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IRS MATTERS

2012 REG., RULINGS & PRONOUNCEMENTS OF NOTE

I. Taxpayer Advocate Report

National Taxpayer Advocate Nina E. Olson issued the agency's annual report to Congress on January 9, 2013. The report cited the dire need for tax reform and simplification of the Code. Underfunding of the IRS, identity theft and return preparer fraud were also identified as chronic problem areas.

The report found that the existing Code makes compliance difficult, and requires taxpayers to spend "excessive time" in preparing their returns. The Code also "obscures comprehension, leaving many taxpayers unaware of how their taxes are com-

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FROM THE COURTS

2012 Gift & Estate Tax Decisions of Note

I. Formula Clauses

The Tax Court in *Wandry v. Com'r*, T.C. Memo 2012-88, non-acq., 2012-46 I.R.B. upheld a defined value clause containing a formula transfer clause. The case is significant since it seemingly vanquished the last vestiges of *Proctor v. Com'r*, 142 F.2d 824 (4th Cir. 1944) which had invalidated savings clauses as violating public policy, and marks the first time that a court affirmatively sanctioned the use of formula clauses in cases not involving a charitable overflow beneficiary.

Some believe that reliance on *Wandry* may be risky until other Cir-

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FROM WASHINGTON

2012 TAXPAYER RELIEF ACT

TAX OUTLOOK FOR 2013

I. Overview of Act

On January 2, President Obama signed the American Taxpayer Relief Act of 2012 (the Act) into law, averting automatic tax increases. A bipartisan effort, the Act has changed the tax landscape, but not seismically.

Tax Analysis

As expected, the Clinton-era 39.6 percent tax rate was reincarnated and applies to joint filers whose income exceeds $450,000. The existing Bush-era rates for other taxpayers remain unchanged and have been made permanent, thus ensuring no tax increases for 98 percent of taxpayers.

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Elder Law Planning: Deciphering the Puzzle

Medicaid Trusts

I. Social Security

The Social Security program, begun during the Great Depression under President Roosevelt, is the forerunner of Medicare and Medicaid. The largest program under the Social Security Act is that which provides for retirement benefits.

Retirement Planning

The monthly retirement benefit is a function upon two variables: the recipient's earnings record (which is tracked by the Social Security Administration automatically) and the

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Use of Disclaimers in Pre and Post-Mortem Estate Planning

I. Introduction

Disclaimers can be extremely useful in estate planning. A person who disclaims property is treated as never having received the property for gift, estate or income tax purposes. This is significant, since the actual receipt of the same property followed by a gratuitous transfer would result in a taxable gift. Although wills frequently contain express language advising a beneficiary of a right to disclaim, such language is gratuitous, since a beneficiary may always disclaim.

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FEBRUARY COMMENT

Portability of Estate Tax Exclusion: Did Congress Guild The Lily?

I. Introduction

As part of the 2010 Tax Act, Congress enacted a statute allowing a surviving spouse to utilize the unused portion of the predeceasing spouse's lifetime estate tax exemption. This option offers protection to spouses who have not engaged in any estate planning. However, persons with estates large enough to benefit from the provision would in most cases be remiss in relying solely on the efficacy of portability as the cornerstone of their prudent estate plan.

Estate Planning

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A new 20 percent tax tier will be levied on **capital gains** and **dividend income** of taxpayers in the 39.6 percent tax bracket.

Itemized deductions of joint filers with income over $300,000 will be phased out.

The **estate tax** seems to have fared best: The lifetime exclusion amount was made permanent at $5.125 million, and is now indexed for inflation. "Portability" earned its wings and has been made permanent. (*See February Comment*) Ominous changes in the law affecting estate tax planning failed to materialize. (*See IRS Matters).*

Congress failed to extend the temporary 2 percent tax holiday on the employee portion of **FICA tax**, in effect since 2011. The measure to extend the tax break apparently lacked bipartisan support. An employee's contribution to the Social Security withholding tax will be bumped up 2 percent, to 6.2 percent. For self-employed taxpayers, the FICA rate of 10.4 percent will revert to 12.4 percent. Wages in excess of $113,700 are not subject to FICA. For those earning at least $113,700, the FICA increase will result in $2,274 of additional tax (subject to withholding).

Taxpayers with investment income above certain thresholds will be subject to the new **Medicare Surtax** of 3.8 percent beginning January 1, 2013.

The **Medicare Payroll tax** is currently 2.9 percent, divided equally between employer and employee. Under the Act, taxpayers whose **wages or self-employment income** exceeds certain thresholds will now pay an additional 0.9 percent (thereby increasing the employee's portion to 2.35 percent).

II. Provisions Affecting Individuals

New Medicare Surtax and Medicare Payroll Tax

National Health Care is being funded by increased Medicare taxes, which are expected to yield $318 billion over the next ten years. (*See Elder Law Planning: Deciphering the Puzzle*).

The new **3.8 percent Medicare Surtax** is imposed on the lesser of (i) "net investment income" (NII) or (ii) the amount by which modified adjusted gross income (MAGI) exceeds $250,000 for joint filers, and $200,000 for single

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filers.

Net investment income includes interest, dividends, capital gains, rents, royalties, nonqualified annuities, passive activity income, and income from trading financial instruments or commodities. Expressly excluded from the calculation of net investment income are wages, self-employment income, commissions, bonuses, and tips.

In essence, the top capital gains and "qualified" dividend tax rate for those in the higher income brackets will jump to 23.8 percent, an increase of 58.7 percent from the 2012 rate of 15 percent. Ordinary investment income tax rates will now top out at 43.4 percent.

The **new 0.9 percent Medicare Payroll Tax** apples to wages and self-employment income exceeding $200,000 for single filers, $250,000 for joint filers, and $125,000 for married taxpayers filing separately. The IRS provides the following example:

Assume a single filer earns $180,000 in wages and realizes another $90,000 from NII. The taxpayer's MAGI is $270,000. In this case, the taxpayer would have to pay a 3.8 percent surtax on $70,000, which is the lesser of $90,000 or $70,000. Since the taxpayer is below the earned income threshold for single filers, the taxpayer would not be subject to the 0.9 percent surtax on wages.

Under new proposed regulations, Treasury confirms that gain not recognized under other Code sections (*e.g.,* installment sales, like-kind exchanges or involuntary conversions, and gain from the sale of a principal residence up to the exclusion amount) will not be subject to the Medicare surtax. The 3.8 percent surtax applies to trusts but not to grantor trusts (although the grantor will pick up the income from grantor trusts).

Charitable remainder trusts are not subject to the tax, but beneficiaries may be subject to the tax as NII. The new regulations do not articular how rents are to be treated for purposes of the 3.8 percent tax.

Treasury also warns that taxpayer efforts to manipulate NII in order to avoid the 3.8 percent tax will be challenged based upon "applicable statutes" and "judicial doctrines."

