (Mar. 6, 1996).
146. *See id.*
147. *See id.*
148. *See id.*
149. *See id.*
150. Priv. Ltr. Rul. 96-38-036 (June 24, 1996).
151. *See id.*

than the amount required to generate the income stream payable to the decedent.[152] However, because the estate was obligated to pay the trust corpus in satisfaction of a settlement, a deduction for claims against the estate was allowed to the extent of the amount includible in the gross estate.[153] However, the amount includible was offset by I.R.C. § 2053(a)(4).[154]

In PLR 96-43-013,[155] the Service ruled that neither of two revocable trusts created by spouses for the benefit of their children and other descendants was includible in either spouse's estate.[156] Neither spouse retained the reserved right to enjoy or use the property or the right to income from their respective trusts because the trust provisions did not permit distributions of income or invasion of principal for their benefit.[157] An independent trustee had discretion over income and principal distributions to the beneficiaries.[158] However, because the husband held the power to withdraw an amount not in excess of the greater of $5,000 or 5% from the trust established by the wife, that amount was includible in his estate.[159]

In PLR 96-46-021,[160] the percentage of joint trust assets attributable to the decedent's contributions was includible in the decedent's gross estate because, under the terms of the trust, income could be paid to the decedent and the decedent's spouse. The amount includible was determined by calculating the fair market value of the decedent's percentage contribution as of the date of the contribution. Because the trust was irrevocable as of September 25, 1985, the effective date of the GSTT, distributions from and terminations with respect to the trust were not subject to the GSTT, except to the extent of any additions to the trust after September 25, 1985.

In *Estate of McLendon v. Commissioner*,[161] the decedent was diagnosed with cancer and was given less than a 5% chance of recovery.[162] The decedent then amended two family partnership agreements to allow the transfer of partnership interests and to make the decedent's son managing partner upon the decedent's death.[163] The decedent transferred remainder interests in the decedent's partnership interests to trusts for the decedent's children in exchange for $250,000 in annuities payable on the decedent's life.[164] The remainder interests were valued using the actuarial tables of Treas. Reg. § 25.2512-5(f) (Table A) for a person of the decedent's

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152. *See id.*
153. *See id.*
154. *See id.*
155. Priv. Ltr. Rul. 96-43-013 (July 19, 1996).
156. *See id.*
157. *See id.*
158. *See id.*
159. *See id.*
160. Priv. Ltr. Rul. 96-46-021 (Aug. 16, 1996).
161. Estate of McLendon v. Commissioner, 1993 T.C.M. (RIA) ¶ 93,459 at 2437.
162. *See id.* at 2439.
163. *See id.* at 2443.
164. *See id.* at 2446.

age.[165] The annuity agreement specified that the remainder interest purchasers agreed to increase the amount to be paid if the remainder interests were re-valued by the Service or Tax Court.[166] The Tax Court held that the remainder interests could not be valued using the actuarial table because of the decedent's limited life expectancy.[167] The savings clause was ineffective to overcome the fact that the purchasers had paid less than fair market value for the remainder interests.[168] Therefore, the transfers were includible in the decedent's estate as gifts under I.R.C. § 2036, but were offset by the $250,000 actually paid.[169]

On appeal, the Fifth Circuit Court of Appeals reversed in part the Tax Court's decision and remanded the case to determine whether the holding was consistent with Revenue Ruling 80-80, which required that death be "clearly imminent" before the actuarial table could not be used.[170] On remand, the Tax Court held that the decedent's death at the time of the transfer was clearly imminent.[171] Testimony demonstrated that the decedent's chance of surviving for more than one year was less than 10%.[172]

In *Estate of D'Ambrosio v. Commissioner*, before death, the decedent owned preferred stock with a fair market value of $2,350,000.[173] Approximately three years before death, the decedent transferred her remainder interest in the shares in exchange for an annuity of $296,039 per year.[174] The decedent retained her income interest in the shares.[175] The transfer was not made in contemplation of death or with testamentary motivation.[176] At the time of death, the decedent had received $592,078 in annuity payments and $23,500 in dividends.[177] The executor did not include any of the stock interest in the decedent's gross estate.[178] The Tax Court

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165. *See id.* at 2447.

166. *See id.*

167. *See id.* at 2459.

168. *See id.* at 2462-63.

169. *See id.* at 2464-65.

170. Estate of McLendon v. Commissioner, 77 F.3d 477 (5th Cir. 1995), *rev'g in part and remanding without published opinion,* 1993 T.C.M. (RIA) ¶ 93,459 at 2437; Rev. Rul. 80-80, 1980-1 C.B. 194 (holding death must be "clearly imminent" to disregard the actuarial tables).

171. Estate of McLendon v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,307 at 2225.

172. *See id.* at 2225. For gifts made and deaths occurring after 1995, the actuarial tables may not be used if the individual is known to have an incurable illness or other deteriorating physical condition. An incurable illness or deteriorating physical condition is deemed to be present if there is at least a 50% chance that the individual will die within one year. *See* Treas. Reg. § 25.7520-3(b)(3) (West 1989).

173. Estate of D'Ambrosio v. Commissioner, 96-2 U.S. Tax Cas. (CCH) ¶ 60,252, at 86,610, 86,611 (3d. Cir. 1996), *rev'g*, 105 T.C. 252 (1995).

174. *See id.*

175. *See id.*

176. *See id.*

177. *See id.*

178. *See id.*

upheld the Service's position that the full fee simple value of the stock, less the amount of annuity payments the decedent received during life, be included in the decedent's gross estate.[179]

The Third Circuit Court of Appeals reversed the Tax Court, and held that the decedent's sale of the remainder interest for fair market value constituted "adequate and full consideration" under I.R.C. § 2036(a).[180] The court noted that the Service's position would result in double taxation of the transferred interest and considerable difficulty in selling remainder interests.[181]

4. *Miscellaneous Federal Estate Tax Developments*

In TAM 96-46-003,[182] the Service ruled that the value of a restricted homestead and associated mineral interests would not be includible in the estate of a half-blooded American Indian.[183] Federal laws dating back to 1898 exempted certain lands allotted to members of the Chickasaw tribe from tax.[184] Although case law indicated that exemptions from income tax were not to be construed as exemptions from estate tax, the Service ruled that the case law had no application to Indian tax exemptions which, the Service ruled, were to be construed liberally.[185] However, the proceeds from the sale of oil and gas interests obtained from the land and held in a Bureau of Indian Affairs account would be includible in the gross estate.[186] The Service noted that an amendment in 1928 specifically made the income from production of oil and gas on the exempt property subject to tax.[187]

In *Kane v. United States*,[188] the court held that the OBRA 93 retroactive increase in the federal estate tax rate from 50% to 55% was constitutional.[189] The plaintiff, an executor of an estate subject to the maximum federal estate tax rate, argued that the retroactive increase violated both the takings and the due process clauses of the Fifth Amendment.[190] The court noted that retroactive application of a tax statute satisfies due process so long as it is rationally related to a legitimate government purpose.[191] In this case, the court ruled that the tax increase was rationally related to the legitimate goals of raising revenue, improving tax equity, and

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179. *See id.* at 86,615-16.
180. *See id.* at 86,613-14.
181. *See id.* at 86,615.
182. Tech. Adv. Mem. 96-46-003 (July 29, 1996).
183. *See id.*
184. *See id.*
185. *See id.*
186. *See id.*
187. *See id.*
188. Kane v. United States, 942 F. Supp. 233, 234 (E.D. Pa. 1996).
189. *See id.*
190. *See id.*
191. *See id.*

making the tax system more progressive. [192] Similarly, the court held that the retroactive time period of eight months was modest.[193] The court also ruled that OBRA 93 did not violate the takings clause.[194] Even though the tax rate was high, the court opined that it was not a confiscatory rate amounting to a taking.[195]

B. *Valuation*

1. *Discounts*

The area of discounts for minority interest position, lack of marketability, and fractional interests continued to be active during 1996.[196]

Perhaps the most significant case in the discount area in 1996 was *Estate of Bonner v. United States*.[197] In *Bonner*, the court held that the decedent's outright

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192. *See id.*

193. *See id.*

194. *See id.*

195. *See id.*

196. *See* Estate of Luton v. Commissioner, 1994 T.C.M. (RIA) ¶ 94,539, at 2791 *supp. by* 1996 T.C.M. (RIA) ¶ 96,181 at 1355 (evidencing that discounts may also be available for state restrictions on land use). In this case, the decedent's estate included a 78% interest in the common stock of a corporation that owned a 1,300 acre ranch, a one-third interest in a closely-held corporation which owned wetlands used for hunting, and 41.8% of a liquidating trust. *See id.* at 2792. The court rejected the estate's liquidation valuation and comparative property valuation of the ranch and wetlands because the properties were not for sale and the comparable properties used were not sufficiently similar. *See id.* at 2795-96. The corporation was valued using the value of the corporation's assets less a 20% discount for lack of marketability, based on the illiquid nature of the assets caused by the state restrictions. *See id.* at 2798.

The estate was allowed a 20% discount for minority interest and a 15% discount for lack of marketability, in part because of the land use restrictions. *See id.* at 2799-2800. The value of the interest in the liquidating trust was discounted 10% for lack of marketability, but the court did not allow any discount for minority interest because minority interest holders were protected by the trustee's fiduciary duty. *See id.* at 2802-03. The supplemental ruling in early 1996 involved the stipulation that determined the effect on stock valuation of a loan from a related corporation. *See id.* at 1996 T.C.M. (RIA) ¶ 96,181 at 1355.

197. Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996). Another significant case, but decided in late 1995, was *Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995). In *Hoover*, the decedent held a 26% interest in a New Mexico ranching partnership as a limited partner. The estate first discounted the decedent's interest to reflect the decedent's minority position. From this discounted value, the executor further reduced the taxable estate by making a special use value election. The Tax Court first denied the minority interest discount on the basis of its holding in *Estate of Maddox v. Commissioner*, 93 T.C. 228 (1989). In *Maddox*, the decedent owned a 35.5% interest in an incorporated family farm which qualified for special use valuation. The Tax Court held that the "use value" of the shares included in the gross estate was not the "fair market value" of the shares, and that the estate was not entitled to a minority interest discount that would otherwise be available in determining fair market value. Consequently, the court held that the estate was entitled to utilize a minority interest discount or a special use valuation election, but denied the estate the ability to reduce further the value of property included in the estate at use value by a discount. *Id.* at 231. The Tenth Circuit Court of Appeals reversed the Tax Court and allowed the estate to utilize a minority interest

ownership of undivided fractional interests in real and personal property did not have to be aggregated with the remaining interests in the same properties that were included in the decedent's estate by reason of I.R.C. § 2044.[198] Thus, even though 100% of the properties was included in the decedent's estate, the interests held outright at death qualified for fractional interest discounts.

At the time of death, the decedent owned a 62.5% interest in 2,107 acres of Texas ranchland, a 50% interest in New Mexico real estate and a 50% interest in a 56-foot pleasure boat.[199] A QTIP trust established under the will of the decedent's predeceased spouse owned the remaining interests.[200]

The estate valued the decedent's 62.5% interest in the ranchland at a 45% discount (below 62.5% of fair market value) based on the fact that it was a fractional undivided interest.[201] The estate also discounted the value of the New Mexico real estate and the boat.[202] The Service disallowed the discounts, claiming instead that the interests held by the QTIP trust merged with the interests held outright by the decedent. As such, 100% of the properties was included in the decedent's gross estate.[203]

In reversing the district court, the Fifth Circuit Court of Appeals held that a fractional interest discount was available on the basis of the court's 1980 decision in *Estate of Bright v. United States*.[204] The Fifth Circuit, while noting that I.R.C. § 2044 contemplated that QTIP property is to be treated as having passed from the decedent, held that § 2044 does not require the QTIP assets to merge with the assets the decedent owned outright.[205] The court reasoned that the decedent's predeceased spouse could have left the assets in the QTIP to anyone, and neither the decedent nor the decedent's estate had any control over their ultimate disposition.[206] The court also rejected the Service's public policy argument that the decedent should be prevented from using a QTIP to avoid paying taxes on the unified value of the

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discount and a special use valuation election on the qualified property. *See* Estate of Hoover, 69 F.3d at 1047.

198. *See* Estate of Bonner, 84 F.3d at 198-99.

199. *See id.* at 197.

200. *See id.*

201. *See id.*

202. *See id.*

203. *See id.*

204. *See id.* at 198. (relying on Estate of Bright v. United States, 619 F.2d 407 (5th Cir. 1981). In *Bright*, the decedent held a 27.5% interest in an asset as executor of his deceased wife's estate and a 27.5% in the same asset in his individual capacity. The Service argued that the estate tax value of the decedent's interest should be determined as though the decedent held a single 55% controlling interest, with that value then being cut in half. The Fifth Circuit rejected this approach based on the willing buyer, willing seller definition of fair market value, stressing instead that the willing seller is not the estate but a hypothetical seller. *See id.* at 407-12.

205. *See* Estate of Bonner, 84 F.3d at 197.

206. *See id.* at 198.

property.[207] Instead, the court noted that the estate of each spouse should be required to pay taxes only on the assets within the control of each spouse.[208] The Fifth Circuit remanded the case to the district court to determine the appropriate discount.[209]

In *Estate of Casey v. Commissioner*,[210] the decedent held a life estate interest in a residence.[211] Certain charities held the remainder.[212] When a maintenance trust began to run out of funds for maintaining the residence, the parties established a liquidating trust to sell the residence and personal property.[213] The estate argued that the decedent's interest in the trust should have been discounted for its minority interest and the interest's lack of marketability.[214] The Service disagreed, arguing instead that the trust was not a trade or business and that a buyer would be concerned only with the delay in liquidating the trust assets before realizing the value of the decedent's interest in money.[215] The court agreed partially, holding that the trust interest could not be discounted as could a minority shareholder's interest, but allowed the discount for the time delay in liquidating the trust assets.[216]

In *Estate of Wheeler v. United States*,[217] the decedent's estate consisted of 50% of the voting stock of a family owned corporation in which the decedent's heirs owned all of the nonvoting stock and the other 50% of the voting stock.[218] Under local law (Texas), a 50% interest in voting stock was insufficient to control corporate

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207. *See id.* at 198-99.

208. *See id.* at 199.

209. *See id.* While the estate apparently was only seeking a discount for the interests the decedent held outright, the Fifth Circuit's reasoning would appear to support a discount for the assets held in the QTIP trust. The discount should be available regardless of whether the individuals ultimately receiving the QTIP assets are the same persons inheriting the assets held by the decedent. Under the court's reasoning, the valuation is made as of the moment of death and must be measured by the interest that passes, as contrasted with the interest held by the individual before death or the interest held by the legatee after death.

