The Tax Adviser

Recent Developments in Estate Planning (Part 2)

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EXECUTIVE SUMMARY

- Final regulations issued in June clarify the rules for estates to elect portability of a deceased spouse's unused estate tax exemption, called portability.
- A recent nontax federal district court case illustrates how the courts might attribute ownership of foreign grantor trusts for income tax purposes.
- The IRS ruled that a transfer of a life insurance policy owned by a grantor trust created by a husband and wife to the husband's grantor trust was not a transfer for value.
- New rules apply to information-reporting requirements for certain Canadian trusts, including Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs).
- The Obama administration's 2016 budget contains a number of proposals that would change existing estate and transfer taxes, such as a required minimum remainder interest for grantor retained annuity trusts (GRATs).

This is the second of a two-part article examining developments in estate, gift, trust, and generation-skipping transfer taxes between June 2014 and May 2015. Part 1 (http://www.thetaxadviser.com/issues/2015/sep/recent-developments-in-estate-planning.html), which was published in September, discussed gift and estate tax developments. Part 2 covers the final regulations on the portability of a deceased spouse's unused estate tax exemption; trust taxation; President Barack Obama's estate, gift, and generation-skipping transfer (GST) tax proposals; and the inflation adjustments for 2015.

Portability of a Deceased Spouse's Unused Exclusion Amount

One of the provisions in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[1] enacted on Dec. 17, 2010, amended Sec. 2010 to allow for portability of the estate tax exemption between spouses. Sec. 2010(c) generally allows the surviving spouse of a decedent dying after Dec. 31, 2010, to use the decedent's unused estate tax exemption in addition to the surviving spouse's own estate tax exemption. For example, if a decedent dies during 2015 (when the estate tax exclusion amount is $5.43 million) having used $3 million of the decedent's own exclusion amount, the decedent's estate could make the portability election so that the decedent's surviving spouse would have an exclusion amount of $2.43 million from the decedent in addition to his or her own exemption amount. Thus, portability eliminates for many spouses the need to retitle property and create trusts solely to take full advantage of each spouse's estate tax exemption.

On June 16, 2015, the IRS released final regulations (T.D. 9725) on the estate and gift tax applicable exemption amount, as well as the requirements for electing portability of a deceased spouse's unused exemption (DSUE) amount. T.D. 9725 is effective June 12, 2015, and adopts, with some modifications, the proposed regulations.[2] T.D. 9725 also withdraws the temporary regulations.[3] Note that the temporary regulations still apply to estates of decedents dying on or after Jan. 1, 2011, and before June 12, 2015.

The portability election must be made by timely filing an estate tax return, which is due nine months after the date of the decedent's death unless an extension of time to file the return is obtained. The final regulations clarify that, to make the portability election, the estate tax return must be filed within this time period even if the estate would not otherwise be required to file a return because the decedent's gross estate was less than the basic exemption amount under Sec. 2010(c) ($5.43 million in 2015). For estates with a gross estate value below the Sec. 6018 filing threshold amount, the final regulations state that the IRS may grant an extension of time to file under Regs. Sec. 301.9100-3. However, the IRS may not grant an extension of time to elect portability under Regs. Sec. 301.9100-3 to any estate required to file an estate tax return under Sec. 6018, because the due date for the return is governed by statute.

The executor can choose not to elect portability by either making an affirmative statement to that effect on the estate tax return or by not filing a timely return. Once made, the election is irrevocable. The executor is the one who either makes or does not make the election. If there is no appointed executor, any person in actual or constructive possession of any property of the decedent (a "non-appointed executor") may file the estate tax return and choose whether to make the election. A portability election made by a nonappointed executor cannot be superseded by a contrary election made by another nonappointed executor.

To make a valid portability election, the estate tax return must be complete and properly prepared. A special rule applicable to estates that are not required to file an estate tax return, but want to make a portability election, excuses the executor from reporting the values of certain property that qualifies for the marital or charitable deduction. This special rule, set forth in Regs. Sec. 20.2010-2(a)(7)(ii)(A), is not available if the value of property is needed to determine the estate's eligibility for another estate or GST tax provision for which the value of the property must be known. The final regulations clarify that determining basis under Sec. 1014 is not "another provision" for which the value of property must be reported on an estate tax return.

If an executor chooses to apply the rule set forth in Regs. Sec. 20.2010-2(a)(7)(ii)(A), the executor will be required to report only the description, ownership, and/or beneficiary of the property along with the information necessary to establish the right of the estate to the marital or charitable deduction for this property. If the executor chooses this option, he or she must estimate the total value of the gross estate, based on a determination made in good faith and with due diligence regarding the value of all the assets includible in the gross estate. The executor must identify the particular range applicable to the gross estate from the ranges of dollar values provided in the instructions to the estate tax return (Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*).

The final regulations require the executor to compute the DSUE amount on the estate tax return, which is done on Part 6 of Form 706. When the DSUE amount is uncertain (e.g., because the estate requested a refund), the executor satisfies the Sec. 2010(c)(5)(A) computation requirement if the estate tax return is prepared in accordance with the requirements of Regs. Sec. 20.2010-2(a)(7). Thus, there is no need to make a protective election if a DSUE amount is not reflected on an otherwise complete and properly prepared estate tax return.