Phase-out of Itemized Deductions and Personal Exemptions

The Act re-instituted the phase-out limitations on itemized deductions and personal exemptions for high income taxpayers. Although the new provisions are estimated to increase tax liability by only 1 percent, they activate at much lower adjusted gross income thresholds — $300,000 for joint filers and $250,000 for single filers.

Itemized deductions must now be reduced by 3 percent of adjusted gross income, but the phase-out is frozen once 80 percent of itemized deductions have been achieved. The phase-out will adversely affect taxpayers' ability to deduct common itemized deductions such as home mortgage interest, charitable contributions and state and local income tax payments. However, some itemized deductions will be unaffected: Those include medical expenses, investment interest and gambling losses.

To illustrate, assume taxpayer and spouse have $350,000 of AGI and $50,000 of itemized deductions. Since 3 percent of the amount by which AGI exceeds $300,000 is $1,500, allowable deductions are reduced to $48,500.

The new personal exemption phase-out (PEP) reduces the $3,900 personal exemption in effect for 2013 by 2 percent for each $2,500 above the income thresholds. In the example, taxpayers exceed the threshold by $50,000, which results in 20 reductions of 2 percent. Since 2 percent of $3,900 is $78, each spouse will forfeit $1,560 in exemption deductions ($78 x 20), resulting in an allowable personal exemption of $2,340 for each spouse.

Extension of Unemployment Benefits

Congress approved $30 billion in extended unemployment benefits for 2013, preserving assistance for 2.1 million long-term unemployed workers. The measure was not offset by other spending cuts. The extension provides a maximum of 47 weeks of federal benefits. Federal benefits are linked to the jobless rates in individual states and are based on a three-month average. In New York, those unemployed will be able to collect for a maximum of 63 weeks, of which New York funds 26 weeks.

Alternative Minimum Tax

The **Alternative Minimum Tax**, perennial headache for Congress, necessitating yearly "patches," may have been patched for good. The exemption amount has now been raised to reflect inflation over the past 40 years, and is now indexed for inflation. The exemption amount applies retroactively to 2012, and is $50,600 for individual filers, and $78,750 for joint filers. All non-refundable personal credits are now allowed to offset AMT tax liability as well as regular tax liability.

Since the AMT tax applies if the tax calculated thereunder is higher than the tax liability calculated without reference to the AMT, a higher exemption means that the application of the AMT is narrowed. Without the legislation, upwards of 28 million taxpayers may have been subject to the AMT for the 2012 tax year.

Other Provisions Affecting Individuals

The Act also (i) allows taxpayers age 70½ or older to directly transfer up to $100,000 from their IRAs to charities without incurring income tax; (ii) extends mortgage-debt relief under IRC §108; (iii) preserves the $4,000 deduction for qualified tuition and related expenses and (iv) the student loan interest deduction.

III. Estate Tax Provisions

The Act retained the $5 million lifetime exclusion, and made it permanent. The exemption amount will be

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freshened each year, as an inflation adjustment has been included. The inflation-adjusted amount for 2013 is $5.25 million. The Act creates a 40 percent maximum tax rate on gifts, estate and generation-skipping taxes, which rate is higher than the 2012 rate of 35 percent, but lower than the 55 percent rate to which it would otherwise have reverted but for the Act.

Portability allows a couple to effectively shield $10.5 million in assets. However, the GST exemption is not portable. In the event of the death of one spouse and the subsequent remarriage of the other spouse, the surviving spouse will continue to be able to "port" the unused exemption amount of her deceased spouse, unless her new spouse dies, in which case she will be able to use only that new spouse's unused exemption amount.

The gift tax has been permanently reunified with the estate tax. The annual exclusion amount is also now adjusted for inflation, but in $1,000 increments. The annual exclusion amount for 2013 is $14,000.

Congress punted on four areas which are viewed as possible sources of revenue: GRATs, GST Trusts, family entity discounts, and grantor trusts. 2013 would appear to be an excellent year in which to consider taking advantage of some of these planning techniques.

For the past few years, there has been talk of eliminating short-term GRATs, and mandating a minimum 10 -year term for such trusts.

A proposal to limit the GST exemption to 90 years was made. This would make the GST exemption shorter than the rule against perpetuities, and if enacted would deal a severe blow to dynasty trusts.

Congress has considered eliminating the ability of taxpayers to utilized minority discounts or lack of transferability discounts. However, since the courts have sanctioned the viability of these discounts, their abrogation would be more difficult. It is not even certain that Congress could entirely legislate out of existence these discounts without causing a ripple effect into other areas of the tax law.

Some in Congress have also taken note of the revenue losses occasioned by the use of grantor trusts. The grantor trust provisions of the Code were enacted many years ago to prevent income-shifting. No longer needed to prevent income-shifting, the rules have gained prominence as a planning tool which accomplishes a royal flush in taxation: removal of an asset from the estate without creating an income tax event, and a continued liability of the grantor to pay income taxes which are no longer part of his taxable estate. Congress could conceivably shut this down in the next 5 to 10 years by legislatively overruling Revenue Ruling 85-13, the golden rule which is the wellspring of many estate plans today.

Estate planning, once concerned primarily with the estate tax, is now more focused on income tax aspects. Since no benefit will accrue from claiming deductions for estate tax purposes where the estate is not taxable, practitioners' attention will turn to deducting these expenses on fiduciary returns. The IRS can be expected to seek revenue from challenging administration expenses under IRC §83.

In addition, the IRS can be expected to challenge efforts by taxpayers to achieve basis step-up through the use of grantor trusts when utilizing portability, by substituting assets of equal value. In essence, the estate tax playing field has changed drastically for the IRS, but the Treasury is not without the ability to enact new measures to prevent a total collapse of tax imposed on generational transfers.

While individuals are not subject to the new 39.6 percent top rate until their income exceeds $400,000, trusts become subject to that tax when income exceeds only $11,950. Trusts may also be subject to the 3.8 percent Medicare surtax, thus resulting in a top rate of 43.4 percent. Trustees can, to a considerable extent, avoid the tax by distributing income to beneficiaries in lower brackets. Alternatively, choosing grantor trust status would also obviate the problem.

IV. Business and Corporate Provisions

Section 179 Expensing & Bonus Depreciation

The Act extended the IRC §179 expensing deduction of $500,000 through the end of 2013 for tangible, depreciable personal property acquired for use in a trade or business as well as "qualified real property." A phase-out operates to reduce the deduction dollar -for-dollar if the taxpayer places more than $2 million of Section 179 property into service during a taxable year.

The Act also extends the 50 percent bonus depreciation allowed under IRC §168(k).