The Service is challenging *Bonner*. The Service has consistently taken the view that aggregation is required in determining estate tax value in factual situations similar to *Bonner*. In Tech. Adv. Memo 96-08-001 (Aug. 18, 1995), the Service concluded that a partnership interest included in an estate under I.R.C. § 2044 had to be aggregated with an interest in the same partnership held through a revocable trust. The Service also reached the same result for stock held outright and stock of the same company held by a QTIP trust in Priv. Ltr. Rul. 95-50-002 (Aug. 31, 1995).

210. Estate of Casey v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,156, at 1143.

211. *See id.* at 1144.

212. *See id.*

213. *See id.*

214. *See id.* at 1146 (citing Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982)).

215. *See id.*

216. *See id.* at 1147.

217. Estate of Wheeler v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,226, at 84,227 (W.D. Tex. 1995).

218. *See id.* at 84,228.

affairs.[219] The Service allowed a 25% discount for lack of marketability and argued that the estate should not be given an additional 10% minority discount.[220] The court stated that a minority interest discount is different conceptually from a discount for lack of marketability and that an award of the latter does not preclude application of the former. Thus, the court allowed a 10% minority discount.[221]

In *Estate of McClatchy v. Commissioner*,[222] the decedent owned more than two million shares of unregistered voting stock in a closely-held corporation in which the decedent was an affiliate under federal securities law.[223] Sale of the stock during the decedent's life was subject to federal securities law restrictions, but the decedent's estate was not an affiliate to which the restrictions applied.[224] The estate argued that the stock value should be discounted for estate tax purposes because of the restrictions in effect during the decedent's life.[225] The court disagreed, reasoning instead that the valuation was to be determined by reference to the interest that passed because of the decedent's death.[226] Because the stock passed to the estate without the restrictions, a discount was not appropriate.[227]

In *Smith v. United States*,[228] a corporate promissory note issued to the decedent's predeceased spouse was included in the decedent's estate.[229] The note was a private obligation and did not include any protective language found in the publicly issued corporate debt instruments.[230] The note's fair market value was determined by comparing it to similar publicly issued corporate debt instruments.[231] The estate argued that the estate tax valuation should be determined by discounting the note's fair market value to account for the lack of protective documents found in the publicly traded debt instruments.[232] The court agreed and accepted the estate's valuation.[233]

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219. *See id.*
220. *See id.*
221. *See id.*
222. Estate of McClatchy v. Commissioner, 106 T.C. 9 (1996).
223. *See id.*
224. *See id.*
225. *See id.*
226. *See id.*
227. *See id.* The restrictions would have remained in effect if the property had been gifted. Thus, a discount would have been available for gift tax purposes. This would have resulted in a lower gift tax than estate tax on the same shares. However, this outcome must be balanced against the income tax consequences to the donee beneficiary because of the loss of a stepped-up basis. Also, for gifts of closely-held stock to family members, the special valuation rules of I.R.C. §§ 2701-2704 must be considered.
228. Smith v. United States, 923 F. Supp. 896 (S.D. Miss. 1996).
229. *See id.* at 898.
230. *See id.* at 902.
231. *See id.* at 901-02.
232. *See id.* at 901.
233. *See id.* at 904.

In *Krapf v. United States*,[234] the taxpayer donated 26,000 shares of stock to a university in 1976 and valued the shares at $10 each for federal income tax charitable deduction purposes.[235] The gifted stock represented 32.5% of all outstanding shares.[236] The Service deemed the stock worthless and disallowed the deductions.[237] The company lost a major contract four months after the gifts and, as a result, went bankrupt.[238]

The trial court used evidence of post-gift transactions to determine the value of the stock on the date of the gift.[239] This approach resulted in a value of $4.34 for each share of gifted stock.[240] On appeal, the Federal Circuit also used subsequent events to prove the value of the gift, but remanded the case because the trial court's valuation was not based on the evidence and was too speculative.[241] On remand, the court valued the gifted stock at $2.46 per share based on an adjusted net worth analysis with a 33% discount for the taxpayer's minority interest.[242] The value of intangibles was not included for lack of evidence of their values, and the price determined by a buy-sell agreement was ignored because of no evidence that the agreement was executed.[243]

In *Estate of Scanlan v. Commissioner*,[244] the decedent died owning an undivided 50% community interest in a closely-held corporation.[245] The decedent's spouse made gifts of corporate voting stock approximately three months before the decedent's death, for which the decedent and spouse elected split gift treatment.[246] The gifted stock was valued at approximately $35 per share on the decedent's Form 709.[247] The decedent's stock interest was also valued at approximately $35 per share on the decedent's estate tax return.[248] The gifts were valued based on a corporate valuation report prepared by a professional investment banking firm, and the estate tax value was arrived at by a similar valuation report which included a 35% discount for minority interest and lack of marketability.[249]

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234. Krapf v. United States, 35 Fed. Claims 286 (1996).
235. *See id.* at 288.
236. *See id.*
237. *See id.*
238. *See id.*
239. *See id.* at 288-89.
240. *See id.* at 289.
241. Krapf v. United States, 977 F.2d 1454, 1463 (Fed. Cir. 1992).
242. Krapf, 35 Fed. Claims at 294.
243. *See id.*
244. Scanlan v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,331, at 2359.
245. *See id.*
246. *See id.*
247. *See id.* at 2360
248. *See id.*
249. *See id.*

Approximately one year after the decedent's death, the corporation solicited offers to purchase all of the corporate stock or assets.[250] An offer was received to buy all of the corporate stock for $75.16 per share.[251] In accordance with the corporate redemption agreement, non-family member shareholders were required to sell their shares back to the corporation at $75.16 per share.[252] Based on this redemption price, the Service determined that each share of the corporate voting stock was worth $72.15 as of the date of the decedent's death.[253] The Service then discounted this value by an arbitrary 4% figure to account for the decedent's minority interest in the company.[254]

The court rejected the estate's and the Service's values.[255] The court opined that the estate's expert was unpersuasive and that the expert had arbitrarily applied a 35% marketability discount to the decedent's share.[256] The estate's expert did not, in the court's opinion, adequately discuss the publicly traded companies, which he compared to the decedent's corporation, and did not set forth their age, business, or product line with any specificity.[257] The expert also made no mention of a hypothetical buyer or seller.[258] The Service provided no expert, and the court found incredible the Service's argument that a 4% discount adequately reflected a lack of marketability and minority discount for the decedent's stock.[259] As such, the court held that the value of the decedent's stock at the time of death was $50.51 per share.[260] The court arrived at this value by starting with the redemption price of $75.16 per share and reducing it by a 30% discount for lack of marketability and minority interest.[261]

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250. *See id.* at 2361.
251. *See id.*
252. *See id.*
253. *See id.*
254. *See id.*
255. *See id.* at 2366.
256. *See id.* at 2364.
257. *See id.*
258. *See id.*
259. *See id.* at 2365.
260. *See id.* at 2366.
261. *See id.* at 2365. Scanlan v. Commissioner, 1996 T.C.M. ¶ 96,414, at 2903. (The court rejected the estate's motion for reconsideration. The estate claimed that the court erred because the court concluded that the decedent's shares of stock were marketable, failed to account properly for minority and marketability discounts, and did not apply the standards set forth in *Mandelbaum v. Commissioner*, 1996 T.C.M. (RIA) ¶ 95-255, *aff'd. without published opinion*, 91 F.3d 124 (3rd Cir. 1996), to determine the marketability discount).

2. *Special Valuation Rules*

In PLR 96-06-003,[262] the taxpayers, husband and wife, owned certain residential property as community property.[263] The taxpayers each transferred their own interest in the property to separate fifteen-year trusts.[264] Each trust provided that if the grantor died before the end of fifteen years, the trusts terminated and the assets reverted to the grantor's estate.[265] Each grantor's will devised any revested interests to the surviving spouse.[266] If the residence ceased to be the grantor's personal residence, the trust was to be converted to an annuity trust.[267] The Service ruled that the residence qualified as a personal residence trust under Treas. Reg. § 25.2702-5(c)(2), and that the trusts were not subject to the special valuation rules of I.R.C. § 2702(a)(2).[268] The Service also ruled that because the value of each grantor's retained interest exceeded 5% of the value of the trust property, each grantor was considered the owner of the trust and would include trust income, deductions, and credits against tax attributable to the trust under I.R.C. § 671.[269]

In *Estate of Gloeckner v. Commissioner*,[270] the decedent was a majority shareholder in a small closely-held corporation.[271] In 1960, the shareholders executed a stock restrictive sale agreement providing for redemption upon a shareholder leaving the company.[272] In 1987, as part of the decedent's plan to leave control of the company with an employee, and reduce the estate tax burden on the decedent's heirs, the decedent executed another buy-sell agreement which established the value of the stock for redemption by the decedent's estate.[273] Any unredeemed stock was to pass to the employee.[274] The corporation was required to redeem so much of the decedent's stock as necessary to pay federal and state taxes on the decedent's estate.[275]

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262. Priv. Ltr. Rul. 96-06-003 (Nov. 7, 1996).
263. *See id.*
264. *See id.*
265. *See id.*
266. *See id.*
267. *See id.*
268. *See id.*
269. *See id.; see* 61 Fed. Reg. 16,623 (1996) (amending Treas. Reg. § 25.2702-5 stating proposed regulations would allow reformation of a personal residence trust within ninety days after a gift tax return is due for the trust creation). The proposed regulations also provide that a qualified personal residence trust cannot allow the transfer of the residence to the grantor, the grantor's spouse, or any entity controlled by the grantor or the grantor's spouse. This could have important implications for buying back the residence after the period of the retained interest.
270. Estate of Gloeckner v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,148, at 1079.
271. *See id.*
272. *See id.* at 1080-81.
273. *See id.*
274. *See id.* at 1082.
275. *See id.*

The court held the agreement was enforceable because the stock agreement was executed before the effective date of I.R.C. § 2703.[276] However, the court held that the buy-sell agreement was ineffective to establish the stock value because it was a testamentary device.[277] As such, the stock was to be valued at fair market value as of the decedent's death, but the estate elected alternate valuation.[278]

In PLR 96-38-016,[279] the Service ruled that redemptions of stock held by three groups of trusts were not subject to the valuation rules applicable to transfers with retained interests under I.R.C. § 2702.[280] The Service ruled that the interests that the trusts held were substantially identical before and after the change in the corporation's capital structure.[281] As a result, no taxable gifts occurred.[282] The trusts owned all of the corporate stock, and the corporation owned all of one parcel of commercial real estate and 40% of another parcel of commercial real estate.[283] The corporation distributed its fee interests in the properties to the trusts and retained a term interest approximately equal to the number of years remaining under separate ground leases that had been executed between the trusts and the corporation.[284] The redemption was made on a pro rata basis in accordance with each trust's respective interest in the corporation.[285]

In PLR 96-39-054,[286] the Service ruled that a contribution to a limited partnership designated under the partnership agreement as a preferred capital account contribution was not subject to the special valuation rules.[287] After aggregating the interests of the transferor and certain related individuals and entities, the limited partnership was not a "controlled entity" immediately before the transaction.[288]

3. *Miscellaneous Valuation Developments*

In *Estate of Lloyd v. Commissioner*,[289] the decedent owned 50% of a trust which owned two parcels of rural land zoned as residential.[290] Upon the decedent's death, the estate argued that the land should be valued as residential property because

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276. *See id.* at 1085.
277. *See id.* at 1087-88
278. *See id.* at 1085.
279. Priv. Ltr. Rul. 96-38-016 (June 14, 1996).
280. *See id.*
281. *See id.*
282. *See id.*
283. *See id.*
284. *See id.*
285. *See id.*
286. Priv. Ltr. Rul. 96-39-054 (June 21, 1996).
287. *See id.*
288. *See id.*
289. Estate of Lloyd v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,030, at 296.
290. *See id.* at 297.

the highest and best use of the land was for residential purposes and because the land was zoned residential.[291] The estate also argued that any attempt to rezone the land for commercial purposes would be difficult.[292] The court rejected the estate's arguments and held that the evidence demonstrated that local development was commercial and that a rezoning could be obtained easily.[293] As such, the fair market value would be determined on the basis of the commercial use value of the property.[294]

In *Wrona v. United States*,[295] the decedent owned a 67% leasehold interest in a parking garage.[296] The executors valued the leasehold for estate tax purposes based on a pending offer to purchase the leasehold.[297] The sale fell through and the leasehold was sold to the decedent's son for much less than the estate tax value.[298] The executors sought to amend the estate tax return to decrease the value.[299] The trial court denied the lower value and the appellate court affirmed.[300]

In re Taylor,[301] the donor gifted several parcels of land to the taxpayer and retained a life estate in each parcel.[302] The Service used several sales of comparable nearby land to value the gifts.[303] The taxpayer's appraiser claimed that no comparable sales were available and used an income-producing approach to value the parcels.[304] However, both parties agreed that a comparable sales approach would produce the most accurate valuation.[305] The court held that the Service's value was to be used to value the gifts.[306]

In TAM 96-37-006,[307] the executor filed the federal estate tax return for the decedent's estate and elected to value the assets on the alternate valuation date, six months after the date of death.[308] One of the estate assets consisted of the right to receive annual lottery payments for sixteen years.[309] The decedent died before

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291. *See id.* at 302.
292. *See id.* at 303.
293. *See id.* at 312.
294. *See id.*
295. Wrona v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,227, at 84,231 (Fed. Cir. 1996).
296. *See id.*
297. *See id.* at 84,232.
298. *See id.*
299. *See id.*
300. *See id.* at 84,233.
301. 96-1 U.S. Tax Cas. (CCH) ¶ 60,229, at 84,237 (Bankr. M.D. Fla. 1996).
302. *See id.*
303. *See id.* at 84,238.
304. *See id.*
305. *See id.*
306. *See id.*
307. Tech. Adv. Mem. 96-37-006 (May 10, 1996).
308. *See id.*
309. *See id.*

receiving the first payment which was received within the alternate valuation period.[310] As of the date of the decedent's death, the applicable federal rate was 8.4%, and at the alternate valuation date six months later, the applicable federal rate was 9.4%.[311] The estate valued the decedent's interest in the lottery payments as of the date of death, but adjusted this value by using the factor based on the applicable federal rate of 9.4%.[312] The Service ruled that the lottery winnings represented the right to receive a fixed dollar amount annually for a defined period of time and constituted an interest whose value is effected by mere lapse of time.[313] However, the Service ruled that a change in interest rates is not a change due to a mere lapse of time and that the estate had properly valued the interest as of the date of the decedent's death with the adjustment for the difference in its value as of the alternate valuation date because of the change in the applicable federal rate.[314] In essence, this means that lottery winnings should be valued in the same manner as an annuity.[315]