The computation of the DSUE amount is based on the basic exemption amount in effect in the year of the death of the decedent whose DSUE amount is being computed. If the decedent paid gift tax on taxable gifts because the taxable gifts exceeded the applicable exemption amount at the time of the gift, these gifts are exempted from adjusted taxable gifts for purposes of computing the decedent's DSUE amount. This adjustment is necessary so that the decedent's exemption amount is not used for amounts on which gift tax was paid. The final regulations state that the eligibility for other estate tax credits (e.g., the credits contained in Secs. 2012 through 2015) does not factor into the calculation of the DSUE amount. Estate tax liability is calculated by first subtracting the applicable credit amount under Sec. 2010 and then applying the credits under Secs. 2012 through 2015. Any unused credit derived under Secs. 2012 through 2015 is lost.

If the portability election is made, the DSUE amount of the last deceased spouse is available for use by the surviving spouse for transfers occurring after the decedent's date of death. The last deceased spouse is the most recently deceased individual who was married to the surviving spouse at that individual's death, provided the individual died after Dec. 31, 2010. Remarriage by the surviving spouse does not affect who will be considered the last deceased spouse and does not prevent the surviving spouse from including in the surviving spouse's applicable exclusion amount the DSUE amount of the deceased spouse who most recently preceded the surviving spouse in death. The identity of the last deceased spouse is not affected by whether the estate of the last deceased spouse makes the portability election or has any DSUE amount available.

When a surviving spouse has more than one deceased spouse, the final regulations apply an ordering rule. Any gifts made by a surviving spouse use up the DSUE amount of the last deceased spouse (identified as of the date of the gift) before using up any of the surviving spouse's own basic exemption amount. The surviving spouse's DSUE amount then becomes the DSUE amount of the last deceased spouse (identified as of the date of a subsequent gift or the death of the surviving spouse) plus any DSUE amount actually applied to the surviving spouse's taxable gifts to the extent it was from a decedent who is no longer the last deceased spouse. Examples in the final regulations illustrate the operation of these provisions.

The final regulations confirm that the IRS may examine the returns of each deceased spouse of the surviving spouse in order to adjust or eliminate the DSUE amount, regardless of whether the period of limitation for assessment has expired. The IRS may assess additional estate tax on those prior returns only if the period of limitation on assessments is still open.

Observation: The final regulations resolve multiple questions practitioners raised in comments, but they also leave open some issues the IRS plans to resolve in the future. The IRS did not take the opportunity to make permanent the automatic extension of time to elect portability as set forth in Rev. Proc. 2014-18, for estates with no estate tax return filing requirement under Sec. 6018. The Treasury Department indicated that it will continue to consider requests for permanent extensions of this type of relief for estates of decedents who died on or after Jan. 1, 2014, that did not make portability elections because they were not required to file an estate tax return. Until further guidance is issued, however, relief to make a late election must be obtained through a private letter ruling.

The IRS did not provide any guidance, but plans to do so in the future, regarding whether a qualified terminable interest property (QTIP) election made under Sec. 2056(b)(7) may be disregarded and treated as null and void (under Rev. Proc. 2001-38) when an executor has elected portability of the DSUE amount. Rev. Proc. 2001-38 treats a testamentary QTIP election as null and void when the value of a decedent's gross estate does not exceed the basic exemption amount; that is, the QTIP election is void where it is not necessary to reduce the estate tax liability to zero. However, with the advent of portability, an executor might choose to make a QTIP election to preserve the decedent's basic exclusion amount so that the decedent's surviving spouse could avail himself or herself of it in the future. Thus, there is a need for clarification.

Trusts

Income in Respect of a Decedent

In Letter Ruling 201438014, a trust requested a ruling that amounts it received upon the death of the grantor of the trust from his individual retirement account (IRA) was not income in respect of a decedent (IRD) and therefore not includible in its income. The IRS determined that those amounts were includible in the trust's income despite changes made to the trust to make the income excludible.

The decedent created a trust during his lifetime. At the time of his death, the decedent owned an IRA of which the trust was the beneficiary. The trust provided for the distribution of the decedent's estate, including the payment of pecuniary bequests to two charities. The trust also contained other assets the decedent contributed during his life. When he died, the bequests to the charities exceeded the amount of the trust's non-IRA assets. To ensure that the trust's distribution of IRA assets to the charities would be treated as direct bequests to the charities or alternatively would qualify for the income tax charitable deduction, the trustee of the trust reformed the trust.

The taxpayer requested rulings that (1) the payment of the pecuniary amounts to the charities from the IRA was not IRD to the trust; (2) if it was IRD, the trust would be entitled to claim a charitable deduction; and (3) the IRS would respect the reformation of the trust. In a relatively short ruling, the IRS denied all three ruling requests.

As to the IRD request, Sec. 691 generally defines IRD as items of income to which the decedent was entitled but had not received before death. Amounts contained in a traditional IRA are considered IRD to the extent they consist of amounts that were not previously subject to income tax. When a recipient receives IRD, the recipient is required to include the IRD in income in the year of receipt. When a trust or estate uses those amounts to satisfy a pecuniary bequest, the distribution of IRD items is considered a sale or exchange requiring the trust or estate to recognize income. The IRS ruled that satisfying the charities' pecuniary bequests with IRA assets caused the assets to be included in the trust's income in the year in which the assets were distributed to it. The IRS did not give effect to the reformation of the trust.