Section 1374 Built-in-Gains Relief Extended Through 12/31/2013

IRC §1374 applies if, during the recognition period, a C corporation converts into an S Corporation and sells at a gain assets that had appreciated at the time of the conversion. Those "built-in gains" are taxed at 35 percent. The recognition period was to increase from five years to ten years as of January 1, 2013. Under the Act, the five year recognition period will continue through the end of 2013.

Other Business Provisions

The Act also (i) retroactively extends through 2013 the research tax credit, which expired at the end of 2011; (ii) extends through 2013 the Work Opportunity Tax Credit, which grants employers a credit of 40 percent on the first $6,000 paid to employees from a targeted group; (iii) retroactively extends through 2013 the "active financing income" exception from taxation under Subpart F for income from the active conduct by a controlled foreign corporation (CFC) of a banking, financing or similar business; (iv) retroactively extends through 2013 the CFC look-through rule, which pro-

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vides an exclusion from income for certain dividends, interest, rent and royalties received from a CFC from a related CFC; and (v) extends the exclusion of 100 percent of gain realized on the disposition of qualified small business stock acquired before 2014.

V. Outlook for 2013

The American Taxpayer Relief Act of 2012 prevented an estimated $500 billion shock to the economy that would have upset the fledgling recovery by imposing draconian tax rates, and would without doubt roiled the financial markets if the federal deficit had not been addressed.

While the Act averted disaster, ultimately it again failed to address the deficit issue. The first tranche of automatic spending cuts that had been scheduled to go into effect on January 1st were merely postponed until March. Also left unfinished by Congress and the Administration was the crucial issue of the statutory borrowing limit of the government.

In other areas, substantial progress was made. A measure of certainty and permanency — lacking for a decade — was instilled into the estate tax regime. The AMT was given a more permanent patch. Finally, income tax rates were made permanent, which means that an act of Congress will be required in order to modify the tax rates, rather than an act of Congress being required to avert an unwanted change in the tax rates.

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cuits opine. [*See* TAX COURT DEFIES IRS: EXPANDS USE OF DEFINED VALUE CLAUSES, *Tax News & Comment, October 2012.*]

II. Constitutionality of DOMA

Windsor v. U.S., 833 F.Supp.2d 394 (S.D.N.Y. 6/6/12), *aff'd*, 2012 WL 4937310 (2nd Cir. 2012), now on appeal to the Supreme Court, held that the Defense of Marriage Act was unconstitutional for purposes of the federal estate tax marital deduction. The Supreme Court may not reach the merits, as the case could be decided on the issue of standing.

III. Estate Planning With Family Entities

Estate of Stone v. Com'r, T.C. Memo 2012-48 held that the management of a family asset consisting of real estate was a legitimate nontax objective in creating a family partnership. Therefore, the value of the partnership assets was not includible in the decedent's gross estate under IRC §2036. The taxpayers in *Stone* had dotted their "i's" and crossed their "t's" by ensuring that they did not transfer so many assets to the partnership such that they would not be able to continue in their accustomed standard of living without the transferred assets. The transferors also avoided personal use of the assets. Interestingly, no discounts whatsoever were taken. Apparently, asset protection (some of the children were about to be married) and a desire to shift future appreciation were the motivations for the transfers.

Similarly, in *Estate of Kelly v. Com'r*, T.C. Memo 2012-73, the Tax Court held that since legitimate nontax reasons existed for the transfer of assets into a family partnership, no inclusion would result under IRC §2036. Section 2036 had no application since the decedent had gifted the interests to the partnership and retained no interest whatsoever in the transferred interests. The decedent retained sufficient assets to pay for living expenses, and a *bona fide* purpose existed for forming the partnership, one of which included asset protection.

When planning with family entities and trusts, the issue frequently arises as to whether gifts qualify for the annual exclusion where the agreement or trust limits the right of the beneficiaries. That issue arose in *Estate of Wimmer v. Com'r,* T.C. Memo 2012-157 in the context of gifts of limited partnership interests. The Tax Court found that the gifts in question satisfied a three-prong test for qualification as an annual exclusion gift: (i) the partnership had income; (ii) income would flow to the donee; and (iii) income flowing to the donee could be ascertained. An important factor in this case was that distributions were required to be made pro rata.

IV. Administration Expenses

Although it would appear to be permissible to inform an appraiser of the purpose of an appraisal, civil fraud penalties were assessed against the taxpayer in *Gaughen v. U.S.,* __F.Supp.2d__, 109, 109 A.F.T.R.2d 2012-752 (N.D. Pa. 2012) who hired a "Certified General Appraiser" and advised him that he "need[ed] a restricted appraisal report very close to $65,000." The court denied the taxpayer's motion for summary judgment, finding that a reasonable jury could find fraudulent intent.

Estate of Gill, T.C. Memo 2012-7 involved the propriety of administration expenses and the marital deduction. Four months before his death, the decedent married a German citizen, who took the name Valerie Gill. Shortly thereafter, the decedent amended the terms of his trust to provide that all income and discretionary payments of principal from a testamentary marital trust would be distributed to Valerie, and that upon her death his children would be trust beneficiaries.

Upon the decedent's death, his children sued Valerie, alleging undue influence. Eventually the claim was settled, but at a cost of $829,965 in legal fees. The issue was whether the legal fees were deductible by the estate, and whether the marital deduction should be reduced. The court held for the estate on the first issue, finding that the legal fees were necessary to resolve the issue of undue influence.

Resolution of the second issue was more complex. As part of the settlement, the children reimbursed the estate for taxes. The IRS argued that the marital deduction should be reduced since the estate was reimbursed for estate taxes paid as part of the settlement. The Estate argued that the tax burden ultimately fell on the children since they reimbursed the estate. The Tax Court noted that the decedent's will provided that increases in estate tax would be paid by the person to whom the property was distributed. Since the children who received the property reimbursed the estate for estate taxes previously paid, the children ultimately paid the estate taxes, and therefore the marital deduction did not require reduction.

In *Estate of Kahanic v. Com'r*, T.C. Memo 2012-81, the decedent had a legal obligation to name his divorced spouse as beneficiary of a life insurance policy on his life. At the time of his death, he had failed to comply with this legal obligation, and payments were made to his estate. Nevertheless, the surviving spouse to whom the obligations were owed received the proceeds of the $2.495 million life insurance policy. The estate reported the value of the life insurance policy and took a corresponding debt deduction. The Tax Court agreed with the estate that under IRC §2053(a)(4), the estate was entitled to take a deduction for the full value of the policy, since the debt was *bona fide* and was incurred for adequate and full consideration.