In *Estate of Williamson v. Commissioner*,[316] the Service issued a statutory notice of deficiency to the decedent's estate more than three years after the estate tax return was filed.[317] Attached to the Form 709 was a request for an extension of time with an explanatory statement that because of a dispute with the surviving spouse, the estate was unable to list and value the items of the estate.[318] This, the court held, gave the Service adequate notification of the estate's failure to itemize and value specific items of the decedent's gross estate.[319] As such, the six-year statute of limitations applicable to an estate tax return that omits items from the gross estate exceeding 25% of the gross estate reported on the estate tax return did not control.[320]

V. FEDERAL ESTATE TAX MARITAL DEDUCTION PLANNING AND DRAFTING

A. *Tax Formulas*

In PLR 96-34-011,[321] the decedent died survived by his spouse.[322] The decedent's will provided that the residue of his estate would be held in three separate

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310. *See id.*
311. *See id.*
312. *See id.*
313. *See id.*
314. *See id.*
315. *See id.*
316. 1996 T.C.M. (RIA) ¶ 96,426, at 2993.
317. *See id.*
318. *See id.* at 2994.
319. *See id.* at 2995.
320. *See id.* at 2996. *See, e.g.,* I.R.C. § 6501(e)(2)(1994).
321. Priv. Ltr. Rul. 96-34-011 (May 20, 1996).
322. *See id.*

trusts: an exempt GSTT trust, a nonexempt GSTT trust, and a residuary trust.[323] The will defined the "marital amount" as the minimum amount necessary to reduce the federal estate tax on the estate to zero or to the lowest possible amount of federal estate tax if federal estate tax could not be reduced to zero.[324] The marital amount was to be divided into two separate marital trusts: an exempt GSTT trust and a nonexempt GSTT trust.[325]

The exempt GSTT trust was to be funded with a fraction of the marital amount, the numerator of which was the GSTT exemption available to the decedent at the date of death, reduced by the smallest amount of the exemption which, if allocated to the specific pecuniary bequests made to the decedent's grandchildren and the residuary trust, would except the specific pecuniary bequests and the residuary trust from the GSTT to the maximum extent possible.[326] The denominator of the fraction was the marital amount.[327]

The balance of the marital amount remaining after the exempt GSTT trust was funded by this fraction of the marital amount funded the nonexempt GSTT trust.[328] The balance of the estate remaining after the marital amount was used to fund the exempt GSTT trust and the nonexempt GSTT trust would fund the residuary trust.[329]

The estate filed an estate tax return and elected QTIP treatment for the exempt GSTT trust and the nonexempt GSTT trust.[330] The executor allocated $400,000 of the decedent's GSTT exemption to the exempt GSTT trust and allocated $540,000 of the decedent's GSTT exemption to the residuary trust.[331]

A reverse QTIP election was not made on Schedule R.[332] The Service ruled that good cause existed for granting the estate an extension of time to make a reverse QTIP election.[333]

In *Estate of Swallen v. Commissioner*,[334] the Sixth Circuit Court of Appeals reversed the Tax Court in holding that the executors of the decedent's estate acted properly when they paid the estate tax solely from funds of a trust established by the decedent rather than allocating a portion of the tax burden to the residue of the estate

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323. *See id.*
324. *See id.*
325. *See id.*
326. *See id.*
327. *See id.*
328. *See id.*
329. *See id.*
330. *See id.*
331. *See id.*
332. *See id.*
333. *See id.; see also* Priv. Ltr. Ruls. 96-41-013 (July 2, 1996) and 96-41-014 (July 2, 1996). In each of these rulings, the Service acted in accordance with its discretionary authority under Treas. Reg. § 301.9100-1 (1996) and found that good cause for granting an extension of time to elect reverse QTIP treatment under I.R.C. § 2652(a)(3) existed for the portion of an estate passing to a surviving spouse.
334. Estate of Swallen v. Commissioner, 98 F.3d 919 (6th Cir. 1996).

passing to the surviving spouse in accordance with the Ohio apportionment statute.[335] The court ruled that the decedent's will did not express intent to avoid the state apportionment statute.[336]

The decedent created an inter vivos trust in 1972, reserving the income and principal for life, with the surviving spouse having the right to receive the income and principal as needed during life.[337] Upon the surviving spouse's death, the trust was to be distributed according to its terms.[338]

The decedent executed her will on December 20, 1985, declaring that the residue of her estate was to pass to her husband.[339] The executors filed a federal estate tax return indicating that the taxable portion of the estate consisted solely of the decedent's interest in the trust.[340] The estate took a marital deduction for the value of the residue passing to the surviving spouse.[341] The federal estate tax due in the decedent's estate was paid solely from the trust funds.[342] The executors allocated none of the tax burden to the residuary passing to the surviving spouse.[343] The executors argued that this apportionment of the estate tax burden was required by the Ohio apportionment statute.[344] The Service issued a notice of deficiency, contending instead that the estate tax should have been paid with funds from the residue in accordance with the will.[345] The executors filed the will construction action in the probate court, and the probate court adopted a referees report concluding that the executors had acted properly in apportioning the estate tax according to the Ohio apportionment statute.[346] The Sixth Circuit agreed, noting that the decedent's will did not express a clear intent to burden the residue with taxes.[347] Instead, the court held that the decedent's real intent was expressed in the section of the will that granted the executor the powers to minimize the combined tax burden of the decedent's estate and the estate of the decedent's husband.[348] The fact that the decedent's will did not specify that taxes should be paid from the trust was irrelevant according to the court because "Ohio law . . . requires . . . clear intent to avoid . . . statutory apportionment."[349]

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335. *See id.*
336. *See id.* at 924.
337. *See id.* at 920-21.
338. *See id.* at 921.
339. *See id.*
340. *See id.*
341. *See id.*
342. *See id.*
343. *See id.*
344. *See id.*
345. *See id.*
346. *See id.*
347. *See id.* at 924.
348. *See id.* at 925.
349. *Id.*

B. *Marital Deduction Trusts and Credit Shelter Arrangements*

1. *Administration Expenses*

Under the facts of PLR 96-17-003,[350] the decedent's estate included an inter vivos trust which became irrevocable on the decedent's death.[351] Upon the decedent's death, the trust passed to the surviving spouse and was split into two trusts, a marital GSTT exemption trust and a marital share trust.[352] The decedent's will bequeathed an amount of trust property equal to the GSTT exemption amount to the GSTT trust, with the residue passing to the marital trust.[353] The decedent's will provided that estate, inheritance and other taxes, all debts, funeral expenses, last illness expenses, and administrative expenses were to be paid from trust principal except to the extent the executor elected to pay such expenses from trust income generated during the time between the decedent's death and the distribution to the two trusts, but only if such election did not diminish the marital deduction.[354]

The Service cited *Estate of Street v. Commissioner*,[355] for the rule that all estate expenses are considered to have accrued as of the decedent's date of death.[356] Thus, such expenses diminish the estate before any bequests are satisfied, regardless of whether the expenses are paid from estate property or income from estate property.[357] The Service ruled that the marital GSTT trust was not reduced by the expenses because that trust was funded with a specific bequest.[358] However, because the marital trust received the residue of the trust property, the expenses, whether paid from principal or income, reduce the amount of the estate passing to the surviving spouse and, hence, the size of the marital deduction.[359]

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350. Priv. Ltr. Rul. 96-17-003 (Jan. 3, 1996).
351. *See id.*
352. *See id.*
353. *See id.*
354. *See id.*
355. Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992).
356. *See supra* note 350.
357. *See id.*
358. *See id.*
359. *See id.* The U.S. Supreme Court granted certiorari on April 29, 1996, in *Estate of Hubert v. Commissioner*, 63 F.3d 1083 (11th Cir. 1995), *aff'g*101 T.C. 314 (1993), which conflicted with *Estate of Street* and *Burke v. United States,* 994 F.2d 1576 (Fed. Cir. 1993) *cert. denied*, 114 S. Ct. 546 (1993) on the issue involved in Priv. Ltr. Rul. 96-17-003.

The Supreme Court heard oral arguments in the *Hubert* case on Nov. 12, 1996. The Service argued that the amount the beneficiary receives should be reduced by administrative expenses, even when they come out of income, and that the marital or charitable deduction should be correspondingly reduced and the size of the taxable estate increased. Several justices took a dim view of the Service's argument.

In *Estate of Sobota v. Commissioner*,[360] the decedent's will devised the decedent's entire estate to the surviving spouse and provided that all expenses and debts be paid from the residuary estate.[361] The estate paid the executor $62,000 as a personal representative's fee.[362] The estate realized more than $105,000 in income during its administration.[363] The estate argued that the income was part of the residue of the estate and that the fee could be charged against that income.[364] The court disagreed, and held that under local law (Wisconsin), the estate income was not part of the residuary.[365] As a result, the executor's fee was chargeable against the property passing to the surviving spouse and diminished the amount available for the marital deduction.[366]

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360. 1996 T.C.M. (RIA) ¶ 96,294, at 2040.
361. *See id.*
362. *See id.*
363. *See id.* at 2042.
364. *See id.*
365. *See id.*
366. *See id.* As such, the court determined that the case was clearly distinguishable from *Estate of Hubert v. Commissioner*, *see supra* note 359, and that it was not necessary to await the U.S. Supreme Court's decision in *Hubert.*

2. *"Stub" Income*

Perhaps the most significant marital deduction drafting development during 1996 was *Estate of Clack v. Commissioner*.[367] In *Clack*, the decedent's will created a marital trust for his wife.[368] The will required the trustee to pay the net income of the trust to the surviving spouse in "convenient installments at least quarterly."[369] Accrued, but unpaid income at the time of the surviving spouse's death was to be paid to the surviving spouse's estate.[370] The trustee had discretion to appoint trust principal to the surviving spouse and, upon her death, the trust principal was to be added to a family trust created under the decedent's will.[371] The will stated that the executor could elect QTIP treatment for part or all of the marital trust and that any part for which the QTIP election was not made would go into the family trust.[372] The trustee of the family trust had discretion to distribute its income to the surviving spouse and the couple's children.[373]

The executor elected QTIP treatment for the entire marital trust.[374] The Service disallowed the deduction because the trust was subject to the executor's power to appoint trust corpus to someone other than the surviving spouse.[375] The Tax Court held that the entire interest qualified for QTIP treatment.[376] This is contrary to previous Tax Court opinions holding that no QTIP marital deduction would be allowed where the surviving spouse's income interest was contingent on the executor making the QTIP election.[377]

In *Estate of Shelfer v. Commissioner*,[378] a case of first impression in the Eleventh Circuit, the court held that a testamentary trust giving a surviving spouse an income interest for life but not entitling her to receive or appoint trust income

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367. Estate of Clack v. Commissioner, 106 T.C. 131 (1996).
368. *See id.* at 132.
369. *See id.* at 134.
370. *See id.*
371. *See id.*
372. *See id.* at 134-35.
373. *See id.* at 135.
374. *See id.*
375. *See id.* at 136-37.
376. *See id.* at 141.
377. The Tax Court's decision does not invalidate Treas. Reg. § 20.2056(b)-7(d)(3), which denies a QTIP election for a surviving spouse's income interest that is contingent upon the executor's QTIP election. This regulation applies to estates of decedents dying after March 1, 1994, and was not in issue in *Clack* or the circuit court cases mentioned above. Thus, unless the Service withdraws this regulation, practitioners should be cognizant that there is a risk that a QTIP marital deduction that is contingent upon an executor's election will not be allowed or at least will be challenged in cases where the decedent died after March 1, 1994. The Office of Chief Counsel has recommended acquiescence in the result of *Clack* for estates of decedents dying before March 1, 1994, if the QTIP election is properly made. Action on Decision 1996-011 (July 15, 1996).
378. Estate of Shelfer v. Commissioner, 86 F.3d 1045 (11th Cir. 1996).

accruing between the last distribution date and her death (so-called "stub" income) was a qualified terminable interest property (QTIP) trust.[379] With this decision, the Eleventh Circuit joins the Ninth Circuit in holding that such stub income does not need to be paid to the surviving spouse, but rather may be paid to the beneficiaries of the trust and still be entitled to QTIP treatment.[380]

The decedent's will directed the creation of a trust comprised of two-thirds of his estate.[381] Trust income was to be paid to the surviving spouse in quarterly installments, except that the surviving spouse had no power of appointment over the income that accumulated between the date of last distribution to her and the date she died.[382] Upon the surviving spouse's death, the principal and undistributed income from the trust passed to the decedent's niece, as provided in the decedent's will.[383] The decedent's estate tax return claimed a marital deduction for approximately half of the trust's assets, which the estate treated as QTIP property under I.R.C. § 2056(b)(7). The Service allowed the deduction.[384] The surviving spouse died in 1989 (after the Service issued a closing letter with respect to the decedent's estate) and the trust property subject to the QTIP election on the predeceased spouse's return was not included in her gross estate.[385] The Service determined a deficiency of more than $1 million and asserted that the same percentage of the trust treated as QTIP on the decedent's estate tax return should have been included in the surviving spouse's gross estate.[386] The estate argued before the Tax Court that because the surviving spouse did not control the stub income, the assets were not includible under I.R.C. § 2044.[387] The Tax Court agreed with the estate and held that the trust was not a QTIP trust because neither the surviving spouse nor her estate had the right to the stub income.[388] The Eleventh Circuit reversed the Tax Court and held that the trust was a QTIP trust and that the phrase "all the income" in § 2056(b)(7)(B)(ii)(I) means all income "that has been distributed" during the surviving spouse's life so long as distributions are required at least annually.[389] While the court noted that the statute was ambiguous, it concluded that the history and purpose of the marital deduction and the QTIP trust provision supported the Service's construction.[390]

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379. *See id.* at 1053.

380. *See id. See, e.g.,* Estate of Howard v. Commissioner, 910 F.2d 633 (9th Cir. 1990), *rev'g* 91 T.C. 329 (1988).

381. *See id.* at 1046.

382. *See id.*

383. *See id.*

384. *See id.*

385. *See id.*

386. *See id.*

387. *See id.* at 1047.

388. *See id.*

389. *See id.*

390. *See id.* Treas. Reg. § 20.2056(b)-7(d)(4) applies to estates of decedents dying after March 1, 1994, and specifies that an income interest can qualify for QTIP treatment even if the stub income is

3. *Executor's Power to Fund QTIP Trust*

In *Mathis v. United States*,[391] the decedent established an inter vivos trust that created a QTIP trust for the decedent's surviving spouse upon the decedent's death.[392] The trust gave the executor or trustee the discretion to determine the amount of trust property to include in the QTIP trust.[393] The Service argued that the trustee had a power of appointment over the trust that disqualified the trust as QTIP.[394] The court rejected the Service's argument and cited cases from the Fifth, Sixth and Eighth Circuits, which held that the power of an executor to determine how much property to transfer to a trust does not disqualify the trust as QTIP.[395]

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not required to be distributed to the surviving spouse or the surviving spouse's estate. However, the regulation requires any undistributed stub income to be included in the spouse's estate.