As to the charitable deduction, Sec. 642(c) generally provides that a trust or estate is entitled to an income tax charitable deduction for the payment of its income to charity, if, among other things, the terms of the trust provide that income of the trust be payable to charity. Because the IRS did not recognize the trust's reformation for tax purposes and the governing instrument did not provide for the payment of income to charity, the requirements for the charitable deduction had not been met.

Regarding the reformation, the IRS turned to *Bosch*, in which the Supreme Court determined that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Instead, the state's highest court is the best authority on state law to be applied to a federal statute. If there is no decision by that court, the federal taxing authority must decide what state law is after giving proper regard to the trial court's determination and relevant state rulings. The IRS explained that the reformation was not done to resolve a conflict among beneficiaries and that it will not recognize the trust reformation if it is done for tax purposes.

The ruling is missing some facts that need to be assumed to piece together what the IRS is ruling on, specifically, the terms of the reformation. Reformation would never change the classification of the IRA as an IRD item. However, it must be assumed that the reformation changed the bequests to the charities from pecuniary bequests to residuary bequests, in which case satisfying the bequests would not have resulted in a sale or exchange that would have caused the trust to recognize IRD. It must also be assumed that the trust reformation amended the trust's governing instrument to provide that the transfers to the charities be made from income so that the transfers would be eligible for the income tax deduction under Sec. 642(c).

This issue is commonly missed when trusts are allowed to make distributions to charities. It is imperative that the governing instrument of trusts with charitable beneficiaries require that distributions to the charitable beneficiaries come from the income of the trust or the trust will not be entitled to an income tax charitable deduction. Ideally, what should have happened in this case is the decedent should have made the charities beneficiaries of the IRAs. In that case, the IRA would have had no effect for both income and estate tax purposes.

Although an IRA would still be an IRD item subject to inclusion in the decedent's gross estate, the estate would receive an estate tax charitable deduction for the value of the IRA, and the IRD pickup would be by a tax-exempt entity. This letter ruling also reminds practitioners that the IRS rarely gives trust modifications retroactive effect unless the reformation is done to resolve a bona fide dispute among parties or to correct a scrivener's error (see Part 1 (http://www.thetaxadviser.com/issues/2015/sep/recent-developments-in-estate-planning.html) of this article on p. 686 of the September issue for a case where the IRS permitted retroactive reformation of a trust to correct a scrivener's error).

Grantor Trusts

In *Securities and Exchange Commission v. Wyly*,[4] a District Court determined that the profits earned and the income taxes avoided by certain foreign trusts the defendants created were includible in determining the amount of disgorgement against the defendants for failing to properly disclose their beneficial ownership of publicly traded stock they traded within the foreign trusts. Although this was not a tax case, the court used the Code's grantor trust rules to attribute ownership of the foreign trusts to the defendants to determine the amount of money that had to be disgorged.

Between 1992 and 1996, Sam and Charles Wyly created a number of Isle of Man trusts (foreign trusts), each of which owned several subsidiary companies. The Wylys' family attorney, the CFO of the Wylys' family office, and the CFO of a foreign trust company related to the Wylys served as trust protectors of the foreign trusts who conveyed the Wylys' investment recommendations to the foreign trust trustees.

The Wylys served as directors of Michaels Stores, Sterling Software, Sterling Commerce, and Scottish Annuity and Life Holdings Limited (the Companies), for which they were compensated with stock options and warrants. Between 1992 and 1999, the Wylys sold or transferred to the foreign trusts stock options in the Companies in exchange for private annuities while simultaneously disclaiming beneficial ownership over the securities in public SEC filings. Between 1995 and 2005, the foreign trusts (or their subsidiary companies) exercised these options and warrants, separately acquired options and stock in the Companies, and sold the shares without filing proper disclosures with the SEC.

The jury found that the Wylys were the beneficial owners of the securities transferred to, held, and sold by the foreign trusts because the Wylys, directly or indirectly, had or shared voting and/or investment power over the securities. Thus, the jury concluded that the Wylys failed to accurately disclose the extent of their beneficial ownership in the securities, misrepresented their beneficial ownership in SEC filings, and aided and abetted the foreign trusts and the Companies in fraud under various sections of the Securities Exchange Act and the Securities Act of 1933. In the current action, the SEC sought an order of disgorgement against the Wylys of $619,298,512 for the profit they reaped from the violation of the SEC rules. One of the issues addressed was whether the disgorgement amount could include certain profits and income taxes the foreign trusts avoided.

Two sets of trusts were involved in the case: the Bulldog Trusts and the Bessie Trusts. The Bulldog Trusts were created in 1992 by the Wylys, and their beneficiaries included the Wylys' wives and children and several charities. The trust agreements permitted the trust protectors to add or substitute a charitable organization by written notice to the trustees. The trusts were designed to be nongrantor trusts with trust agreements that prohibited any U.S. beneficiary from receiving a distribution until two years after the grantor's death.

In 1993, one of the trust protectors engaged a law firm to determine whether the Bulldog Trusts were nongrantor trusts as they were designed to be. The law firm determined that there was a significant risk that the trusts would be grantor trusts (1) under Sec. 679 (creating grantor trust status if a U.S. person transfers property to a foreign trust that has U.S. beneficiaries) because income was being accumulated for the benefit of U.S. beneficiaries and (2) under Sec. 674 (creating grantor trust status if the grantor or a nonadverse party has certain powers to control the beneficial enjoyment of property transferred to the trust) because the trustees had the power to add or substitute other foreign charities as beneficiaries of the trusts.