V. Claims for Refund

In *Marshall Naify Revocable Trust v. U.S.*, 672 F.3d 620 (9th Cir. 2/15/12), *aff'g* 2010 WL 3619813 (N.D. Cal., 2010) the decedent's estate paid California $26 million on a disputed tax claim. The IRS allowed a

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$26 million deduction on the decedent's estate tax return. The estate then filed a claim of refund based on a $47 million deduction, arguing that the higher deduction was appropriate given the likelihood of prevailing in litigation against California, *measured at the date of the decedent's death*. The IRS disallowed the refund claim, finding that post-death events were relevant because the amount of the deduction could not be ascertained with reasonable certainty at the date of the decedent's death.

The District Court agreed with the IRS that since the amount of California's claim against the estate was not ascertainable with reasonable certainty as of the decedent's death, under *Propstra v. U.S.,* 680 F.2d 1248 (9th Cir. 1982), it was proper to consider post-death events.

VI. Intra-family Loans

In *Estate of Lockett v. Com'r*, T.C. Memo 2012-123, a limited liability partnership was created. Partnership interests eventually funded a marital trust. The partnership subsequently made various loans to son of the decedent in amounts ranging from $135,000 to $200,000. The loans were evidenced by properly executed promissory notes and some were repaid. On audit of the estate tax return, the IRS determined that the loans were actually gifts, and asserted a deficiency of $706,110.

Tax Court found that the loans were *bona fide* since, taking into account the facts and circumstances, a real debtor-creditor relationship existed. However, the Tax Court also found that since the partnership had been dissolved and no gifts of partnership interests had been made to either of two sons, the decedent herself owned all of the assets outright at her death. Accordingly, no discounts were allowed the estate.

VII. Gift Tax Returns

In *Dickerson v. Com'r*, T.C. Memo 2012-60, a waitress at Waffle House won a lottery worth $10 million, which had a cash payout of $5 million. On the advice of an attorney, Dickerson formed an S Corporation in which other family members owned a 51 percent interest and she a 49 percent interest. The lottery winnings were deposited into the corporation.

Although no gift tax return was filed, the IRS found out about the stock ownership, and asserted a gift tax deficiency alleging that Dickerson had made a taxable gift of 51 percent of the lottery winnings to other family members. The Tax Court agreed with the IRS that a taxable gift had been made, but also accepted the taxpayer's argument that the gift should be discounted due to ensuing litigation from four other waitresses at Waffle House who claimed an interest in the lottery winnings. Ultimately, the Tax Court settled on a discount of 67 percent, and arrived at total gift of $1.119 million.

VIII. Fiduciary Liability

Being an executor or trustee is not without its risks. The government has a cause of action under The Federal Priority Statute, 31 U.S.C. §3713, where executors or trustees make distributions to which the government had priority. In *U.S. v. MacIntyre*, 2012 WL 1067283 (S.D. Tex.) the government proceeded under §3713 against a trustee and an executor who had distributed assets in a situation where they had sufficient notice of the government's claim. Although the amount of assets distributed was very small in relation to the size of the estate, the fiduciaries were held personally liable for an amount of $1.119 million, which had been set aside for a charity.

Although no formal probate may transpire, an estate tax return must nevertheless be filed by the "executor." In *Estate of Gudie v. Com'r,* 137 T.C. 165 (2011) the trustee of an *inter vivos* trust signed the estate tax return as executor. Later, the IRS asserted a substantial deficiency. The trustee argued that since she had not been formally appointed as executor of the estate, the IRS was without jurisdiction to send her a notice of deficiency. The District Court disagreed, finding that a person who is in possession of assets of an estate has an obligation to file an estate tax return, regardless of whether the assets passed through the probate or non-probate estate. Therefore, the executor was a statutory executor under IRC §2203.

IX. IRS Power to Issue Summons to States

It is fairly well known that donors of real estate in which the donees are family members are not always reported on a gift tax return. However, such transfers should be reported for many reasons, not the least of which is that the government will most likely find out about the transfer anyway.

Many states, including New York, Connecticut, New Jersey, Pennsylvania, Florida and Texas have provided this information to the IRS. California refused, citing a state statute that prohibits disclosure about personal information. In response, the IRS issued a summons to the California Board of Equalization for the data. The federal District Court denied the summons, finding that the requirements for the issues of a summons under IRC §7609(f) were not met, since the IRS could obtain the data elsewhere.

Following the denial of its petition without prejudice, the IRS served a revised petition, wherein it alleged that it would be unduly burdensome to request the data from each of the 58 counties in California. In response to the revised summons, the District Court found that the IRS had exhausted all administrative remedies, and that California's sovereign immunity did not preclude the issues of the "John Doe" summons. The court granted the summons.

X. Abatement of Penalties

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In *Freeman v. U.S.*, 2012 WL 26273 (E.D. Pa. 2012), the attorney for the executor failed to file timely estate tax returns, eventuating a penalty. The executor sought remission of the penalties, alleging that the attorney was suffering from physical and emotional ailments, and that the attorney had embezzled from the estate. The executor asserted that reasonable cause existed to annul the penalties. The District Court found for the IRS. Although Reg. §301.6651-1(c)(1) provides that reasonable cause exists where the taxpayer "exercised ordinary business care and prudence and was . . . unable to file the return within the prescribed time . . ." the Supreme Court in *U.S. v. Boyle*, 469 U.S. 241 (1985) held that a taxpayer's duty to timely file a return is nondelegable.

XI. Liability of "Fiduciary" for Purposes of Estate Tax Return

U.S. v. Johnson, 2012 WL 1898873 (Dist. Ct. Utah 2012), involved the interpretation of IRC §6324 (a)(2) which imposes personal liability for unpaid estate taxes upon "transferees" and "beneficiaries." After the trustee had distributed funds to trust beneficiaries, the estate defaulted on certain estate tax obligations. The IRS argued that the trust beneficiaries were "beneficiaries" for purposes of Section 6324. The defendant beneficiaries motion to dismiss was granted.

The District Court agreed that a "transferee" is a person who receives property immediately after a person's death, and that transferee liability does not extend to beneficiaries of a trust because a trustee, and not the trust beneficiaries, are in receipt of trust assets at the death of the settlor.

XII. Protective Refund Claims

In *Davis v. U.S.*, 2012-1 USTC ¶ 60,634 (N.D. Miss. 2011) the estate paid estate tax based on the belief that the estate owned a fee interest in real property. The estate later learned that it did not own a fee interest, but only a life estate. By the time the (losing) appeals for the estate were exhausted, the estate was time-barred from filing a claim for refund. The estate argued that its due process rights were violated.

The District Court, citing the Supreme Court decision in *U.S. v. Brockamp*, 519 U.S. 347 (1997) noted that courts may not toll "for non-statutory equitable reasons, the statutory time and related amount limitations for filing tax refund claims set forth in Section 6511 of the . . . Code." The court noted that the proper course for the estate would have been to file a protective claim. It appears that the existence of the right to file a protective claim was a factor in the court's finding that no due process violation had occurred.