391. Mathis v. United States, 917 F. Supp. 595 (N.D. Ind. 1996).

392. *See id.* at 597.

393. *See id.*

394. *See id.*

395. *See id.* at 600. *See* Estate of Spencer v. Commissioner, 43 F.3d 226 (6th Cir. 1995); Estate of Robertson v. Commissioner, 15 F.3d 779 (8th Cir. 1994); Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992).

4. *Extension of Time to Make QTIP Election*

Several Service rulings involved the issue of whether an estate had shown good cause for a grant of a reasonable extension of time for making a QTIP or reverse QTIP election.[396]

5. *Eligibility for the Marital Deduction*

In *Roels v. United States*,[397] the decedent's will bequeathed the residuary estate to his surviving spouse, as trustee of a testamentary trust.[398] The will required the trustee to pay the surviving spouse the entire net income of the trust until the surviving spouse died or remarried.[399] Upon either of those events, the trustee was to distribute the balance of the trust to four charities designated in the will.[400] The trust did not provide the surviving spouse any power of appointment, and the trust was not a qualified unitrust, annuity trust, or pooled income fund.[401] On the estate

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396. Priv. Ltr. Rul. 96-37-012 (June 6, 1996). In this PLR the executor failed to make a reverse QTIP election on Schedule R, but subsequently filed a supplemental Schedule R properly signifying the election. *See id.* The Service granted the executor an extension of time to make the reverse QTIP election, noting that the executor showed good cause for the receipt of an extension of time and that the other requirements of Treas. Reg. § 301.9100-1 had been satisfied. *See id.* However, the Service ruled that the extension of time did not apply to the allocation of any remaining GST tax exemption. *See id.*

In Priv. Ltr. Rul. 96-37-009 (May 24, 1996), the executor reported the full value of the decedent's marital trust property on Schedule M and claimed a marital deduction as to those assets. *See id.* However, the executor failed to make a QTIP election. *See id.* The executor subsequently filed an amended Schedule M properly signifying the election. *See id.* The Service granted the estate an extension of time to make the QTIP election noting at the time the return was filed the executor had the requisite intent to make the election and that the estate satisfied all other requirements for receiving an extension. *See id.*

In Priv. Ltr. Rul. 96-29-011 (Apr. 18, 1996), the decedent's will provided for a marital trust and a residuary trust. *See id.* The estate tax return was filed before its due date and claimed a marital deduction for the property passing outright to the surviving spouse. *See id.* No election was made to treat the amount passing to the residuary trust as QTIP property under I.R.C. § 2056(b)(7). *See id.* As a result of later litigation and a settlement agreement, the estate filed an amended estate tax return and an amended Schedule M that contained a QTIP election on the property in the residuary trust. *See id.* The Service ruled that the estate had shown good cause for the granting of an extension of time to elect QTIP treatment for the residuary trust. *See id.*

In Priv. Ltr. Rul. 96-26-037 (Apr. 2, 1996), the decedent's estate timely filed an estate tax return and claimed a marital deduction on Schedule M for a trust that otherwise qualified under I.R.C. § 2056(b)(7). *See id.* In claiming the deduction, the executor deducted the value of the trust. *See id.* However, the filed return contained a statement inconsistent with the intent to make a QTIP election for the trust. *See id.* The executor subsequently filed an amended Schedule M properly electing QTIP treatment. *See id.* The Service determined that the estate had shown good cause for a grant of a reasonable extension of time for making the QTIP election. *See id.*

397. Roels v. United States, 928 F. Supp. 812 (E.D. Wis. 1996).

398. *See id.* at 814.

399. *See id.*

400. *See id.*

401. *See id.*

tax return, no marital deduction was claimed, nor was a charitable deduction claimed for any residual value of the trust.[402] However, on an amended estate tax return, the estate claimed a marital deduction for the full value of the residue and remainder of the decedent's estate which was bequeathed to the trust and sought an estate tax refund.[403] The estate did not claim any charitable deduction in the original or the amended return.[404] The Service disallowed any marital deduction.[405]

The court held that the estate was not entitled to a marital deduction because the interest that passed to the decedent's surviving spouse was a terminable interest.[406] The court held that the QTIP exception to the terminable interest rule did not apply because the estate did not make the QTIP election on either return and the surviving spouse's life estate was contingent upon her not remarrying.[407] The court also held that the exception for a charitable remainder trust did not apply because the charitable remainder of the trust was not determinable.[408] While the estate argued that the decedent's assets would only go to the surviving spouse or a qualifying charity, the court held that there was no support in the legislative history for the estate's proposition that a deduction is allowable where there is an income interest in the spouse for life and a remainder interest in charity.[409]

Under the facts of PLR 96-34-020,[410] the decedent, a resident of Texas, died in 1995 survived by his wife.[411] The decedent's 1967 will established a trust for his wife to be funded with the entire residue of his estate, including his community and separate property.[412] The trust was to continue for ten years from the date of the decedent's death, distributing $1,250 per month to the surviving spouse.[413] In addition, the trustee was authorized to distribute sums in excess of the $1,250 per month to the surviving spouse if such sums were necessary for her support or welfare.[414] At the end of the ten-year term, the trust would terminate and distribute its remaining assets to the surviving spouse.[415]

The decedent amended his will in 1976 to change the monthly sum payable to the surviving spouse to $2,500 and to change the trust's term to terminate the trust when the surviving spouse reached age fifty, but in no event could termination occur

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402. *See id.*
403. *See id.*
404. *See id.*
405. *See id.*
406. *See id.* at 814-15.
407. *See id.* at 815.
408. *See id.*
409. *See id.*
410. Priv. Ltr. Rul. 96-34-020 (May 24, 1996).
411. *See id.*
412. *See id.*
413. *See id.*
414. *See id.*
415. *See id.*

earlier than ten years from the date of the decedent's death.[416] The surviving spouse was over age fifty when the decedent died.[417] Thus, the trust would terminate on the tenth anniversary of the decedent's death.[418]

The Service ruled that under Texas law, if the surviving spouse died before the ten-year term of the trust that the trust's corpus and accumulated income would pass to the surviving spouse's estate.[419] As such, the trust qualified for the marital deduction.[420]

The Service ruled in TAM 96-44-001[421] that property passing to a revocable trust was not eligible for an estate tax marital deduction.[422] A husband and wife executed joint inter vivos revocable trusts.[423] Each spouse also executed individual wills pouring over the residue of their probate estates to the trust, and retained the right to alter, amend, or revoke the trust while competent.[424] Upon the death of a spouse, part of the property passed to trust A, which provided that income "may be paid" to the surviving spouse.[425] Trust A also gave the surviving spouse the power to withdraw all trust assets, but this right terminated if the spouse was declared incompetent.[426] Trust A also provided that after the death or incompetency of the surviving spouse, all trust property was to be distributed as the surviving spouse designated by will.[427] Any undistributed portion would pass to the couples' children.[428]

The Service determined that the interest passing to the surviving spouse was not QTIP property because the surviving spouse was not entitled for life to all of the trust income.[429] Instead, the trust provided that the trustee "may" pay trust A income to the spouse.[430] In addition, the spouse's right to receive trust income terminated upon the spouse's incompetency. Thus, the trust was subject to termination during the spouse's life.[431] Likewise, the power of appointment granted to the spouse did

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416. *See id.*

417. *See id.*

418. *See id.*

419. *See id.* The Service reasoned that the interest of the trust devised to the surviving spouse was an interest passing from the decedent within the meaning of I.R.C. § 2056(c) and "not a nondeductible terminable interest within the meaning of I.R.C. § 2056(b)(1) because no interest in the trust passed from the decedent to any person other than the surviving spouse or her estate." *Id.*

420. *See id.*

421. Tech. Adv. Mem. 96-44-001 (July 3, 1996).

422. *See id.*

423. *See id.*

424. *See id.*

425. *See id.*

426. *See id.*

427. *See id.*

428. *See id.*

429. *See id.*

430. *See id.*

431. *See id.*

not satisfy the income requirement because upon incompetency and failure to exercise the power, the trust corpus would be distributed to persons other than the spouse.[432] In any event, the power did not qualify because it would lapse if it was unexercised at the time of the spouse's incompetency.[433]

In TAM 96-23-002,[434] the decedent's holographic will devised the entire estate to the surviving spouse "to be used to maintain the family & educate our children."[435] The Service ruled that under Virginia law, the quoted language did not devise any specific interest in the estate to the decedent's children, but instead devised a fee simple interest in the property to the surviving spouse.[436] Therefore, the property was eligible for the marital deduction.[437]

In *Estate of Dowell v. Commissioner*,[438] the decedent's will devised stock to a daughter, but if the daughter failed to make installment payments to the surviving spouse, the stock would pass to the surviving spouse.[439] The decedent's daughter failed to pay for the stock pursuant to the terms of the decedent's will and codicil, and the stock passed to the surviving spouse.[440] The court held that the estate was not entitled to a marital deduction because the stock was inherited by the daughter subject to a condition subsequent.[441]

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432. *See id.*

433. *See id.* *See also*Tech. Adv. Mem. 96-45-006 (July 24, 1996), where the Service ruled that a joint trust in which the income payable to the surviving spouse could be withheld upon that spouse's incapacity did not qualify for the marital deduction as either a general power of appointment trust or QTIP trust. *See id.* The spouse was not entitled to all of the income for life. *See id.* Further, the power to withdraw principal was not exercisable in all events because the trustee could withhold property upon the spouse's incapacity. *See id.*

434. Tech. Adv. Mem. 96-23-002 (Feb. 7, 1996).

435. *See id.*

436. *See id.*

437. *See id.*

438. Estate of Dowell v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,491, at 3549.

439. *See id.*

440. *See id.*

441. *See id.* at 3558-59. The court also held that the decedent's deathbed cancellation of the daughter's obligation to make payments required under a stock purchase agreement constituted a taxable gift. *See id.* at 3559. The court found it immaterial whether the decedent had donative intent to make the gift, noting instead that donative intent is not a requirement for a taxable gift. *See id.* In addition, the court noted that a presumption exists that a transfer between closely related parties is a gift, and under Treas. Reg. § 25.2512-8, the amount of the gift equaled the debt because the evidence showed that no consideration was given for the cancellation of the indebtedness. *See id.*

VI. FEDERAL GIFT TAX

A. *Completion of Gift*

In Revenue Ruling 96-56,[442] the Service modified Revenue Ruling 67-396[443] and ruled that for federal estate and gift tax purposes, the delivery of a check to a non-charitable donee will be deemed to be complete on the earlier of the following: (1) the date the donor parts with dominion and control of the check under local law; or (2) the date the donee deposits (or cashes) the check or presents the check for payment.[444]

B. *Valuation of Gifts*

No major developments occurred in this area during the time period under review.[445]

C. *Marital Deduction*

Under the facts of PLR 96-06-008,[446] the taxpayer transferred closely-held corporate stock to a spouse.[447] The stock was subject to a buy-sell agreement. Under the agreement, the taxpayer and the corporation had a right of first refusal to repurchase the shares at fair market value if (1) the spouse decided to sell the shares; (2) the taxpayer and spouse divorced; or (3) the spouse died and did not devise the stock to the taxpayer.[448] The Service ruled that the stock transfer to the spouse qualified for the federal gift tax marital deduction.[449]

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442. Rev. Rul. 96-56, 1996-50 I.R.B. 7.

443. Rev. Rul. 67-396, 1967-2 C.B. 351.

444. *See supra* note 442.

445. However, in early 1995 the Tax Court decided *Estate of Trenchard v. Commissioner*, 1995 T.C.M. (RIA) ¶ 95,121, at 743, where a husband and wife transferred their interests in Illinois farm property to their daughter and her children. *See id.* at 745. The transferees organized a corporation and transferred the real estate into the corporation. *See id.* at 745-46. The husband and wife received debentures and voting preferred stock sufficient enough to give then voting control in return for their contribution of real estate to the corporation. *See id.* The transferees received common stock and debentures. *See id.* The value of the stock received in return for the real estate contributed to the corporation was less than the fair market value of the real estate at the time of the transfer to the corporation. *See id.* at 746. The estate argued that the transfer was not a gift because the husband and wife were entitled to a control premium for their control of the corporation. *See id.* at 749. The estate argued for a 138% control premium, but the court allowed only 40%. *See id.* at 754-56. A gift resulted to the extent of the difference. *See id.*at 757-58.

446. Priv. Ltr. Rul. 96-06-008 (Nov. 9, 1995).

447. *See id.*

448. *See id.*

449. *See id.*

D. *Trusts*

1. *Annual Exclusion Gifts*

The question of whether contributions to an irrevocable trust would qualify for the present interest annual exclusion under I.R.C. § 2503 was presented in PLR 96-25-031.[450] The taxpayers proposed to establish an irrevocable trust and name their adult child as the primary beneficiary.[451] The taxpayers intended to transfer to the trust nonvoting stock of corporations which had elected, or intended to elect S corporate status.[452] The taxpayers would retain no right to alter, amend, revoke, or terminate the trust.[453] The terms of the trust would give the primary beneficiary a withdrawal power exercisable through a written instrument delivered to the trustees within sixty days after receipt of the contribution or transfer, but not later than the last day of the calendar year in which the contribution or transfer was made.[454]

The Service ruled that the annual exclusion would be available because the beneficiary was granted an adequate time following notice in which to exercise the withdrawal right and, upon any withdrawal, the beneficiary would have the immediate and unrestricted right to the amount of the contribution or transfer to the trust.[455] The court also held that because the adult beneficiary would be considered the owner of the entire trust under the terms of the trust for purposes of I.R.C. § 671, the trust would be a permitted S corporation shareholder.[456] The Service also ruled that the trust property would not be includible in the taxpayers' gross estates.[457]

In TAM 96-28-004,[458] the taxpayer established three irrevocable trusts, only two of which were at issue in this ruling.[459] In both trusts, a child of the taxpayer was the primary beneficiary and one of the three co-trustees, all of which were the taxpayer's children.[460] The trusts granted the taxpayer's grandchildren, their