The trust protector was then advised by the law firm that if a foreign person established a foreign grantor trust with U.S. beneficiaries, neither the foreign trust nor its U.S. beneficiaries would be taxable on trust distributions. In 1994 and 1995, two foreign persons established the Bessie Trusts for the benefit of the Wylys and their families. Two trusts were created by one of the foreign persons with a purported initial funding of $25,000 to each trust. However, at trial, it was established that that contribution was never made (except for a "factual dollar bill"). Two trusts also were created by the other foreign person with a purported initial funding of $25,000.

Letters prepared by the trust protector stated that the foreign person was creating the trusts to show his gratitude for the Wylys' loyalty to their mutual ventures and the Wylys' personal support and friendship. At trial it was established that the foreign person had never met or dealt with the Wylys before establishing the trusts and had only contributed $100 to the trusts. Shortly after the trusts were settled, the foreign person's trust management company was hired to serve as trustee for some of the foreign trusts.

The court determined that the transactions creating the Bessie trusts were shams intended to circumvent the grantor trust rules (although income taxes were not an issue). The trust protectors, acting as agents of the Wylys, recruited the foreign persons to create the Bessie Trusts, and the initial stated gratuitous contributions were never made. The court determined that even in the instances of the minimal contributions to the Bessie Trusts that those transfers were not gratuitous. As to the trusts created with $1, the court doubted that the $1 contribution had been made, and even if it had, the premise that $1 is sufficient to establish a tax-free foreign grantor trust could not be taken seriously. As to the trusts created with $100, the court determined that the transfers could not be considered gratuitous because shortly after settling the trusts, the foreign person received lucrative work from the Wylys as trustee of some of their foreign trusts. Finally, in light of the falsified trust agreements and supporting documentation surrounding the creation of the trusts, the court determined that it would be unjust to consider anyone but the Wylys to be the true grantors of the Bessie trusts.

The foreign trusts, the court noted, were administered by professional asset management companies in the Isle of Man, and the trustees were selected by the Wylys or the trust protectors. The trust protectors, all of whom were Wyly agents, had the authority to remove and replace the trustees and also transmitted the Wylys' investment recommendations to the trustees. The court noted that the Wylys presented no evidence of the foreign trusts' making investments that did not originate with the Wylys' recommendations or of the trustees rejecting their recommendations. Also, the court noted that the Wylys had entirely bypassed the trustees in several transactions and that some of transactions were ones that no independent trustee would reasonably initiate. Finally, it noted that the Wylys recommended personal purchases, loans, and investments for the benefit of the Wylys' children or their various business ventures.

In addition, the Wylys received private annuities from the foreign trusts for the stock options and warrants they transferred to the trusts which, the court noted, the Wylys had tried to conceal because of the potential income tax consequences of the private annuity transactions.

The Wylys sought legal advice that the Companies had no IRS filing requirements related to the exercise of the options or warrants the Wylys transferred to the foreign trusts. They also contacted the IRS without disclosing their names because they were concerned that the private annuity payments would be taxable to the Wylys if the trusts were, in fact, grantor trusts and explored the possibility of voluntary disclosure of the transactions. After meeting with the IRS, the Wylys decided not to proceed with voluntary disclosure. However, shortly after, Charles Wyly and then Sam Wyly received a notice of audit. The SEC's action against the Wylys also resulted from the audit.

In the disgorgement action, the court determined that the foreign trusts were grantor trusts taxable to the Wylys. As to the Bulldog Trusts, the court determined that the trusts were grantor trusts under Sec. 674. The Wylys conceded that Sec. 674 would apply because nonadverse parties (parties who were not beneficiaries of the trust) had the power to control the beneficial enjoyment of the trusts (through the nonadverse parties' discretionary authority to determine when and to whom distributions from the trust could be made) unless one of the exceptions in Sec. 674 applied. They asserted that because the discretionary power to make distributions was made by independent trustees, the exception in Sec. 674(c) applied. The court noted that, to determine if the Bulldog Trusts were covered by this exception, it was necessary to answer three questions: (1) Did the trustees have the power to make distributions to, or for the benefit of, a beneficiary?; (2) Were the trustees the grantor or a related or subordinate party under Sec. 672(c)?; and (3) Were the trustees able to exercise those powers without the approval or consent of any other person?

The court determined that the answers to the first two questions were straightforward. As to the first question, it determined that the evidence showed that the trustees had the power to make distributions to, or for the benefit of, a beneficiary. As to the second question, the court determined that the trustees were not the grantors or a related or subordinate party to the grantors.

As to the third question, the Wylys cited *Goodwyn*,[5] which held that a grantor may be taxed only on a power reserved by the trust instrument or other contract creating an ascertainable and legally enforceable right, not merely the persuasive control that the grantor might exercise over an independent trustee who is receptive to the grantor's wishes. Because the trust instruments provided that all powers of the trust were held by the independent trustees, the exception in Sec. 674 should apply.

The court did not accept this argument and determined instead that such a strict interpretation would violate the spirit of the independent trustee exception. Through the trust protectors, all of whom were the Wylys' agents, the Wylys retained the ability to terminate and replace the trustees. It determined that the Wylys expected the trustees to follow their every order and that is exactly what they did. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Finally, the court determined that because the Wylys and their family members were beneficiaries of the trusts, the trustees were distributing income for a beneficiary at the direction of the Wylys.