XIII. Attorneys' Fees

In *Estate of Palumbo v. U.S.*, 675 F.3d 234 (3rd Cir. 2012), a charitable trust and the son of the decedent had a dispute over the amounts to be received by each. Eventually, they settled. The IRS denied the deduction taken by the estate for the amount paid to the charitable trust, on the grounds that the trust had no enforceable claim against the estate. The District Court granted the estate's motion for summary judgment.

The estate then sought attorney's fees arguing that the government's position was not "substantially justified." The motion for attorneys fees was denied. On appeal to the Third Circuit, the decision to deny attorneys fees was affirmed on procedural grounds. The appeals court never reached the question of whether the government's position was substantially justified. Instead, the court found that the net worth of the estate exceeded the $2 million threshold for recovery of attorneys fees. The estate argued that the net worth requirement did not apply to 501(c)(3) charitable entitles. Even so, the court held that the attorneys fees could not be granted, since fees can only be awarded to a "prevailing party," and although the charitable trust would benefit from the award of attorneys fees, it was not a "party" to the litigation.

XIV. Conservation Easements

The Code allows an income tax deduction for a qualified donation of a conservation easement. Generally, the deduction is up to 30 percent of the taxpayer's adjusted gross income. The IRS contested deductions associated with conservation easements in a number of cases in 2012.

In *Trout Ranch, LLC v. Com'r*, 2012 WL 3518564 (10th Cir. 2012), the taxpayer contributed a conservation easement consisting of water rights, which the taxpayer's appraiser valued at between $1.59 and $2.3 million. The IRS ascribed a value of zero to the easement. The Tax Court, in a Solomonic manner, rejected both appraisals individually, but arrived at a value of $560,000 using both together.

In *Rolf v. Com'r,* 668 F.3d 888 (7th Cir. 2012*)* the taxpayers contributed a lakefront house to the local fire department which intended to burn the house down in training exercises, and claimed a charitable deduction of 76,000 on their income tax return, which was disallowed. The case went to the Court of Appeals, which affirmed the finding of the District Court that the taxpayers had not shown that they did not receive a benefit equal to or exceeding the value of the house. The courts reasoned that since the house was to be burned down immediately, it was of no value. Moreover, it was established at trial that the cost of demolishing the house would have been $10,000 had the taxpayers paid that expense.

XV. Adequate Disclosure

Treasury regulations are not always a model of clarity with respect to when and whether professional valuations are required when making gifts. Form 8283 at one time stated "If your total art contribution was $20,000 or more you must attach a complete copy

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of the signed appraisal. Since the taxpayer was not contributing art, he reasoned (incorrectly) by negative implication that no appraisal was required since he was not contributing art.

The Tax Court noted that the result was "harsh" since all deductions would be disallowed, but noted that the statute and regulations comprise the authority for determining whether am appraisal was necessary, and in this case that authority was clear — noncash donations exceeding $5,000 must be supported by a written appraisal completed by an independent qualified appraiser. *Mohamed v. Com'r,* T.C. Memo 2012-152.

XVI. Charitable Contributions

In *Durden v. Com'r*, T.C. Memo 2012-8, the taxpayer made $25,171 in contributions by check or cash to his church, which donations were supported by evidence consisting of cancelled checks and a letter from the church acknowledging receipt. The IRS disallowed the deduction by reason of the failure of the donee organization to provide a contemporaneous acknowledge and description and good faith estimate of the value of any goods or services provided by the donee organization. Following the disallowance, the taxpayer obtained the required information. However, the IRS still continued to deny the deduction. The Tax Court held for the IRS, citing Reg. §1.170A-13(f)(3) which states that a written acknowledgement is contemporaneous only if it is received on or before the due date of the return for the taxable year of contribution.

XVII. Asset Protection Trusts & Federal Income Tax Liability

The effectiveness of an asset protection trust depends in substantial part on the *bona fides* of the transaction and of the trust. *In U.S. v. Evseroff*, 2012 USTC ¶50,328 (E.D.N.Y. 2012), the Eastern District concluded that the asset protection trust created by the taxpayer did not provide any protection against the IRS claim for income tax liabilities. The court found that (i) the trust was not a bona fide entity; that (ii) it had never assumed title to real estate purportedly transferred into the trust; and that (iii) the taxpayer had disregarded the entity by taking deductions attributable to trust property. Accordingly, the transfer constituted a fraudulent conveyance.

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puted. . . it facilitates tax avoidance by enabling sophisticated taxpayers to reduce their tax liabilities and provides criminals with opportunities to commit tax fraud."

The report found that the Internal Revenue Code imposes a "significant, even unconscionable burden on taxpayers" and noted that if tax compliance were an industry, it would be "one of the largest in the United States."

Simplification, according to the report, would occur if Congress reassessed and reduced the dizzying number of exclusions, deductions, exemptions and credits, generally known as "tax expenditures." If Congress were to eliminate all such tax expenditures, the report concludes that individual income tax rates could be cut by 44 percent, and still generate the same amount of income. The suggestion is made that as a starting point all tax expenditures be eliminated and then reassessed, with the objective of determining whether the incentive would be best administered through the Code or as a direct spending program.

The report fails to comprehend the difference between the complexity of the Code and the purpose of a tax expenditure. Achieving simplification of the Code is not dependent on eliminating tax expenditures. To cite a case in point, Code Section 1031 provides a deferral of tax when exchanging property of like kind. There is no question but that Section 1031 is a tax expenditure or tax incentive. If Section 1031 were eliminated, there would be no feasible way for Congress to provide this incentive in a direct spending program.

Another example which illustrates the folly of suggesting that tax expenditures be eliminated would be Section 179, which provides a current deduction for business investments. Eliminating Section 179 would result in taxpayers being required to capitalize the cost of tangible personal property used in a business. Again, no comparable method of providing the benefit of Section 179 could be achieved by a "direct spending program."

The confusion about the purported cause and effect relationship between the complexity of the Code and tax expenditures is surprising. Tax expenditures are not bad per se. Nor is the "complexity" of the Code bad per se. A flat tax with no deductions would likely "simplify" the Code, but it would come at the cost of eliminating progressivity in the tax system. The very problems which have plagued the Alternative Minimum Tax would visit an attempt to simplify the Code by eliminating appropriate deductions, credits and exclusions.

This is not to say that the Code is not complicated. There are undoubtedly many areas of the tax law that are complex. However, to cite another example, Congress has decided that losses incurred in "passive" activities should not be permitted to offset other deductions. This is a judgment that Congress has made, and Section 469 stands as a proper exercise of the legislative power of Congress to collect tax. The complexity of Section 469 is undeniable, but should the difficulty — or perhaps impossibility — of "simplifying" a provision designed to achieve a specific purpose necessarily result in an indictment of that statute?