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450. Priv. Ltr. Rul. 96-25-031 (Mar. 21, 1996).
451. *See id.*
452. *See id.*
453. *See id.*
454. *See id.*
455. *See id.*
456. *See id.*
457. *See id.* The Small Business Job Protection Act of 1996, Pub. L. 104-188 (signed into law on Aug. 20, 1996, and effective for tax years beginning after 12/31/96), allows stock in an S corporation to be held by "electing small business trusts." To qualify for this treatment, all beneficiaries must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. Interests in the trust must be acquired either by gift or bequest. Each potential current trust beneficiary counts as a shareholder for purposes of the seventy-five shareholder limitation (up from thirty-five under previous law). Act § 1302, *amending* I.R.C. § 1361(c)(2)(A) (1994).
458. Tech. Adv. Mem. 96-28-004 (Apr. 1, 1996).
459. *See id.*
460. *See id.*

spouses and their issue the right to withdraw trust contributions by the end of each calendar year.[461] The trusts did not require the taxpayer or the trustees to notify the beneficiaries with withdrawal rights that any contributions were made.[462] In 1990, the taxpayer made contributions to the trusts on December 31, but the taxpayer's attorney sent letters notifying the beneficiaries of the contributions on December 27.[463] Banking rules prohibited crediting the trusts' accounts until January 2, 1991.[464] On December 10, 1991, the taxpayer's attorney sent letters to the beneficiaries that contributions to the trusts were made.[465] However, not until December 31, 1991, was a check dated December 26, 1991, deposited in the trusts' account.[466] The Service ruled that the taxpayer was not entitled to a gift tax exclusion amount for contributions to the trusts because the withdrawal rights were shams.[467] The failure of the taxpayer to make contributions within sufficient time to make the withdrawals indicated that the beneficiaries had agreed not to exercise the withdrawal rights.[468]

With Action on Decision (AOD) 1996-010,[469] the Office of Chief Counsel has recommended acquiescence in result only in the case of *Cristofani v. Commissioner*,[470] where the U.S. Tax Court held that a fifteen day unrestricted demand right given to each of decedent's grandchildren was a present interest in the corpus of a trust.[471] In *Cristofani*, the decedent created an irrevocable inter vivos trust to which she made annual contributions of property in each of the two years immediately preceding her death.[472] Her two children were the primary beneficiaries and her five minor grandchildren were contingent beneficiaries.[473] The trust provided that for fifteen days after decedent's contributions of property, each of the two primary and five secondary beneficiaries had an unrestricted right to withdraw an amount not to exceed $10,000.[474] The Service allowed the annual exclusions to the children but disallowed the exclusions attributable to the grandchildren's withdrawal rights on the ground that these rights did not constitute

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461. *See id.*
462. *See id.*
463. *See id.*
464. *See id.*
465. *See id.*
466. *See id.*
467. *See id.*
468. *See id.*
469. Cristofani v. Commissioner, 97 T.C. 74 (1991), *action on decision*, 1996-010 (July 15, 1996).
470. *See id.*, *acq. in result in part* 1992-1 C.B. 1.
471. *See id.* at 79.
472. *See id.* at 77.
473. *See id.* at 75.
474. *See id.*

gifts of present interests in property.[475] The Tax Court held that the fifteen day unrestricted demand right given to each of decedent's grandchildren was a present interest in the corpus of a trust, basing its decision on *Crummey v. Commissioner*.[476]

In *Estate of Greco v. Commissioner*,[477] the decedent made a gift in 1986 of an interest in real property held by the decedent as a tenant by the entirety with the decedent's spouse.[478] The Tax Court ruled that the gift was an adjusted taxable gift for purposes of computing the decedent's estate tax.[479] The court also held that no additional annual donee exclusions under I.R.C. § 2503(b), above those allowed by the Commissioner were available in respect of four donated remainder interests.[480]

2. *Split-Dollar Arrangements*

In PLR 96-36-033,[481] the Service ruled that the payment of life insurance policy premiums by the trustee of an irrevocable insurance trust and the spouse of the insured under a reverse split-dollar arrangement was not a gift to the trust by the spouse or the insured.[482] Under the terms of the split-dollar agreement, the trustee was designated the policy owner and paid that portion of the premiums equal to the lesser of the applicable amount set out in the P.S. 58 Tables and the current rates for one-year term life insurance available to standard risks of the insurance company.[483] The spouse paid the balance of any premiums due out of her own separate property.[484] If the agreement terminated before the insured's death, the spouse would receive the policy's cash value amount.[485] If the agreement terminated upon

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475. *See id.* at 77-78.

476. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). While the Service did not appeal *Cristofani*, it does disagree with the Tax Court's broad interpretation of *Crummey*. Accordingly, practitioners should expect the Service to continue to litigate cases with facts indicating that the substance of the transfers was merely to obtain annual exclusions and that no bona fide gift of a present interest was intended. For example, in Priv. Ltr. Rul. 95-32-001 (Apr. 12, 1995), "the decedent and spouse created a trust for the benefit of their nine grandchildren." *See id.* The trust terms provided that the grandchildren had a right of withdrawal over the initial contribution to the trust. *See id.* However, each of the grandchildren-beneficiaries signed statements on the date of trust creation waiving their right to withdraw the initial gift and receive any further notices regarding their right of withdrawal as to future gifts. *See id.* The Service ruled that all transfers to the trust after the initial transfer were transfers of a future interest that did not qualify for the present interest annual exclusion. *See id.* Thus, all of the procedures that accompany *Crummey* trusts must be followed. *See id.* While it may seem like an unnecessary hassle to send the annual notices, the Service requires that they be sent. *See id.*

477. Estate of Greco v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,373, at 2623.

478. *See id.* at 2624.

479. *See id.*

480. *See id.*

481. Priv. Ltr. Rul. 96-36-033 (Mar. 12, 1996).

482. *See id.*

483. *See id.*

484. *See id.*

485. *See id.*

the insured's death, the spouse would receive an amount equal to the greater of the policy's cash value immediately before the insured's death and the amount of premiums the spouse paid.[486]

The insured did not retain any incidents of ownership in the policy.[487] While the trustee purchased the policy with the insured's funds, the insured retained no interest or powers over the trust.[488] In addition, neither the insured nor his spouse could serve as trustee, and the independent trustee exercised all discretion regarding income and principal distributions to the insured's issue.[489]

E. *Disclaimers*

Under the facts of PLR 96-12-002,[490] the decedent died within nine months after the death of the decedent's spouse.[491] The decedent and spouse owned a bank account and certificates of deposit in tenancy-by-the-entirety.[492] The decedent's executor filed a written disclaimer of half of the funds in the account and half of the certificates of deposit within nine months after the death of the spouse.[493] The Service noted that, under Pennsylvania law, joint accounts and certificates of deposit held in tenancy-by-the-entirety "belong to the joint tenants during their joint lifetimes in proportion to each tenant's contribution to the funds on deposit."[494] The survivorship interest is created on the first joint tenant's death.[495] Before death, each joint tenant could unilaterally withdraw the 50% portion attributable to such tenant's contribution. As a result, the disclaimers were effective.[496]

In TAM 96-10-004,[497] the decedent was survived by a spouse, two children and six grandchildren.[498] Under the terms of the decedent's will, the spouse received the personal property, with the residue being divided between a pecuniary credit shelter and a residuary marital trust.[499] Under the terms of the marital trust, the spouse was entitled to the income for life and the trustee was given discretion to

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486. *See id.*
487. *See id.*
488. *See id.*
489. *See id.*
490. Priv. Ltr. Rul. 96-12-002 (Nov. 7, 1995).
491. *See id.*
492. *See id.*
493. *See id.*
494. *Id.*
495. *See id.*
496. *See id.* This ruling is contrary to the position the Service took in Priv. Ltr. Rul. 94-27-003 (Mar. 30, 1994), where the Service ruled that interests in tenancy by the entirety are not disclaimable by the surviving spouse.
497. Tech. Adv. Mem. 96-10-004 (Nov. 8, 1995).
498. *See id.*
499. *See id.*

make principal distributions for the spouse's support or maintenance.[500] The spouse also was given a "testamentary power to appoint all or part of the principal of the marital trust" among the two children and issue of the decedent and the surviving spouse.[501] Any unappointed principal was to be added to the principal of the credit shelter trust.[502] The trustee of the credit shelter trust had the discretion to make distributions of income and principal to the surviving spouse during life.[503] Upon the surviving spouse's death, any remaining income and principal was to be divided into equal shares for the two children.[504] If the children predeceased the surviving spouse, that child's share was directed to pass to their respective issue.[505] If the children and all of their issue predeceased the surviving spouse, the remaining income and principal was to pass to the decedent's heirs.[506]

"Under local law (Virginia), the real and personal property of a person, who dies intestate and is survived by a spouse passes entirely to . . . surviving spouse unless the decedent is survived by a child or children who are *not* descendants of the surviving spouse."[507] The surviving spouse and two children filed a petition in the local court requesting authority to withhold the decedent's will from probate and to administer the estate as if the decedent had died intestate.[508] The court granted the petition, and the decedent's estate claimed a marital deduction for the entire amount of the adjusted gross estate.[509]

The Service ruled that the estate would not be entitled to a marital deduction because the property did not pass from the decedent to the surviving spouse, but rather passed to the surviving spouse by virtue of the agreement and the petition granted by the local court.[510]

The estate also claimed that the agreement between the surviving spouse and the children not to probate the decedent's will constituted a qualified disclaimer of the children's interests resulting in a marital deduction for the entire property passing

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500. *See id.*
501. *Id.*
502. *See id.*
503. *See id.*
504. *See id.*
505. *See id.*
506. *See id.*
507. *Id.*
508. *See id.*
509. *See id.*
510. *See id.* The Service noted that Treas. Reg. § 20.2056(c)-2(d)(2) requires that property is regarded as having passed from the decedent to the surviving spouse only if an assignment or surrender is a bona fide recognition of the surviving spouse's enforceable rights in the decedent's estate. Here, the Service reasoned, the assignment was pursuant to a decree rendered by consent or pursuant to an agreement not to contest the will or not to probate the will. The Service noted that there was no indication of the conflict among the parties to the agreement that would result in adversarial proceedings and, as such, the agreement did not represent a compromise, bona fide or otherwise, between the parties that would constitute an arm's length negotiation.

to the surviving spouse.[511] The Service rejected this argument noting that under Virginia law a petition of a court to allow the decedent's estate to be administered as if the decedent had died intestate did not satisfy the requirements for valid a disclaimer.[512]

In *Estate of Delaune v. United States*,[513] the decedent-to-be, twelve days before death, instructed counsel to draw up a written disclaimer of a portion of the predeceased spouse's estate.[514] However, the decedent died before the disclaimer was written and executed.[515] The heirs of the predeceased spouse and the heirs of the decedent agreed to a division of the estates which was similar to the division that would have occurred had the decedent executed the disclaimer.[516] The agreement was submitted to court and signed by the heirs' attorneys and some of the heirs.[517] The court held that the agreement was not sufficient as a disclaimer because not all of the heirs signed the agreement and the agreement was not a disclaimer executed by the decedent's heirs for the decedent, but was an agreement for division of the estates.[518] The court also noted that the decedent had accepted benefits from the allegedly disclaimed property before the attempted disclaimer by virtue of a family member paying the decedent's living expenses out of a joint account containing funds that were the community property of the decedent and the pre-deceased spouse.[519]

Under the facts of PLR 96-25-033,[520] the decedent's will devised the entire estate to the decedent's two siblings.[521] Any remainder was to pass to the children of the siblings.[522] One sibling disclaimed any interest in the estate, causing the entire estate to pass to the other sibling.[523] The other sibling disclaimed a one-half

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511. *See id.*

512. *See id.* The Service also noted that the requirements of I.R.C. § 2518(c)(3) were not satisfied because the issue of the decedent's children alive at the decedent's death did not file a disclaimer or enter into the agreement to administer the estate as if the decedent had died intestate. Only if all issue of the decedent's children also had predeceased the decedent would the principal have passed to the surviving spouse as the decedent's heir.

513. Estate of Delaune v. United States, 96-1 U.S. Tax Cas. (CCH) ¶60,221, at 84,203 (M.D. La. 1996).

514. *See id.*

515. *See id.*

516. *See id.* at 84,203-204.

517. *See id.* at 84,204.

518. *See id.* at 84,205. The court also held that the portion of the estate that passed to the predeceased spouse's heirs was not an allowed claim against the decedent's estate because the predeceased spouse's heirs did not have an enforceable claim against the decedent's estate. *See id.* at 84,205.

519. *See id.*

520. Priv. Ltr. Rul. 96-25-033 (Mar. 22, 1996).

521. *See id.*

522. *See id.*

523. *See id.*

interest in the estate.[524] The disclaimed portion of the estate passed to the child who disclaimed any interest in the estate.[525] The ruling is silent as to whom the disclaimed property passed.[526] The Service ruled that the disclaimers were effective.[527]

In 1996, the Service issued a non-acquiescence in *Estate of Goree v. Commissioner*,[528] arguing that the Tax Court used the wrong standard of appellate review of the state court decision.[529] In *Goree*, a decedent's surviving spouse petitioned the court for protective orders for disclaimers by the decedent's minor children of their interests in the decedent's estate.[530] The court granted the orders and the disclaimers were filed, resulting in passage of the property to the surviving spouse.[531] The Service argued that the disclaimers were invalid under state law because the disclaimers were not in the children's best interest and would be reversed by the state appellate court.[532] The Tax Court held that the disclaimers were in the children's best interest because the disclaimers would result in larger inheritances and would keep the family corporation within the family.[533]

In PLR 96-29-023,[534] the decedent was survived by a spouse, one adult child and two minor grandchildren.[535] The decedent's estate consisted solely of a one-half community property interest in property that the decedent owned with the surviving spouse.[536] Under the terms of the decedent's will, $600,000 was left in trust to the surviving spouse as trustee for the two minor grandchildren.[537] The trust provided that if the two grandchildren died before becoming entitled to a complete distribution of the trust assets, the undistributed trust balance would be distributed to the decedent's adult child.[538] Upon the death of all of the decedent's issue, the trust was to be distributed to the decedent's heirs under state law.[539] The residue of the decedent's estate was devised to the adult child.[540] If the adult child did not survive

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524. *See id.*
525. *See id.*
526. *See id.*
527. *See id.*
528. Estate of Goree v. Commissioner, 1994 T.C.M. (RIA) ¶ 94,331, at 1814, *nonacq.*, 1996-10 I.R.B. 4.
529. *See id.*
530. *See id.* at 1820.
531. *See id.*
532. *See id.*
533. *See id.*
534. Priv. Ltr. Rul. 96-29-023 (Apr. 23, 1996).
535. *See id.*
536. *See id.*
537. *See id.*
538. *See id.*
539. *See id.*
540. *See id.*

the decedent or disclaimed his entire interest, the decedent's will provided that the residue was to be added to the trust for the minor grandchildren.[541]

A disclaimer was filed with the probate court within nine months of the decedent's death.[542] However, the adult child did not renounce his continued interest in the decedent's bequest of $600,000 to the surviving spouse as trustee of the trust for the minor children.[543] A guardian ad litem petitioned the court for permission to disclaim on behalf of the grandchildren and the unborn issue of the decedent's adult child as well as the grandchildren all of their interests in the residue of the decedent's estate passing under the will or through intestate succession.[544] However, the guardian ad litem did not disclaim their interests in the bequest of $600,000 to the surviving spouse as trustee of the grandchildren's trust.[545] The court authorized the disclaimers and the disclaimers were filed by the guardian ad litem within nine months of the decedent's death.[546] The child and grandchildren had not accepted any of the interests in or benefits of the disclaimed property, and the disclaimers were filed in compliance with state law.[547]

The Service ruled that the disclaimers by the adult child and the grandchildren all qualify under I.R.C. §§ 2046 and 2518.[548] Consequently, the residue of the decedent's estate would be deemed to pass directly from the decedent to the surviving spouse in a form qualified for the estate tax marital deduction.[549]

In TAM 96-40-005,[550] the spouses died within a short time of each other. The wife left the bulk of her estate to her husband.[551] The husband died before the

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541. *See id.*

542. *See id.*

543. *See id.*

544. *See id.*

545. *See id.*

546. *See id.*

547. *See id.*

548. *See id.*

549. *See id.* The Service has issued proposed regulations concerning the estate and gift tax treatment of disclaimers. The proposed regulations provide that (a) the application of I.R.C. § 2518 is not dependent on the actual imposition of a transfer tax when the interest to be disclaimed is created; (b) for joint property interests, if either joint tenant unilaterally severs the joint tenancy, the surviving joint tenant can disclaim the one-half survivorship interest in the property within nine months of the death of the first joint tenant. Any nonseverable joint tenancy interest must be disclaimed within nine months of the date of the tenancy's creation; (c) interests in joint bank accounts must be disclaimed within nine months of the first joint tenant's death. A surviving joint tenant cannot disclaim any portion of the account attributable to the survivor's contribution to the account. This rule applies even if only one-half of the property is included in the decedent's gross estate under I.R.C. § 2040(b) because the joint tenants are married. *See* Prop. Treas. Reg. §§ 20.2041-3(d)(6); 20.2046-1(a); 20-2056(d)-2(a), (b); 25.2511-1(c); 25.2514-3(c); 25.2518-1; 25.2518-2(c)(3); 25.2518-2(c)(4); 25.2518-2(c)(4)(iv); 25.2518-2(c)(5); 61 Fed. Reg. 43,197 (1996).