As for the Bessie Trusts, the court determined if it concluded that the Wylys were the Bessie Trusts' real grantors, the profits earned on the trusts' sales of the stock options and warrants would be taxable to the Wylys, not the foreign persons who created the trusts. Because the court concluded that the purported foreign grantors did not make gratuitous transfers to the Bessie Trusts, the trusts were grantor trusts taxable to the Wylys under Sec. 674. The court did not elaborate why the trusts were grantor trusts, but it is probably for the same reasons it determined the Bulldog Trusts were grantor trusts under Sec. 674. Because the court had determined that the trusts were grantor trusts under Sec. 674, it need not consider whether they were grantor trusts under Sec. 679.

After going through other amounts, the court determined that Sam Wyly must disgorge $123,836,958.76 and Charles Wyly must disgorge $63,881,743.97 (for a total of $187,718,702.73–$431,579,809.72 less than the amount requested by the SEC). It further determined that joint and several liability was not warranted because the gains were reasonably apportioned between the Wylys.

As previously stated, this case did not involve the IRS seeking to impose a deficiency on the Wylys for income tax on the income of the foreign trusts. However, the court could very well have ruled this way in an income tax case under the same facts. What the case does not address is whether the trustees exercised their fiduciary duties in evaluating the requests of the trust protectors. If the trustees (who presumably have fiduciary duties to the trusts' beneficiaries under Isle of Man law) independently evaluated the trust protectors' requests and it was determined that the trust protectors gave prudent directions, the fact that the trustees followed the trust protectors' direction should not indicate that the trustees are essentially agents of the Wylys. This decision treats the Wylys as de facto trustees of their respective trusts, which is what the IRS argued in *Goodwyn* (cited in the *Wyly* opinion). In *Goodwyn,* the Tax Court rejected this notion, finding that Sec. 674 required the grantor to have an ascertainable and legally enforceable power and citing the Supreme Court's decision in *Byrum*[6] to support its conclusion.

What weight should be given to this decision? This court could, if faced with a similar situation in an income tax case, reach the same conclusion. Fortunately, the Tax Court seems to reject the de facto trustee argument, and a taxpayer faced with having this court or the Tax Court hear a similar case should choose the Tax Court. However, as in all situations, documenting trustees' decisions is always the best evidence of independent evaluation of requests made by grantors or their agents.

Transfer for Value

In Letter Ruling 201423009, the IRS ruled that the sale of an insurance policy owned by a couple's joint grantor trust to a grantor trust owned entirely by the husband was not a transfer for value under Sec. 101.

The husband and wife were the grantors of a joint trust, and the husband was the sole grantor of a trust. The joint trust owned, and was the current beneficiary of, life insurance contracts on the joint lives of the husband and wife, and the current beneficiary of a life insurance contract on the wife's life. In the proposed transaction, the husband's trust would purchase all the life insurance policies from the joint trust. The couple requested a ruling that the transfers of the policies would not be considered a transfer for value under Sec. 101.

Sec. 101(a)(1) generally provides that gross income does not include amounts received under a life insurance contract if those amounts are paid by reason of the death of the insured. However, Sec. 101(a)(2) provides that if a life insurance contract or any interest therein is transferred for valuable consideration, the exclusion from gross income provided by Sec. 101(a)(1) is limited to an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee. An exception to the rule of Sec. 101(a)(2) is provided in Sec. 101(a)(2)(A) when the basis of the life insurance contract in the hands of the transferee is determined in whole or in part by reference to the basis of the insurance contract in the hands of the transferor (e.g., a gift of a policy).

In Rev. Rul. 85-13, the IRS held that a wholly owned grantor trust with a sole grantor is disregarded for federal income tax purposes. Therefore, a transaction between a grantor trust and its grantor cannot be recognized as a sale or exchange for income tax purposes because the same person is treated as owning the consideration both before and after the transaction.

In Rev. Rul. 2007-13, the IRS determined that the transfer of life insurance contracts between grantor trusts owned by the same grantor is not a transfer for valuable consideration under Sec. 101(a)(2). In the revenue ruling, a trust acquired a life insurance contract in exchange for cash from a separate trust. The two trusts were both grantor trusts, which were treated as wholly owned by the same grantor. The grantor was the insured under the policy subject to the transfer. The revenue ruling held that the grantor was treated for federal income tax purposes as the owner of the contract for purposes of applying the transfer-for-value limitations of Sec. 101 (a)(2).

Sec. 1041(a)(1) provides that no gain or loss shall be recognized on the transfer of property from an individual to the individual's spouse. However, Sec. 1041(b) provides that in the case of any transfer of property described in Sec. 1041(a): (1) for income tax purposes, the property is treated as acquired by the transferee by gift; and (2) the transferee's basis in the property is the transferor's adjusted basis.

The IRS noted that, in this situation, the sale of the insurance contracts had two aspects. First, a portion of the policies was transferred between grantor trusts as to the husband. As to this part of the transfer, Rev. Rul. 2007-13 and Rev. Rul. 85-13 applied to disregard the transfer. Therefore, this portion of the transfers was not a transfer for value under Sec. 101(a)(2).