There is arguably a need to simplify compliance procedures. However, the argument that it takes sophisticated tax software for the average taxpayer to complete a return is somewhat naïve. The world is more complex today than 50 years ago. The availability of sophisticated software makes compliance easier. Few taxpayers today sit down with a form 1040 and a pencil and calculate their tax liability.

Congress has taken concrete steps to ease compliance difficulties. Withholding laws have been strengthened. Information reporting for securities transactions, as well as for other receipts of income from sources requiring 1099 reporting, have been expanded. The complexity of the Internal Revenue Code is not the problem. Part of the problem lay in the fact that the forms and instructions provided by the IRS are not always models of clarity.

Report Cites IRS Underfunding

The Advocate's report also cites extreme IRS underfunding as a major problem. The report postulates that it is "ironic and counterproductive" that deficit concerns result in less funding for the IRS. A statistic is cited in the report that the "return on investment" of the IRS is "214:1" and states that "no business would fail to fund a unit that . . . brought in [much more than] every dollar spent."

The report then finds that the decline in IRS services since 2004 has been the result of IRS underfunding. Fewer taxpayer telephone calls are answered by live agents, and more ominously, automated enforcement procedures are causing the issuance of liens and levies where an installment agreement or offer-in-compromise could be considered.

This argument seems strained. Computers do not issue liens and levies. Computers could be just as easily programmed to issue letters requesting that delinquent taxpayers consider an installment agreement or offer in compromise. There is no question but that IRS personnel have a daunting task in handling millions of taxpayer inquiries. Yet other large companies also face the same task and can seemingly deliver prompt customer service. No one would argue that the IRS should not be properly funded. However, "fencing off" the IRS and making it immune from spending ceilings imposed on other governmental agencies based on the argument that the IRS "is the de facto Accounts Receivable Department of the federal government" seems specious. Not everyone would agree with the conclusion of the Taxpayer Advocate that "[t]he plain truth is that the IRS's mission trumps all other agencies' missions."

Tax-Related Identity Theft

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The report cites the spiraling incidence of taxpayer identity theft, which often results in a six month or longer delay in a taxpayer receiving a refund, since no refund will issue until a case is closed. The report cites the need for a "streamlined process" to resolve the cases and notes that taxpayers still face a "labyrinth of procedures and drawn-out timeframes for resolution."

Among other "serious" problems encountered by taxpayers and identified by the IRS include the following:

(i) the failure by the IRS to provide tax refunds to victims of preparer fraud;

(ii) the "extraordinarily high audit rate" of taxpayers claiming the adoption tax credit (which results in only about 10 percent of the credits being denied);

(iii) the failure of the Offshore Voluntary Compliance Program to distinguish between "bad actors" and "benign actors" in enforcing Foreign Bank and Financial Accounts Reporting (FBAR) requirements. By requiring taxpayers to "opt out" of the voluntary program and submit to onerous audits to avoid the imposition of "draconian" penalties, the program has caused an "excessive burden" on taxpayers who had reasonable cause not to file FBAR returns; and

(iv) the need to improve voluntary compliance by small businesses and sole proprietors, whose compliance is regarded as generally poor. The report found that low-compliance taxpayers were more suspicious of the tax system and were less likely to have trust in tax preparers and were less likely to use them.

II.. Treasury Proposals in 2012

¶ Treasury proposed expanding the category of "disregarded restrictions" under IRC §2704(b) to impair the ability to take discounts on intra-family transfers. Since courts have upheld the viability of discounts when compared to state law, the proposal would instead reference standards in Treasury regulations.

¶ Treasury raised the subject of requiring a minimum ten-year term for GRATs. However, no action was taken, and there was no mention of impairing the ability of taxpayers to "zero-out" GRATs.

¶ Treasury proposed limiting the duration of the GST tax exemption to 90 years. If adopted, this measure would be more stringent than the existing rule against perpetuities.

¶ In what would constitute a damaging blow to a popular estate planning technique, Treasury proposed including the date-of-death value of all grantor trusts in the grantor's gross estate. Taxpayers who have relied on the ability to shift assets out of their estate while picking up the income tax would be "grandfathered," as the proposed changes would not be retroactive. While this proposal if enacted would defeat the benefit of funding grantor trusts, the measure appears to be years away from enactment and, if one had to speculate, it appears that there is greater chance that the estate tax itself would be eliminated than that this measure would see the light of day.

¶ Treasury proposed regulations to implement the Supreme Court's decision in *Knight v. Com'r*, 552 U.S. 181 (2008), which interpreted IRC §67(e)(1). Section 67 states that certain expenses incurred in administering a trust or estate are not subject to the 2 percent itemized deduction limitations.

Section 67(e)(1) provides an exception to nondeductibility for costs that "would not have been incurred if the property were not held in such trust or estate." The Supreme Court interpreted that phrase to mean costs that were not "commonly or customarily" incurred by individuals. The decision effectively repudiated a decision of the 2nd Circuit (by then Justice Sotomayor) which limited the exception to costs individuals were "incapable of incurring." *Rudkin Testamentary Trust v. Com'r*, 467 F.3d 149 (2006).

¶ Treasury proposed introducing "present value concepts" in relation to the timing of deductions claimed by an estate. In certain cases, deductions are taken on an estate tax return but the associated payment is not made until much later. This creates an opportunity for arbitrage with respect to which Treasury disapproves.

¶ Treasury proposed final regulations under IRC §2642(g) addressing extensions of time to make allocations of the GST tax exemption. Under the proposed regulations, the standard under which requests for extensions of time to make allocations will be measured is that "the transferor or the executor . . . acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government." In addition, the Proposed Reg. §26.2642-7(h)(3)(i)(D) would require affidavits from "tax professionals" who advised or were consulted by the taxpayer with respect to the GST tax.

¶ Trust decanting could create a taxable event for income, gift, estate, or generation-skipping tax (GST) purposes. For this reason, a trustee has an affirmative duty to consider tax implications before consummating a decanting transaction. Notice 2011-101 requested comments from the public regarding possible income, gift, estate and Generation Skipping tax issues arising from transfers by a trustee of all or a portion of the principal of a distributing trust. Treasury identified thirteen "facts and circumstances" potentially affecting one or more tax consequences.

Although the IRS encouraged the public to participate in formulating guidance, and stated that it would continue to publish PLRs addressing decanting, no further action was taken. Viewed in a favorable light, this may mean that the IRS has concluded that any tax issues arising in connection with decanting do not rise to a level serious enough to warrant further study.

III. Rulings of Note

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In PLR 201229005, the beneficiary of a trust was given a testamentary power to appoint trust assets to a class consisting of descendants of the beneficiary's parents. Since the "class of appointees" did not include the beneficiary's estate or his creditors, the power was not taxable as a Section 2041(a)(2) general power.