550. Tech. Adv. Mem. 96-40-005 (June 14, 1996).

551. *See id.*

final distribution of the wife's estate.[552] The wife's will provided that if the husband disclaimed any portion of the estate, the disclaimed portion would pass to a family residuary trust.[553] The trust would be held, during the husband's life, for the benefit of the husband and their child. On the decedent's death, the trust property was to be distributed to the child or the child's living descendants.[554]

The husband's estate claimed that the husband had made a qualified disclaimer of the property passing from his wife and submitted a ledger and probate court inventory that the decedent had prepared along with an unsigned letter prepared by an attorney four years before the wife's death.[555] The husband, as executor of the wife's estate, filed the inventory of her estate in the probate court.[556] The inventory listed all of the property by identification number and gave each item's stated value.[557] The attorney's letter to the couple explained that the family residuary trust also could be called a "disclaimer" trust and it advised the couple that the surviving spouse would have nine months after the deceased spouse's death to direct funds into the trust.[558] The Service concluded that the letter could not be construed as the decedent's unequivocable renunciation of property under I.R.C. § 2518, reasoning that the notations and items in the ledger evidenced only a compilation of the decedent's net worth.[559]

In a case with a Texas set of facts, inherited property was subject to a federal tax lien even though the heir executed a disclaimer of her interest in the property under Texas law.[560] Texas law provided that all of the estate had vested in devisees and legatees immediately upon the decedent's death.[561] Therefore, the heir had an interest in the property sufficient for the federal tax lien to attach.[562] Consequently, the state law disclaimer could not operate to prevent the attachment of the federal tax lien.[563]

In PLR 96-46-010,[564] the Service ruled that a surviving spouse's disclaimer of a percentage of a farm bequeathed to her was qualified.[565] The decedent died testate on February 20, 1996, survived by a spouse and two sons.[566] The decedent

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552. *See id.*
553. *See id.*
554. *See id.*
555. *See id.*
556. *See id.*
557. *See id.*
558. *See id.*
559. *See id.*
560. *In re* Estate of Leggett, 96-2 U.S. Tax Cas. (CCH) ¶ 60,249, at 86,596 (S.D. Tex. 1996).
561. *See id.* at 86,597.
562. *See id.* at 86,598.
563. *See id.*
564. Priv. Ltr. Rul. 96-46-010 (Aug. 12, 1996).
565. *See id.*
566. *See id.*

devised all of his probate estate and most of his nonprobate estate to the surviving spouse.[567] Under the terms of the will, if the surviving spouse pre-deceased the decedent or did not survive for thirty days, the residue of the estate would pass to a trustee to be held in trust for the benefit of one of the sons.[568]

To fully utilize the decedent's unified credit, the surviving spouse proposed to execute a disclaimer constituting of a percentage of the "home farm" based upon the value of the home farm as finally determined for federal estate tax purposes such that the remaining undisclaimed percentage of the home farm and the other undisclaimed assets passing to the surviving spouse by virtue of the decedent's death would be the smallest amount of assets that qualified for the estate tax marital deduction and resulted in the lowest federal estate tax being imposed upon the estate after allowing for the unified credit and other allowable credits.[569] The surviving spouse did not accept any benefits from the disclaimed property and the property passed without the surviving spouse's direction to the decedent's son under the will.[570] The undisclaimed property passing to the spouse outright qualified for the marital deduction, and maximum federal estate tax savings could be achieved.[571]

F. *Calculation of Gift Tax*

In TAM 96-42-001,[572] the Service ruled that when computing the federal gift tax, gifts made by a decedent before 1977 are taken into account in computing the gift tax payable for gifts made after 1976 that reduce the tentative estate tax.[573] Here the decedent made a taxable gift in 1976, before the unified rate structure became effective.[574] The decedent also made gifts in 1987 and in 1988.[575] The decedent computed her gift tax for 1987 by applying the unified rate schedule to the total of the 1987 and 1976 gifts to arrive at a tentative tax.[576] The decedent then subtracted the tax based on the unified rate schedule attributable to the 1976 gift from the tentative tax.[577] The decedent also calculated her 1988 gift tax in a similar fashion.[578] The decedent died in 1991 and the executor, on the estate tax return, took the pre-1976 gift into account in computing the amount of tax that would have

567. *See id.*
568. *See id.*
569. *See id.*
570. *See id.*
571. *See id.*
572. Tech. Adv. Mem. 96-42-001 (Nov. 30, 1994).
573. *See id.*
574. *See id.*
575. *See id.*
576. *See id.*
577. *See id.*
578. *See id.*

been payable for the 1987 and 1988 gifts.[579] This had the result of increasing the deduction from the tentative estate tax.[580] The Service ruled that the computation was proper.[581]

VII. GENERATION SKIPPING TRANSFER TAX

A. *Transfers Under a Power of Appointment*

In *Peterson Marital Trust v. Commissioner*,[582] the decedent held a lifetime income interest in an irrevocable marital trust established by the decedent's predeceased spouse in 1974.[583] The decedent also held a testamentary general power of appointment over the trust corpus, but did not exercise the power.[584] The trust corpus passed to the predeceased spouse's grandchildren.[585] The court held that the trust was subject to GSTT because the decedent's failure to exercise the general power of appointment was a constructive addition to the trust occurring after the effective date of the GSTT.[586] The court also held that the application of GSTT to the trust did not violate the due process clause of the U.S. Constitution because the tax resulted from the decedent's actions after enactment of GSTT, and did not violate the Equal Protection Clause because a rational basis supported application of the tax to the decedent's actions.[587]

In TAM 96-30-003,[588] the decedent died in 1966 with a will that established a marital trust that gave the surviving spouse a general testamentary power to appoint the corpus.[589] The spouse died in May 1993.[590] Under her 1982 will, the spouse exercised her general power of appointment to transfer the trust corpus equally to seven grandchildren and to one trust for an eighth grandchild.[591] The Service concluded that the GSTT applied to the transfers, stating that the facts were identical to those in *Peterson Marital Trust v. Commissioner*.[592] As in *Peterson Marital Trust*, the Service said, the trust is included in the spouse's gross estate under §

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579. *See id.*
580. *See id.*
581. *See id.*
582. Peterson Marital Trust v. Commissioner, 78 F.3d 795 (2d Cir. 1996), *aff'g* 102 T.C. 790 (1994).
583. *See id.* at 797
584. *See id.*
585. *See id.* at 799.
586. *See id.*
587. *See id.*
588. Tech. Adv. Mem. 96-30-003 (Apr. 16, 1996).
589. *See id.*
590. *See id.*
591. *See id.*
592. *See id.*

2041.[593] As such, the spouse became the transferor of the marital property for GSTT purposes.[594] Because the transfers to the grandchildren were direct skips, the GSTT applied.[595]

B. *Qualification for Grandfathered Exempt Status*

During 1996, the Service released numerous rulings concerning modifications to GSTT trusts, and whether such modifications rendered the particular trust ineligible for GSTT exempt status.[596]

One of the most significant tax case law development in 1996 was the Sixth Circuit's opinion in *Comerica Bank v. United States*.[597] In *Comerica Bank*, the residue of the decedent's estate passed to a pre-1990 trust for the benefit of the decedent's three grandchildren.[598] The trust provided that if any of the grandchildren died before receipt of the corpus that such child's interest would pass to his or her children or to his or her siblings.[599] The decedent's estate claimed that the transfers to the grandchildren qualified for the special pre-1990 $2 million per grandchild GSTT exemption, but the Service determined that the exemption did not apply because the transfers were contingent on the grandchildren surviving until actual receipt of the trust corpus.[600] The district court agreed and held that the trust language was unambiguous in creating a conditional interest in the surviving grandchildren.[601]

The Sixth Circuit reversed and held that the decedent's grandchildren acquired vested interests in the trust corpus as of the date of the decedent's death in 1987. As such, the $2 million exemption from GSTT for each grandchild applied.[602] The court noted that under I.R.C. § 2601, the GSTT would not apply if the trust assets were includible in the gross estate of a grandchild if such child died before the termination of the trust.[603] In addition, the court noted that under applicable state law (Michigan), only the clearest expression of a preference for delayed vesting should be affected.[604] However, the court found persuasive the fact that the trust

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593. *See id.*

594. *See id.*

595. *See id.*

596. *See* Priv. Ltr. Ruls. 96-52-009 (Sept. 9, 1996); 96-45-030 (Aug. 14, 1996); 96-44-055 (Aug. 1, 1996); 96-44-048 (Aug. 1, 1996); 96-44-025 (July 25, 1996); 96-42-007 (July 8, 1996); 96-39-015 (June 14, 1996); 96-35-039 (June 4, 1996); 96-30-032 (Apr. 30, 1996); 96-30-009 (Apr. 23, 1996); 96-19-047 (Feb. 7, 1996); 96-02-016 (Oct. 11, 1995).

597. Comerica Bank v. United States, 93 F.3d 225 (6th Cir. 1996).

598. *See id.* at 227.

599. *See id.*

600. *See id.*

601. *See id.*

602. *See id.* at 230.

603. *See id.*

604. *See id.* at 228-29.

instrument required annual reports to vested beneficiaries, and the court reasoned that if no vestiture occurred before distribution of trust corpus, the reporting requirement would not make sense.[605] As such, the court determined that an ambiguity existed as to whether the decedent meant that a grandchild who survived him would have a vested interest as soon as that grandchild had a right to receive part of the trust corpus, or whether the decedent meant that the grandchild's estate would lose any interest in the trust if the grandchild died before actual distribution.[606] The court concluded that, under Michigan law, the interest vested at the decedent's death.[607]

C. *Miscellaneous GSTT Developments*

In PLR 96-07-011,[608] the grantors created an irrevocable trust for their child.[609] The trust provided for the child to have a testamentary special power of appointment over the trust corpus exercisable in favor of the child's heirs or the grantors' heirs.[610] If the power of appointment was not exercised, the trust passed to the child's heirs, or if no heirs survive, to the grantors' heirs.[611] The trust could not be extended more than twenty-one years past the death of the last survivor of the heirs living as of the date of creation of the trust in December 1983.[612] The child executed a will which appointed the trust to separate trusts for the child's heirs.[613]

The Service ruled that the trust was not subject to GSTT because it was irrevocable before September 25, 1985 and because the power of appointment was not exercised in a manner that either extended the life of the trust more than twenty-one years after the death of a person living in December 1983 or constituted a constructive addition to the trust.[614]

In PLR 96-17-029,[615] the decedent's estate included the decedent's interest in an inter vivos trust which became irrevocable upon the decedent's death.[616] At the decedent's death, the trust was to be split into two trusts, one funded with a fraction of the estate equal to the amount of the GSTT exemption amount over the total trust value.[617] The other trust was to receive the remainder of the estate. The trustee funded the trusts with non-pro rata shares of the estate property, but the

605. *See id.* at229.
606. *See id.*
607. *See id.*
608. Priv. Ltr. Rul. 96-07-011 (Nov. 9, 1995).
609. *See id.*
610. *See id.*
611. *See id.*
612. *See id.*
613. *See id.*
614. *See id.*
615. Priv. Ltr. Rul. 96-17-029 (Jan. 26, 1996).
616. *See id.*
617. *See id.*

property chosen for each trust fairly represented the appreciation or depreciation occurring since the decedent's death.[618] The Service ruled that the second trust was eligible for the GSTT exemption and that the trust's inclusion ratio was zero.[619]

In PLR 96-29-014,[620] the decedent's will provided for a residuary trust to be divided into two parts in accordance with a formula.[621] Trust A contained an amount equal to the decedent's GSTT exemption remaining "after taking into account all allocations of such exemption made by the decedent or the decedent's executors to other transfers of which the decedent is the transferor."[622] Trust B contained the balance of the residuary estate.[623] The surviving spouse was entitled to discretionary payments of principal for her support and all of the net income from each subtrust for her life at least quarterly.[624] Eight months after the decedent's death, the surviving spouse disclaimed a power to appoint each subtrust to the decedent's lineal descendants.[625]

The decedent's estate claimed a deduction for the value of trust A and trust B and made a valid QTIP election for the value of property funding each trust. However, the estate failed to check the box to signify that a reverse QTIP election was being made for trust A.[626] However, the estate allocated $405,000 of the decedent's GSTT exemption to trust A.[627] The executor filed an amended Schedule R properly signifying that a reverse QTIP election was being made for trust A.[628]

The Service granted the estate an extension of time for making a reverse QTIP election, but noted that the extension did not extend the time for allocation of the GSTT exemption.[629] Consequently, the $405,000 amount that the estate reported as the value of trust A and on Schedule R as being the portion of the decedent's GSTT exemption allocated to trust A was irrevocable under I.R.C. § 2631.[630]

In PLR 96-41-030,[631] the decedent, before death, established a charitable remainder unitrust and partially funded it with stock.[632] The decedent completed funding of the charitable remainder unitrust in late 1985 with additional stock.[633]