The second aspect of the sale was the portion of the policies that the wife transferred (via her being treated as the grantor of one-half of the joint trust) to the husband (via the trust of which he was the sole grantor). The IRS ruled that under Sec. 1041(a)(1), the transfer between the spouses is treated as a gift in which the husband's grantor trust would receive a carryover basis. Therefore, this portion of the transfers was not a transfer for value under Sec. 101(a)(2).

This letter ruling applies Rev. Rul. 2007-13 for the portion of the grantor trusts treated as owned by the husband. The revenue ruling did not address aspects of a transaction in which the transfer is between a jointly owned grantor trust and a wholly owned grantor trust. The letter ruling cites Sec. 1041 to essentially treat the transfer as a gift. However, the transfer is not a gift. For example, if the policies were transferred for a note, the payment of interest on the note would be income to the transferor-spouse and interest expense to the transferee-spouse. However, the interest would not be deductible as Sec. 264 prohibits the deduction of interest on indebtedness paid for the purchase or carrying of insurance. Sec. 101(b)(2)(A), however, excludes the application of the transfer-for-value rule when the basis of the life insurance contract in the hands of the transferee is determined in whole or in part by reference to the basis of such an insurance contract in the hands of the transferor. Under Sec. 1041(b), this is exactly what happens; therefore, the letter ruling reaches the right result.[7]

Foreign Trusts

In Rev. Proc. 2014-55, the IRS issued guidance modifying the reporting requirements for U.S. citizens and residents with interests in Canadian retirement plans, including Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs).

In general, a U.S. citizen or resident who is a participant (referred to here as a beneficiary) in a Canadian retirement plan is subject to U.S. income tax as income accrues in the plan, even if the income is not currently distributed to the beneficiary. The accrued income, however, will not be taxable for Canadian purposes until the income is actually distributed from the plan. As a result of this difference in timing of taxation, a U.S. person may be subject to double taxation for which no relief is available under U.S. law.

Article XVIII(7) of the U.S.–Canada Tax Treaty (the Treaty) provides relief from double taxation for an individual who is a citizen or resident of the United States and who is a beneficiary of a retirement plan in Canada that is exempt from income tax in Canada and operated exclusively to provide pension, retirement, or employee benefits. Examples of such plans include an RRSP, a registered pension plan, or an RRIF. The Treaty requires a taxpayer to elect the application of Article XVIII(7).

U.S. citizens and residents use Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*, to: (1) elect under Article XVIII(7) to defer taxation of accrued income in an RRSP or an RRIF, and (2) report distributions received from their RRSPs or RRIFs, contributions to their RRSPs or RRIFs, and undistributed earnings of the RRSPs or RRIFs. Taxpayers who report an RRSP or RRIF on Form 8891 are relieved from reporting the RRSP or RRIF on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

The IRS issued Rev. Proc. 2014-55 to simplify the procedure for U.S. taxpayers making elections under Article XVIII(7) of the Treaty. The revenue procedure addresses two categories of individuals who have not made elections under Article XVIII(7): (1) individuals who have not reported accrued income from a Canadian retirement plan but have reported any and all distributions received from that plan; and (2) individuals who have reported undistributed, accrued income from a Canadian retirement plan. The revenue procedure states that eligible individuals in the first category will automatically be treated as if they had made an election to defer taxation. An "eligible individual" is defined as a beneficiary of a Canadian retirement plan who:

1. Is or was a U.S. citizen or resident while a beneficiary of the plan;

2. Has satisfied any requirement for filing a U.S. federal income tax return for each tax year during which the individual was a U.S. citizen or resident;

3. Has not reported as gross income on a U.S. federal income tax return the earnings that accrued in, but were not distributed by, the plan during any tax year in which the individual was a U.S. citizen or resident; and

4. Has reported any and all distributions received from the plan as if the individual has elected under Article XVIII(7) of the Treaty for all years during which the individual was a U.S. citizen or resident.

An eligible individual who did not previously make a deferral election under Article XVIII(7) will automatically be treated as having made the election in the first year in which the individual would have been entitled to elect the benefits under Article XVIII(7). Thus, the eligible individual will not be required to make the election on Form 8891 for the first year or for any subsequent years.

Individuals in the second category (i.e., beneficiaries who reported undistributed income that has accrued in a Canadian retirement plan) are not "eligible individuals." These individuals may not make an election under Article XVIII(7) and will remain currently taxable on the undistributed, accrued income in their RRSPs and RRIFs. Individuals interested in electing to defer taxation of accrued income must obtain the IRS's consent.

Beneficiaries who have previously made elections on Form 8891 are no longer required to file Form 8891 for tax years ending after Dec. 31, 2012. In addition, all letter rulings issued granting relief to make late elections under Article XVIII(7) are modified to eliminate the requirement to file Form 8891. All taxpayers must include in gross income any distributions received from a Canadian retirement plan. Finally, individuals with interests in a Canadian retirement plan do not need to report these interests on Form 3520 (whether or not the individuals are "eligible individuals"), but may be required to report on FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), or Form 8938, *Statement of Specified Foreign Financial Assets*.