The trust in Rev. Rul. 2011-28, permitted the grantor to reacquire trust property, which consisted of a life insurance policy. The issue was whether the grantor's right to reacquire the insurance policy constituted a retained "incident of ownership" over the policy which would result in estate inclusion. The ruling stated that since the grantor was constrained under local law from exercising the powers for his personal benefit, he had not retained any prohibited incidents of ownership.

Non-spouses may not enjoy the benefits of property they disclaim. In PLR 201243001 a joint revocable trust executed by both spouses provided that upon the death of last spouse to die, assets would pass outright to son. The trust was later amended to provide that son could disclaim into a trust with respect to which he and his descendants were beneficiaries. After the death of the last spouse, the attorney became aware that the requirements for a qualified disclaimer could not be satisfied, since son was a beneficiary of property he disclaimed.

An application made to the state court to amend the trust based on "ambiguity" or "scrivener's error due to mistake of law" was granted by the state court. However, the IRS opined that it was not bound by the amendment, since it was not a contracting party to the agreement to amend. Furthermore, the IRS noted that under *Estate of Bosch*, 387 U.S. 456 (1967), federal courts, though bound by decisions of a state's highest court, are not bound by state trial courts, to which they must only give "proper regard."

In PLR 2012233011 the grantor created a lifetime QTIP trust for his spouse. Although a gift tax return was filed, the preparer failed to make the QTIP election on the return. Following the death of the grantor's spouse, the grantor requested an extension of time in which to make the QTIP election. In general, extensions of time limitations that are not otherwise provided by statute will be granted if the taxpayer acted reasonably and in good faith, and the interests of the government are not prejudiced. Reg. §301.9100-3(b)(1(v) provides that a taxpayer has acted in good faith if he relied on a tax professional who failed to make or advice of the necessity of a required election.

The problem in this case was that the time period for making the lifetime QTIP election was statutory, and not regulatory. Therefore Section 9100 relief could not issue. However, the IRS had earlier ruled favorably, only to withdraw the ruling upon realizing its error.

Even though the erroneous ruling and its withdrawal were two years before the requested ruling in the instant PLR, the IRS granted relief and ruled favorably. Under IRC §7805(b)(8), Treasury may determine the extent to which any revenue ruling will be applied without retroactive effect. Here, the IRS determined that the earlier ruling had been issued for a proposed transaction, the taxpayer in the instant case had relied on the ruling in good faith and had released the law firm involved from a malpractice action.

The ruling is interesting first because of the generosity of the IRS in deciding not to apply retroactively a PLR that had been available for two years. Also interesting is that the PLR seems to dispel the notion that PLRs cannot be relied upon by taxpayers, because in this very case the IRS spoke of the taxpayer's justifiable reliance on the PLR.

PLR 201245004 blessed the disclaimer by a surviving spouse of an IRA account in which she was the designated beneficiary, despite her having received two distributions from the account that were in excess of her required minimum distribution (RMD). The RMD and the excess actually received could be disclaimed.

In PLR 201235006 the taxpayer created two trusts, Trust A and Trust B. Trust B was a grantor trust under IRC §675(4)(C), since the grantor had retained the power to reacquire trust assets by transferring other property of equal value. The ruling requested advice as to whether the purchase by Trust B of a life insurance policy owned by Trust A would cause Trust B to lose its grantor trust status by reason of the application of IRC §2042.

Section 2042 requires in inclusion the decedent's estate if the decedent retains "incidents of ownership" over the policy. The IRS noted that in the facts of the ruling (i) the sale to the grantor trust is not a transfer for value for income tax purposes and (ii) local law requires that the trustee of Trust B ensure that the property which the grantor seeks to substitute is of equal value to the property that the grantor seeks to reacquire. Accordingly, Trust B would remain a grantor trust. [The IRS also stated that the existence of *Crummey* powers in Trust B would not affect its grantor trust status.]

* * *

In Rev. Proc. 2013-13 the IRS announced a simplified option for claiming a home office deduction in 2013. The new deduction would be capped at $1,500 per year based on $5 per square foot up to 300 square feet. The rule is intended to ease administrative and compliance burdens imposed on taxpayers. Currently, taxpayers must file Form 8829, which requires complex calculations of expenses, deductions and depreciation.

Though homeowners who use the new options cannot depreciate the portion of the home used for a trade or business, they may claim allowable mortgage interest, real estate taxes, and casualty losses as itemized deductions on Schedule A. These deductions would not need to be allocated between personal and business use, as currently required using Form 8829.

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The current requirement that the home office be used "regularly and exclusively" for business would still apply under the simplified option.

IV. Proposed Changes to Circular 230

The IRS has proposed changes to Circular 230, which governs ethical considerations relating to taxpayer representation. The first major change proposed by the IRS is to eliminate the disclaimer that must now appear on nearly every communication between an attorney and his client. According to the IRS, such disclaimers cause confusion and their requirement on nearly every communications likely causes clients to disregard the disclaimer entirely. The IRS concludes that the disclaimer is "irrelevant."

Instead, the IRS proposes that ethical rules requiring a practitioner to (i) use reasonable factual and legal assumptions in providing advice; (ii) reasonably consider all facts the practitioner knows or should know; (iii) not rely on statements of the client that are unreasonable; and (iv) not take into account when rendering advice that the return will not be audited.

V. Chief Counsel Memoranda

Persons maintaining foreign trusts are now under a heightened duty to file annual information returns. CCM 201208028 expressed the view of the IRS that the failure of the decedent to file informational returns during his life resulted in the imposition of significant failure to file penalties under IRC §6677(a). Since the decedent was a "responsible party" prior to his death, and his estate assumed the "rights, duties, and privileges" of the decedent, the estate became liable for the penalties. The returns in question were (i) Form 3250 "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) and (ii) Form 3250-A ("Annual Information Return of Foreign Trust with U.S. Owner").

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age at which the recipient chooses to begin receiving benefits.

The recipient's monthly income benefit is based on the highest 35 years of the recipient's "covered earnings." Covered earnings in any year cannot exceed the Social Security Wage Base, which is also the maximum amount of earnings subject to the FICA payroll tax. In 2013, that amount is $113,700.

FICA (Federal Insurance Contributions Act) imposes a Social Security withholding tax of 6.2 percent on employers and employees alike. During the tax years 2011 and 2012, the employee's contribution was temporarily reduced to 4.2 percent. Wages in excess of $113,700 though not subject to FICA are subject to a separate payroll tax of 2.9 percent. Liability for the amount above FICA is divided equally between the employer and the employee, with each paying 1.45 percent.

If a recipient has fewer than 35 years of covered earnings, the number of years required to reach 35 years are assigned a zero value. Nevertheless, the formula utilized in calculating benefits is progressive and significant benefits can be achieved even if the recipient has far fewer than 35 covered years.