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618. *See id.*
619. *See id.*
620. Priv. Ltr. Rul. 96-29-014 (Apr. 19, 1996).
621. *See id.*
622. *Id.*
623. *See id.*
624. *See id.*
625. *See id.*
626. *See id.*
627. *See id.*
628. *See id.*
629. *See id.*
630. *See id.*
631. Priv. Ltr. Rul. 96-41-030 (July 16, 1996).
632. *See id.*
633. *See id.*

The decedent filed a timely gift tax return reporting the transfers to the charitable remainder unitrust, but did not allocate any GSTT exemption.[634] The decedent died approximately nine years later.[635] During preparation of the estate tax return, the executor discovered the failure to allocate the decedent's GSTT exemption and filed a request for an extension of time to make the allocation.[636]

The Service reasoned that I.R.C. § 1433(b)(1) of the Tax Reform Act of 1986 did not otherwise prescribe a due date for an allocation of the generation skipping transfer tax exemption, which would be effective as of the date of transfer if the transfer was made after September 25, 1985, and before October 23, 1986, and a timely gift tax return was filed reporting the transfer before the enactment of the statute.[637] As such, the Service granted an extension of time pursuant to Treas. Reg. § 301.9100-1 to make an allocation effective as of December 17, 1985, of the decedent's remaining GSTT.[638]

VIII. ESTATE PLANNING AND LONG-TERM HEALTH CARE

A. *Trusts*

In a Minnesota case, *In re Kindt*,[639] the plaintiff suffered a brain injury that rendered him incompetent to manage his affairs and in need of constant medical care.[640] The plaintiff's former spouse was appointed guardian and received a settlement of approximately $1 million for the event causing the injury.[641] She petitioned the court to execute a settlement agreement in favor of her former spouse and their two children.[642] The court, as grantor, executed an agreement creating an irrevocable trust.[643] The trust specified that its express purpose would be "only to supplement other benefits received by or on behalf of" the plaintiff.[644]

After initially qualifying for public benefits, the plaintiff's benefits were terminated because his assets were deemed to exceed applicable program limits.[645] The plaintiff appealed the state agency's determination and argued that the trust could not be a Medicaid-qualifying trust because a court was grantor and, in any event, the trust terms prohibited the distribution of any amount that would render the

634. *See id.*
635. *See id.*
636. *See id.*
637. *See id.*
638. *See id.*
639. In re Kindt, 542 N.W.2d 391 (Minn. Ct. App. 1996).
640. *See id.*
641. *See id.*
642. *See id.*
643. *See id.*
644. *See id.*
645. *See id.* at 394.

plaintiff ineligible for public benefits.[646] The court rejected this argument, finding instead that the plaintiff was the grantor of the trust for Medicaid eligibility purposes.[647] The court noted that the trust was funded for the plaintiff's benefit in accordance with a plan devised by the guardian and sheltered assets for the plaintiff's children.[648] The court also ruled that the trustee had discretion to distribute any part of the trusts corpus in the absence of medical assistance.[649]

In *Allen v. Wessman*,[650] the decedent established and funded an irrevocable trust naming himself and his nephew as trustees.[651] The trust directed the trustees to pay the decedent income necessary for his support during his life.[652] Upon the decedent's death, income and principal was to be distributed to specified nephews and cousins.[653] The trust also contained language providing that the trustees could terminate the trust and distribute the principal according to the trust's terms if continuation of the trust is contrary to the best interests of the beneficiaries by reason of legislation.[654]

The North Dakota Supreme Court determined that the trustees had the discretion to make the full amount of the trust corpus available to the decedent by terminating the trust.[655] Consequently, the court ruled that all of the trust assets were available to the decedent for purposes of Medicaid eligibility.[656] Because the decedent gave the trustees the discretion to terminate the trust "by reason of legislation," the court determined that if the decedent needed long-term care that he was unable to pay for out of trust income or otherwise, and federal legislation made the decedent ineligible for Medicaid benefits to pay for his needed care, continuation

646. *See id.* at 396.

647. *See id.* at 397.

648. *See id.* at 399.

649. *See id.* at 393.

650. Allen v. Wessman, 542 N.W.2d 748 (N.D. 1996).

651. *See id.* at 750.

652. *See id.*

653. *See id.*

654. *See id.* at 752. The state Medicaid agency determined that the trust was an available asset. *See id.* at 751. A trial court disagreed, and ruled that the decedent could not receive any of the trust principal because the trustees could terminate the trust during the decedent's lifetime only if there was a substantial change in the legislation or if the trust assets dwindled to an extent that made the trust uneconomical or burdensome to continue. *See id.* The court also ruled that even if the trust were terminated, any undistributed income and principal would be unavailable to the decedent. *See id.* Shortly after the trial court decision, the trustees applied for Medicaid benefits on the decedent's behalf. *See id.* The state Medicaid agency again denied the application, and from that decision the decedent appealed. *See id.*

655. *See id.* at 754.

656. *See id.*

of the trust would be contrary to the decedent's best interests by reason of legislation.[657]

In *Arkansas Department of Human Services v. Wilson*,[658] the decedent executed an irrevocable trust that directed the trustee to distribute net income to the grantor.[659] The decedent contributed more than $20,000 to the trust's principal to be distributed to the decedent's nieces and nephews upon the decedent's death.[660] The decedent entered a nursing home and applied for Medicaid benefits.[661] Her application for long term care benefits was approved.[662] After the approval, the plaintiff notified the decedent that her benefits would be terminated because the trust principal was now being counted as a resource available for her care and maintenance.[663] A trial court ruled that the plaintiff's decision was arbitrary.[664] The plaintiff appealed, arguing instead that the decedent's trust was subject to an Arkansas statute stating that "[a] provision in a trust, which limits the availability of, or provides directly or indirectly for the suspension, termination, or diversion of the principal . . . in the event that the grantor or grantor's spouse should apply for medical assistance . . . shall be void as against public policy . . . without regard to the irrevocability of the trust . . . ."[665]

The Arkansas Supreme Court held that the statute did not disqualify the decedent from receiving Medicaid benefits because no provision in her trust made the unavailability of the principal contingent on an application for medical assistance.[666] Instead, the court determined that the trust limited the trustee's distribution power to income only and that this power was not altered depending upon the grantor's long-term care needs.[667] The court also determined that there was no evidence that the decedent's goal in establishing the trust was to shelter assets from Medicaid.[668]

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657. *See id.* at 753. In addition, the decedent's failure to specify who would receive the trust property if the trustees exercised their discretionary power to terminate the trust during his life caused the court to rule that the trustees would be deemed to hold the property for the decedent. *See id.*

658. Arkansas Dept. of Human Services v. Wilson, 913 S.W.2d 783 (Ark. 1996).

659. *See id.* at 784.

660. *See id.*

661. *See id.*

662. *See id.*

663. *See id.*

664. *See id.* at 783.

665. *Id.*; Ark. Code Ann. § 28-69-102(b) (Michie 1987).

666. *See id.* at 788.

667. *See id.*

668. *See id.*

B. *Estate Recovery*

In *In Re Estate of Cripe*,[669] the decedent died not survived by a spouse or any dependent children.[670] After the decedent's death, her estate was awarded a 50% interest by decree of heirship in a cousin's estate amounting to $103,712.[671] The decedent had received Medicaid benefits for seven years immediately preceding her death, and after the decedent's death the plaintiff filed a claim against her estate for $90,313.[672] The decedent's executors disallowed the claim, but a trial court approved the portion of the claim corresponding to Medicaid expenditures made on the decedent's behalf from the date of the cousin's death until the decedent's death.[673]

The plaintiff appealed, arguing for the application of a state statute providing that the total amount of medical assistance paid after a beneficiary attains age sixty-five is allowed as a preferred claim against the recipient's estate in favor of the state agency.[674] The decedent's estate relied on a similar statute providing that only benefits paid after a beneficiary came into possession of additional resources was recoverable from the recipient's estate.[675] Because the decedent's property interest in the cousin's estate did not arise until the cousin's death, the estate argued that the estate was only responsible for reimbursing the Medicaid payments made after the cousin's death.[676] The court rejected the estate's argument and held that the plaintiff was entitled to payment for its entire claim.[677]

C. *Miscellaneous Medicaid Developments*

In *Clark v. Iowa Department of Human Services*,[678] the community spouse sought and received a judgment and decree for separate maintenance in January of 1993.[679] The trial court ordered that the institutionalized spouse provide his entire pension to the community spouse as additional support.[680] As a result, Medicaid eligibility was achieved as of the judgment date.[681] However, a Qualified Domestic

669. In Re Estate of Cripe, 660 N.E.2d 1062 (Ind. Ct. App. 1996).
670. *See id.*
671. *See id.*
672. *See id.*
673. *See id.* at 1062-63.
674. *See id.* at 1063.
675. *See id.* at 1063-64.
676. *See id.* at 1064.
677. *See id.*
678. Clark v. Iowa Dep't. of Human Services, 555 N.W.2d 472 (Iowa 1996).
679. *See id.* at 473.
680. *See id.*
681. *See id.*

Relations Order (QDRO) was not filed until September 1993.[682] The defendant applied the "name on the check" rule to hold that the pension amounts were income of the institutionalized spouse until the QDRO was filed.[683] Consequently, Medicaid benefits were denied until September 1993.[684]

The Supreme Court of Iowa reversed the district court, and held that Medicaid benefits were not available until the QDRO was filed.[685] Under ERISA, the court held, a spendthrift provision prevented plan participants from assigning or alienating plan benefits unless accomplished through a QDRO.[686]

D. *Legislative Developments*

The Health Insurance Portability and Accountability Act of 1996, signed into law on August 21, 1996, makes the transfer of assets after December 31, 1996, to qualify for Medicaid a criminal offense punishable by a year in prison or a $10,000 fine.[687] The legislation amends 42 U.S.C. § 1320(a)-7b(a) and subjects to punishment anyone who "knowingly and willfully disposes of assets (including by any transfer in trust) in order for an individual to become eligible for medical assistance under a state plan under Title XIX if disposing of the assets results in the imposition of a period of ineligibility for such assistance under § 1917(c)."[688]

The Act also allows amounts received under qualified long-term care insurance contracts issued after 1996 to be excluded from gross income up to $175 per day ($63,875 annually) (adjusted for inflation after 1997).[689] The deduction for health insurance expenses applies to long-term health care insurance premiums. Premiums attributable to employer-provided long-term care insurance are not excluded from an employee's income if provided under a cafeteria plan or flexible-spending arrangement.

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682. *See id.*

683. *See id.*

684. *See id.*

685. *See id.* at 474.

686. *See id.*

687. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 2008-09 (codified as amended in 42 U.S.C. § 1320(a)-7(b) (1996)).

688. *Id.* The community spouse remains entitled to a monthly income allowance consisting of a minimum maintenance needs allowance (MMNA) and an excess shelter allowance (42 U.S.C.A. § 1396r-5(e)(2)(C) (West 1996)). Effective January 1, 1997, the maximum monthly income allowance is set at $1,975.50. The MMNA floor is $1,295, but until July 1, 1997, states may set the floor at $1,254.

689. *See id.* A qualified long-term care contract is one that cannot pay or reimburse for expenses that are reimbursable under Medicare, must be guaranteed as renewable, does not provide a cash surrender value, provides insurance protection under the contract only for qualified long-term services, uses any refund of premium or policyholder dividends to reduce future premiums or to increase future benefits, and complies with required consumer protection provisions. Any contract issued before January 1, 1997, can be grandfathered by meeting state long-term care insurance requirements. *See id.* at 2054.

In addition, the Act permits the terminally and chronically ill to exclude from gross income life insurance benefits paid out before death if such amounts are received after December 31, 1996.[690]

IX. FARM AND RANCH BUSINESS PLANNING DEVELOPMENTS

A. *Business Structuring Considerations*

1. *Bankruptcy of a Limited Liability Company (LLC)*

In a Nebraska case, *In re Daugherty Construction, Inc.*,[691] the court held that the bankruptcy of an LLC member did not cause termination of the LLC as required under the applicable state LLC Act.[692] The court held that the state LLC Act conflicted with the federal bankruptcy code and was not enforceable.[693] As such, the bankruptcy of an LLC member was held to cause that person's membership to terminate, and that if the remaining members vote to continue the business, the bankrupt member is not a member of the LLC.[694] The court held that the provisions of the articles of organization and of the Nebraska Limited Liability Companies Act for the dissolution of the companies upon the bankruptcy of one or more members was unenforceable under the bankruptcy code.[695] The court agreed that the articles of organization and the operating agreements constituted executory contracts, but held that "the debtor and debtor in possession are the same entity for executory contract purposes in a Chapter 11 reorganization."[696] Because the debtor in possession was the same entity as the pre-petitioned debtor, the bar against assumption of personal service contracts over the objection of an unwilling party did not apply.[697]

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690. *See id.* at 2067 (codified as amended in 42 U.S.C. § 7702(B)). "Terminally ill" is defined as a person certified by a physician as having an illness or physical condition reasonably expected to result in death within two years of the certification. *See id.* at 2069 (as codified as amended in 42 U.S.C. § 101).

"Chronically ill" is defined as a person certified within the previous year by a licensed health care practitioner as being unable to perform at least two activities of daily living for at least ninety days due to loss of functional capacity, or a person requiring supervision for protection from harm due to severe cognitive impairment. *See id.* (codified as amended in 42 U.S.C. § 7702(B),(C) (1994).

691. *In re* Daugherty Contr., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995).

692. *See id.* at 611.

693. *See id.* at 611-12.

694. *See id.*

695. *See id.* at 614.

696. *Id.* at 613.

697. *See id.* In early 1996, the Bankruptcy Court for the Eastern District of Virginia rejected this approach and held that an LLC was dissolved as a result of a member's Chapter 11 filing. *See In re* Deluca*,* 194 B.R. 79, 91 (Bankr. E.D. Va. 1996).

2. *Check-the-Box Regulations*

In Revenue Procedure 95-14,[698] the Service announced its intention to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis.[699] In early May 1996, the Service issued proposed regulations to implement the check-the-box proposal.[700]

The Service finalized the proposed regulations referred to above on December 17, 1996.[701] The final regulations became effective on January 1, 1997.[702] However, under a special transitional rule for existing entities, the Service will not challenge the prior classification of an existing eligible entity for periods before January 1, 1997, if (1) the entity had a reasonable basis for the claimed

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698. Rev. Proc. 95-14, 1995-1 C.B. 297.