Rev. Proc. 2014-55 applies only if a U.S. individual has an interest in a Canadian retirement plan. In addition, it relieves taxpayers only from filing Form 8891. Other Canadian plans that do not provide pension or employee benefits, such as the Canadian registered education savings plan or Tax-Free Savings Account, may not avail themselves of Article XVIII(7) and the revenue procedure. These plans may still be subject to current U.S. income taxation on accrued, but undistributed, income and may be reportable on Form 8938 and FBAR and as foreign grantor trusts on Form 3520 and Form 3520-A.

President's Budget Proposal

On Feb. 2, 2015, President Obama released his 2016 budget.[8] It included the following gift, estate, and GST tax proposals. Most of the proposals are the same as last year; however, some of them contain modifications.

Estate tax reform: Even though the American Taxpayer Relief Act of 2012[9] made permanent changes to the gift, estate, and GST tax regimes, the budget seeks to modify some of these provisions. The budget would increase the maximum rate from 40% to 45% and reduce the exemption amount from $5,430,000 to $3,500,000 for estate and GST tax purposes and $1,000,000 for gift tax purposes. It would also continue to allow portability so a surviving spouse can include any unused estate tax exemption of a predeceased spouse in determining the surviving spouse's exemption for gift and estate tax purposes. The budget would make this proposal effective for decedents dying, and for transfers made, after Dec. 31, 2015. Last year's proposal had an effective date of Dec. 31, 2017.

Treat gifts and bequests as sales (new): The most significant change in the budget this year pertaining to estate planning is the proposal to treat gifts and bequests as sales, taxing the difference between the property's fair market value on the date of the gift or the date of the decedent's death as capital gain. The proposal would effectively eliminate the step-up in basis for property acquired from a decedent under Sec. 1014.

The proposal would allow a decedent's estate a deduction for the capital gains tax on the decedent's estate tax return. Decedents (not donors) would be allowed a $200,000 per couple ($100,000 per individual) capital gains income exclusion, as well as a $500,000 per couple ($250,000 per individual) exclusion for personal residences. The exclusion noted above for transfers at death would not apply to lifetime gifts. The proposal would exclude tangible personal property, except for art and similar collectibles (e.g., bequests or gifts of furniture or other household items), from capital gains income.

Families that inherit small, family-owned and -operated businesses would not owe tax on the gains until the assets were sold, and closely held businesses would be allowed to pay the tax on gains over 15 years. If the gift or bequest is made to the donor/decedent's spouse, the donor/decedent's basis would carry over, and the deemed sale would occur when the spouse disposes of the asset during lifetime or bequeaths it at death.

Minimum GRAT term: This proposal would put a minimum term requirement of 10 years for grantor retained annuity trusts (GRATs). This would make a GRAT a riskier planning technique because the transfer-tax benefits of GRATs are typically achieved when the grantor outlives the GRAT term. The maximum term of the GRAT could not be longer than the life expectancy of the grantor plus 10 years. This would prevent 99-year GRATs that some taxpayers have created so that the amount includible in the grantor's estate under Sec. 2036 is very small.

Last year's proposal also would have required the remainder interest of a GRAT to have a value other than zero but did not provide a required minimum amount. In this year's proposal, the value of the remainder interest on the date the GRAT is created must be equal to the greater of 25% of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). This required minimum value would effectively render the technique useless in many estate plans. The proposal also would prohibit any decrease in the amount of the annuity during the annuity term to prevent front-loading a GRAT. Finally, the proposal would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust, essentially eliminating the grantor's ability to substitute assets in a GRAT.

Coordination of income and transfer-tax treatment for grantor trusts: This proposal was a stand-alone provision in last year's budget but was combined with the GRAT proposal in this year's budget. As in last year's budget, it would provide that if a grantor engages in a transaction that constitutes a sale or exchange that is disregarded for income tax purposes, the portion of the trust attributable to property received in the transaction (including all retained income, appreciation, and reinvestment net of the amount of consideration received by the grantor) will be subject to gift or estate tax when the property is no longer subject to the grantor trust rules. Any gift or estate tax payable due to this proposal would be borne by the trust. The proposal is targeted at shutting down the gift and estate tax benefit of sales to intentionally defective grantor trusts.

Limit duration of GST exemption: This proposal would terminate the GST exemption of a trust no later than the 90th anniversary of its creation (including transfers to pour-over trusts and decanted trusts). After the 90th anniversary, the trust would have an inclusion ratio of one. The proposal is an attempt by the administration to deal with many states that have changed or repealed their rules against perpetuities, which provide the maximum duration of a trust. When the GST tax regime was enacted, most states used the common law rule against perpetuities, which required the term of the trust to last no longer than 21 years after the death of a person in being (or alive) at the time the trust was created. Many states have now removed or revised the common law rule and have opted for longer terms.

Consistency in valuations: This proposal would limit the basis of property for income tax purposes to the value reported by a decedent's estate for estate tax purposes or by a donor for gift tax purposes. It would also grant authority to the IRS to require a donor or decedent to furnish basis information to the recipient of a gift and to the IRS.

Extend liens on estate tax deferrals: This proposal would extend the general estate tax lien that applies to all estate tax liabilities under Sec. 6323 to continue past the normal 10-year period until the deferral period the decedent's estate has elected under Sec. 6166 expires. The proposal seeks to reduce the complexities and costs of requiring additional security once the normal lien period expires as well as secure the government's rank among creditors of the estate and its assets.

This proposal is in response to the Tax Court's decision in *Roski*,[10] in which the court held that the IRS had abused its discretion by requiring that all estates electing to pay estate tax in installments under Sec. 6166 provide a bond or lien. The court ruled that it was Congress's intent that the IRS determine, on a case-by-case basis, whether the government's interest is at risk before requiring security from an estate making an election under Sec. 6166.

Clarify GST tax treatment of health and education exclusion trusts (HEETs): Sec. 2503(e) excludes from gift tax any payments made directly to the provider of medical care and payments made directly to an educational institution for tuition. Sec. 2611(b)(1) excludes from GST tax any transfer made pursuant to Sec. 2503(e). HEETs provide for medical and tuition expenses of multiple generations, and distributions from them for these purposes are excluded from GST tax. Since they are exclusively for purposes described in Sec. 2503 (e), there is no need to allocate GST exemption to them, as distributions from them are excluded from GST tax. This proposal would *clarify* that Sec. 2611(b)(1) applies only to a payment by a living donor.

Simplify gift tax annual exclusion for gifts to trusts: In general, gifts to a trust are not considered gifts of a present interest and, therefore, are not eligible for the gift tax annual exclusion, which, in 2015, excludes the first $14,000 of gifts made to a donee. In *Crummey*,[11] the Ninth Circuit ruled that a transfer to a trust that would otherwise be a gift of a future interest is the gift of a present interest if the beneficiary has the unrestricted right to withdraw the contribution to the trust even if that right exists for only a limited period of time (typically 30 days).

Last year's proposal would have eliminated the present interest requirement for gifts that qualify for the gift tax annual exclusion and impose an annual limit of $50,000 per donor on the donor's transfer of property to a trust. This year's proposal would create a new category of transfers to which the $50,000 per donor annual limit would apply. In addition to transfers to trusts, the new category would include transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers that, without regard to withdrawal, put, or other rights in the donee, cannot immediately be liquidated by the donee.

Expand applicability of the definition of executor: For estate tax purposes, Sec. 2203 defines an executor as the person who is appointed, qualified, and acting as an executor or administrator of the decedent's estate, or, if no one is serving in such a role, any person in actual or constructive possession of any of the decedent's property. This proposal would make the definition apply for all tax purposes, not just estate tax purposes. The proposal cites as the reason for the change the need to allow the executor to take care of any tax matters of the decedent including the ability of the executor to resolve tax matters that arose before the decedent's death.

Require beneficiaries other than surviving spouses to withdraw funds from IRAs and qualified retirement plans within five years of the death of the decedent: In general, someone who inherits funds in an individual retirement account (IRA) or qualified retirement plan must withdraw those funds within five years of the death of the owner of the IRA or retirement plan. Exceptions to this rule are for surviving spouses and designated beneficiaries of the account or plan. Designated beneficiaries are generally allowed to "stretch" the payment of the remaining balance in the account over their remaining life expectancies.

The proposal would generally require any person (other than a surviving spouse) who inherits an IRA or retirement plan to withdraw the balance in the account or plan within five years of the death of the IRA owner or plan participant. Exceptions are provided for eligible beneficiaries who are disabled, chronically ill, no more than 10 years younger than the IRA owner or plan participant, or a child who has not reached the age of majority. The budget cites as the reason for the change that these preferred accounts were intended to provide retirement security for individuals and their spouses, not to provide tax preferences to nonspouse heirs.

Inflation Adjustments

The IRS released Rev. Proc. 2014-61,setting forth inflation adjustments for various tax items for 2015. The following is a list of items that may be of interest to estate planning professionals serving individual clients:

Unified credit against estate tax: For an estate of any decedent dying during calendar year 2015, the basic exclusion amount is $5,430,000 for determining the amount of the unified credit against estate tax under Sec. 2010. This is also the amount of the gift tax exemption and the GST exemption.

Valuation of qualified real property in decedent's gross estate: For the estate of a decedent dying in calendar year 2015, if the executor elects to use the special-use valuation method under Sec. 2032A for qualified real property, the aggregate decrease in the value of the qualified real property resulting from electing to use Sec. 2032A for purposes of the estate tax cannot exceed $1,100,000.

Gift tax annual exclusion: The gift tax annual exclusion for gifts of a present interest remains $14,000 in 2015. The gift tax annual exclusion for gifts of a present interest to a spouse who is not a U.S. citizen is $147,000.

Interest on a certain portion of the estate tax payable in installments: For an estate of a decedent dying in 2015, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under Sec. 6601(j)) of the estate tax extended as provided in Sec. 6166 is $1,470,000.

Footnotes

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[1]Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

[2]REG-141832-11, 77 *Fed. Reg.* 36229 (June 18, 2012).

[3]T.D. 9593.

[4]*Securities and Exchange Comm'n v. Wyly*, No. 10-cv-5760 (S.D.N.Y. 11/3/14).

[5] *Estate of Goodwyn*, T.C. Memo. 1976-238.

[6] *Byrum*, 408 U.S. 125 (1972).

[7] See also IRS Letter Ruling 201426005, which ruled similarly.

[8] Office of Management and Budget, *Fiscal Year 2016 Budget of the U.S. Government*, available at www.whitehouse.gov (https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/budget.pdf).

[9] American Taxpayer Relief Act of 2012, P.L. 112-240.

[10] *Estate of Roski*, 128 T.C. 113 (2007).

[11] *Crummey*, 397 F.2d 82 (9th Cir. 1968).

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