699. *See id.*

700. *See* Prop. Treas. Reg. §§ 301.7701-1 through 301.7701-3 (1996). A hearing on the regulations was held on August 21, 1996. Nine witnesses spoke and expressed praise for the proposed rules. The proposed regulations replace the four-factor test with a four-step classification process. The first step is to determine whether a separate entity is present that needs to be classified. If a separate entity exists, the second step is to determine whether the entity is a trust or a "business entity" for federal income tax purposes. The primary distinction is that a business entity, unlike a trust, has associates and a profit objective. If the entity is a business entity, it may be treated either as a corporation or a pass-through. If it is classified as a pass-through and has two or more members, it will be a partnership. If classified as a pass-through, and if it has only one member, it will be disregarded under the new system and treated as a sole proprietorship, branch, or division. The third step is to determine whether the business entity is an "eligible entity," eligible to elect its own classification under the new system, or instead is a per se corporation. A "corporation" can be any one of eight enumerated entities. Any business entity not falling within one of the corporate categories is treated as a partnership if there is more than one member, but is disregarded if there only is one member. The fourth step involves classifying eligible entities. In general, the classification is accomplished by election, although the need to make an affirmative election is unnecessary if the entity achieves the desired classification by default. An eligible entity with two or more members can elect to be treated as an association or a partnership. An eligible entity with a single owner can elect either to be classified as an association or to be disregarded as an entity separate from its owner for federal tax purposes.

If LLC status is claimed, three criteria must be satisfied: (1) there must be a reasonable basis for the classification claimed (have at least two entity characteristics under the old four-factor test); (2) the same classification must be claimed for all prior periods; and (3) no notice was received before May 19, 1996, that the present classification is under audit.

Single-member LLCs will have two choices. They can be classified as a nonentity, such as a branch or sole proprietorship, and not as a separate entity, or be treated as a separate entity in an association.

For entities operating as an association that select partnership treatment, the result is a liquidation of the corporation and recognition of gain. For corporations, I.R.C. § 332 might be available to avoid or postpone the gain.

Single-member entities will be disregarded, so that sole proprietorships pay no entity-level tax and corporate sole owners can use the tax attributes of the entity as if it were a division, while remaining insulated from the entities' liabilities. As a result, the proposed entity classification rules will tend to make it easier for business activities to fall within the one-level-of-tax partnership regime rather than the two-tier regime currently applicable to corporations.

701. 61 Fed. Reg. 66,584 (1996) (to be codified at 26 C.F.R. pts. 1, 301, 602).

702. *See id.*

classification; (2) the entity and its members recognized the federal tax consequences of any change in the entity's classification with sixty months before the regulations' effective date; and (3) neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification was under examination.[703] The final regulations have default classifications for eligible entities that will provide most entities with the classification they would otherwise choose.[704]

3. *Tax Classifications of Entities*

In PLR 96-18-021,[705] the Service ruled that a general partnership could convert to an LLC tax-free.[706] In this ruling, all assets and liabilities of a general partnership passed to a new LLC.[707] The Service ruled that no gain or loss would be recognized from the conversion and the partners' basis in the LLC would be the same as the partnership.[708]

Similarly in PLR 96-40-006,[709] the conversion of general partnership interests to limited partnership interests were held not to change the entity's classification as a partnership for federal income tax purposes.[710] After the conversion, each general partner and all other partners held the same percentage interest in the limited partnership as currently held.[711] The limited partnership had no current long-term or short-term debt and had no long-term or short-term debt immediately after the conversion transaction.[712] The Service ruled that none of the general partners would recognize gain or loss on the conversion under I.R.C. § 731(a) and would receive a carryover basis and a tacked-on holding period in their converted partnership interest under I.R.C. § 723.[713]

In PLR 96-37-030,[714] the Service ruled that a partnership engaged in the landscaping and nursery business should be classified as a partnership for federal tax purposes after conversion to a limited liability company.[715] The Service noted that the organization lacked the corporate characteristics of continuity of life and free

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703. *See id.*

704. Thus, in many instances, an actual election will not need to be filed. However, an eligible entity's election of its classification may be made on Form 8832.

705. Priv. Ltr. Rul. 96-18-021 (Feb. 2, 1996).

706. *See id.*

707. *See id.*

708. *See id.*

709. Priv. Ltr. Rul. 96-40-006 (June 26, 1996).

710. *See id.*

711. *See id.*

712. *See id.*

713. *See id.*

714. Priv. Ltr. Rul. 96-37-030 (June 10, 1996).

715. *See id.*

transferability of interests.[716] The conversion to an LLC did not result in the termination of the partnership because each partner's interest in partnership capital, profits, and losses remained the same and the partnership continued its business after the conversion.[717] As a result, neither the organization nor any partner recognized gain or loss upon the conversion.[718] Similarly, the conversion did not cause the partnership's tax year to close with respect to any partner because the partnership did not terminate, and each partner continued to hold an interest in the LLC.[719] The Service did rule, however, that the LLC would be required to continue to use the cash method of accounting.[720]

In PLR 96-39-055,[721] a limited liability company owning and operating a riverboat casino was classified as a partnership for federal income tax purposes because it lacked the corporate characteristics of continuity of life and free transferability of interests.[722]

In PLR 96-44-059,[723] a limited liability company was classified as a partnership for tax purposes because it lacked the corporate characteristic of continuity of life and to free transferability of interests.[724] No gain or loss was recognized by the LLC or its two initial members upon the contribution of property by the members in exchange for interests in the LLC.[725]

4. *Termination of S Status*

In PLR 96-42-003,[726] a trust created in a community property state by a couple who designated their children as its beneficiaries was a qualified shareholder of an S corporation.[727] The grantors retained the power to control the beneficial enjoyment of trust income and corpus and their power of beneficial enjoyment of income and corpus was not subject to the exceptions contained in I.R.C. §§ 674(b)-(d).[728] However, the company's S corporation election was terminated upon the expiration of the two-year period after the death of one of the trust grantors because the trust ceased to be an eligible shareholder on the expiration of that period.[729] The

716. *See id.*
717. *See id.*
718. *See id.*
719. *See id.*
720. *See id.*
721. Priv. Ltr. Rul. 96-39-055 (June 24, 1996).
722. *See id.*
723. Priv. Ltr. Rul. 96-44-059 (Aug. 5, 1996).
724. *See id.*
725. *See id.*
726. Priv. Ltr. Rul. 96-42-003 (June 24, 1996).
727. *See id.*
728. *See id.*
729. *See id.*

termination was inadvertent.[730] Within a reasonable time after discovering the terminating event, "steps were taken so that the company was once more a small business corporation. The termination was not part of a plan to terminate the . . . S corporation election and no tax avoidance was intended or resulted."[731] Consequently, the company was treated as continuing to be an S corporation.[732]

The Small Business Job Protection Act[733] gives the Service the authority to treat late subchapter S elections as timely and waive defects.[734] On December 31, 1996, the Service issued Announcement 97-4 informing taxpayers who inadvertently made invalid or late S corporation elections that the Service would treat the election as timely made if reasonable cause is found.[735] Taxpayers desirous of relief must obtain a private letter ruling.[736]

B. *Tax Considerations*

1. *Self-Employment Income*

In TAM 96-37-004,[737] the Service ruled that a farm corporation's rental payments for use of agricultural and grazing land and personal property leased with the land, and CRP payments, were subject to self-employment tax.[738] The taxpayers incorporated their sole proprietorship and transferred livestock and part of the land that included their farmstead to the corporation.[739] They retained ownership of the remainder of the land and ranch equipment and leased it to the corporation.[740] Some of the land had been bid successfully into the CRP.[741] The Service cited *Mizell v. Commissioner*[742] for the notion that "arrangement" in § 1402(a)(1) and the

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730. *See id.*

731. *Id.*

732. *See id.*

733. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).

734. *See id.* at § 1305, *amending* I.R.C. § 1362(b) and (f). The election to be treated as an S corporation must be made no later than the fifteenth day of the third month of the taxable year for which the election is effective.

735. 1997 3 I.R.B. 14 (Dec. 31, 1996).

736. *See id.*

737. Tech. Adv. Mem. 96-37-004 (May 1, 1996).

738. *See id.*

739. *See id.*

740. *See id.*

741. *See id.*

742. *See id.*; 1995 T.C.M. (RIA) ¶ 95,571, at 3667. In *Mizell v. Commissioner*, a partner in a farm partnership was held liable for self-employment tax on income received under the partnership lease agreement even though the agreement did not specifically require the partner to render material participation. *See id.* at 3668. The partner owned the land individually and leased it to the operating partnership in which he was an active member. *See id.* The Tax Court's decision in *Mizell* calls into question a strategy of receiving rents from a family-owned entity under what would appear to be a

corresponding regulations is not limited to contractual relationships, nor to terms and conditions included in a single agreement, contractual or otherwise.[743] As such, the arrangement between the taxpayers and the corporation included not only the lease agreements, but all corporate documents and employment contracts that were a part of the overall scheme of the farming and ranching operation.[744] As such, the arrangements clearly contemplated the husband's material participation because it employed him as general ranch manager, named him to the corporate board, and designated him as the corporate president with supervision and control of all corporate affairs.[745] The arrangement also contemplated the wife's material participation because it designated her as corporate secretary and treasurer, named her to the board, and employed her to provide meals, maintain ranch property, do bookkeeping, provide ranch labor in times of high labor need, and assist other corporate employees.[746]

The Service ruled that the taxpayers also met the actual participation requirement because they participated in production and management.[747] The fact that the taxpayers were paid a post-incorporation salary under the employment contracts did not prevent characterization of the rental payments as net earnings from self-employment.[748] The Service also ruled that the CRP payments constituted net earnings from self-employment because the taxpayers materially participated with respect to the commodities on the land.[749]

In *Ray v. Commissioner*,[750] the court held that CRP payments received by a farmer actively engaged in the business of farming and cattle grazing constituted income subject to self-employment tax.[751] In addition to the taxpayer's active farming operation, additional land was bid into the CRP program.[752] The CCC contract required the taxpayer to tend and nourish the land, fight diseases, and control soil erosion.[753] Because the CRP acreage was in addition to the taxpayer's existing farmland and because the taxpayer was already in the business of farming and

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nonmaterial participation lease entered into to avoid payment of self-employment tax on the rental payments. Several planning approaches may be utilized to avoid the impact of *Mizell* and Tech. Adv. Mem. 96-37-004 (Sept. 13, 1996). One option, not likely to be popular, is to revert to greater use of the single entity approach. A more popular approach may be to transfer the land to a spouse that is not involved in the operating side of the business and have that spouse lease the land to the operating entity under a nonmaterial participation crop-share, livestock-share, or straight cash lease.

743. *See id.*

744. *See id.*

745. *See id.*

746. *See id.*

747. *See id.*

748. *See id.*

749. *See id.*

750. Ray v. Commissioner, 1996 T.C.M. (RIA) ¶ 96,436, at 3105.

751. *See id.*

752. *See id.*

753. *See id.* at 3106.

ranching, the CRP rental income was sufficiently connected with the taxpayer's ongoing trade or business of farming to require the payment of self-employment tax on the rental amounts.[754]

2. *Installment Sales*

In 1996, the U.S. Supreme Court declined to hear a Tenth Circuit case holding that the use of an interest rate in an installment sale lower than the market rate of interest constitutes a gift of the present value of the differences in interest rates.[755] The Seventh Circuit has held otherwise,[756] and this case is the second attempt in four years to have the Supreme Court clear up the differences between the circuit courts.[757]

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754. *See id.* at 3108.

755. Schusterman v. United States, 63 F.3d 986, 994 (10th Cir. 1995), *cert. denied*, 116 S. Ct. 1923 (1996).

756. Ballard v. Commissioner, 854 F.2d 185, 186 (7th Cir. 1988).

757. *See,* Krabbenhoft v. Commissioner, 939 F.2d 529 (8th Cir. 1991), *cert. denied*, 502 U.S. 1072 (1992).

3. *Passive Investment Income*

In PLR 96-43-017,[758] a corporation was anticipating making an S election effective for future tax years.[759] The company owned two properties that provided rental income to the company.[760] The company provided full building operation and maintenance services to its tenants, common area maintenance, employed maintenance staff, maintained a landscaping program, maintained and replaced roofs, and provided construction services for renovations.[761] The company also maintained a parking lot for use by tenants and their customers, provided security for the tenants and customers, and maintained an office on the premises to facilitate management.[762] The company also regularly monitored and inspected the premises for insurance purposes and was directly involved in any subletting.[763] With respect to the second tract, the company provided and maintained swimming pools and landscaping, provided water service, trash removal, security for the tenants, and monitored and inspected the premises on a daily basis. Neither properties were net leased properties.[764]

The Service concluded that the rental amounts received by the corporation were derived in the active conduct of a trade or business because the corporation provided significant services and incurred substantial costs in the rental business.[765] As such, the rental income the company received from the two rental properties would not be passive investment income for purposes of the 25% limit if the S election were made.[766]

4. *Legislation*

Under the Small Business Job Protection Act of 1996, for property placed in service after 1996, the $17,500 amount allowed to be expensed each year under

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758. Priv. Ltr. Rul. 96-43-017 (July 22, 1996).
759. *See id.*
760. *See id.*
761. *See id.*
762. *See id.*
763. *See id.*
764. *See id.*
765. *See id.*
766. *See id.*

I.R.C. § 179 is increased (over a phase-in period) to $25,000.[767] The Act also makes certain changes applicable to S corporations.[768]

Under the Health Insurance Portability and Accountability Act of 1996, for tax years beginning in 1997, the deduction for health insurance premiums for self-employed persons under I.R.C. § 162 has been increased from the 30% rate for 1996.[769]

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767. *See supra* note 733 at § 1111(a) (amending I.R.C. § 179(b)(1996)). The maximum amount to be expensed beginning in the following taxable years is: 1997, $18,000; 1998, $18,500; 1999, $19,000; 2000, $20,000; 2001, $24,000; 2002, $24,000; post-2002, $25,000. The amount expensed is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. *See id.*

768. *See id.* The maximum number of shareholders is increased to seventy-five (Act § 1301, amending I.R.C. § 1361(c)(2)(A)). S corporation stock can be held by an "electing small business trust." All trust beneficiaries must be individuals or estates eligible to be S corporation shareholders and interests must be acquired by gift or inheritance. Each potential current income beneficiary counts as a shareholder for purposes of the 75 shareholder limitation (Act § 1302, amending I.R.C. § 1361(c)(2)(A)). The post-death holding period for all testamentary trusts is expanded to two years (Act § 1303, amending I.R.C. § 1361 (c)(2)). In Notice 97-4, the Service has requested comments on modifications of I.R.C. § 1361 pursuant to § 1308 of the Small Business Job Protection Act of 1996. The changes permit an S corporation to own 80% or more of the stock of a C corporation, and to elect to own a qualified subchapter S subsidiary (QSS).

769. Health Insurance Portability Act of 1996 § 311 (amending I.R.C § 162 (e)(1) (1996)). The rate of increase is as follows: 1997, 40%; 1998-2002, 45%; 2003, 50%; 2004, 60%; 2005, 70%; 2006 and beyond, 80%.