The earliest time at which Social Security benefits become payable to a covered worker is age 62. A person who chooses to begin receiving benefits at age 62 will receive only about 75 percent of the amount which the person would have received had payments been deferred until age 66. A person who defers benefits past age 66 will earn delayed retirement credits that increase benefits until age 70. Past age 70, no further benefits will accrue. These benefits will inure to the surviving spouse.

Married couples may also take advantage of spousal benefits. Under current law, a spouse cannot claim a spousal benefit unless the main beneficiary claims benefits first. Once full retirement age is reached at age 66, a beneficiary can "file and suspend." By doing this, the beneficiary's spouse can claim a spousal benefit, but the beneficiary's own retirement benefit will continue to grow until age 70.

Spouses are entitled to receive 50 percent of the benefits of a covered employee. If a beneficiary age 66 is entitled to receive $2,000 per month, his spouse would, at age 66, be entitled to receive $1,000 per month in spousal benefits. If spouse had not worked, or the benefits that spouse would have received are less than $1,000 per month, it might make sense for the couple to follow this strategy. This strategy will (i) allow one spouse to receive benefits in excess of that which he or she would have received based upon his or her own entitlement; (ii) allow the benefit to continue to grow at 8 percent per year up to age 70; and (iii) allow the benefit of the spouse taking spousal benefits to continue to grow until that spouse also reaches 70, at which time he or she can begin claiming retirement benefits based on his or her own record.

Surviving spouses are also entitled to Social Security Benefits. The benefits of a surviving spouse depend upon when the covered worker began taking benefits: If the covered worker takes benefits at full retirement age, the surviving spouse may take 100 percent of the benefits provided he or she is also at full retirement age. If the covered worker takes benefits before full retirement age, then the surviving spouse — again provided he or she was of retirement age — would take 100 percent of the (reduced) amount that the covered worker was taking.

A surviving spouse need not wait until full retirement age to take survivor benefits: A surviving spouse may elect to begin receiving benefits as early as age 60, or age 50, if he or she is disabled. However, those benefits will be reduced.

Divorced spouses are eligible to receive benefits if the marriage had lasted at least 10 years. (Survivor benefits will not be available to same sex partners, since same sex marriages are not recognized under federal law.) The benefits received by a divorced spouse have no effect on the benefits of the current spouse. Unmarried children, as well as dependent parents, may also qualify to receive survivor benefits.

Social Security benefits were historically not subject to income tax. However, in order to avoid projected insolvency of the Social Security system, 50 percent of the portion of benefits were potentially subject to income tax in 1984. In 1994, 85 percent of Social Security benefits became subject to income tax.

II. National Health Care

The Affordable Health Care Act established a national health insurance program. Under the Act, the existing Medicare program will be expanded to include all U.S. residents. The goal of the legislation is to provide all residents access to the "highest quality and most cost effective healthcare services regardless of their employment, income, or healthcare status." Every person living or visiting the United States will receive a United States National Health Insurance ("USNHI") Card and ID number upon registration.

The program will cover all medically necessary services, including primary care, inpatient care, outpatient care, emergency care, prescription drugs, durable medical equipment, long term care, mental health services, dentistry, eye care, chiropractic, and substance abuse treatment. Patients have their choice of physicians, providers, hospitals, clinics, and practices. No co-pays or deductibles are permitted under the Act.

The system will convert to a non-profit healthcare system over a period of fifteen years. Private health insurers will be prohibited from selling coverage that duplicates the benefits of the USNHI program. However, non-profit health maintenance organizations (HMOs) that deliver care at their own facilities may participate.

Exceptions from coverage will also be made for cosmetic surgery and other medically unnecessary treat-

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ments. The National USNHI will (i) set annual reimbursement rates for physicians; (ii) allow annual lump sums for operating expenses for healthcare providers; and (iii) negotiate prescription drug prices. A "Medicare for All Trust Fund" will be established to ensure constant funding for the program. The Act also requires states to expand Medicaid or face the loss of federal funds.

Advocates of universal health care believe that lower administrative costs will result in savings of approximately $200 billion per year, which is more than the cost of insuring all of those who are now uninsured. A "single-payer" system is said to reduce administrative costs because it would not have to devote resources to screening out high-risk persons or charging them higher fees.

Critics argue that the nationalization of health care will raise taxes for higher-income individuals, and note that the government has a poor track record in effectively managing large bureaucratic organizations (*e.g.*, the Postal Service and AMTRAK). In June of 2012, the Supreme Court, in an opinion written by Chief Justice Roberts, narrowly upheld the Constitutionality of the Affordable Care Act as proper exercise of the federal government's power to impose tax.

II. Medicare

Medicare is a federal insurance program that provides health insurance to persons age 65 and over, and to persons under age 65 who are permanently disabled. Medicare and Medicaid were signed into law by President Johnson in 1965 as part of the Social Security Act. Medicare is administered by the federal government. In general, all five-year legal residents of the U.S. over the age of 65 are eligible for Medicare. Medicare consists of four parts, A through D.

Medicare Part A covers inpatient hospital stays of up to 90 days provided an official order from a doctor states that inpatient care is required to treat the illness. For days 1 through 60, a $1,184 deductible is required for each benefit period in 2013. For days 61 through 90, a daily copay of $296 is required. After 90 days, a daily copay of $592 must be paid for up to 60 "lifetime reserve days." Once lifetime reserve days have been exhausted, Medicare hospitalization benefits will have terminated.

Part A also covers stays for convalescence in a skilled nursing facility (SNF) for up to 100 days following hospitalization. To be eligible, (i) the patient must have a qualifying hospital stay of at least three days (and have unused days); (ii) a physician must order the stay; and (iii) the SNF facility must be approved by Medicare. No copay is required for the first 20 days. Thereafter, a daily copay of $148 is required until day 100.

Part A is funded by the separate payroll tax of 2.9 percent, and the recently enacted 3.8 percent Medicare surtax.

Medicare Part B covers physician and some outpatient services. Eligibility depends on satisfying requirements for Part A, and the payment of monthly premiums, which range from $100 for those with adjusted gross income of up to $85,000, to $319, for those with higher incomes. The patient is responsible for 20 percent of physician's fees. Medicare pays only the "approved" rate. A patient may seek care from a nonparticipating doctor and pay the rate differential.

Private Medicare supplement (Medigap) insurance is available to those who have Medicare Part A and Part B. This insurance will cover such items as copays and deductibles. Those without a Medigap policy are required to pay these costs out of pocket.

Medicaid Part C consists of plans offered by private companies ("Medicare Advantage") that contract with the government to provide all Part A and Part B benefits. By law, these plans must be "equivalent" to regular Part A and Part B coverage. Some Part C plans provide prescription drug coverage. Medicare Advantage supersedes Medigap coverage; if a person is enrolled in a Medicare Advantage Plan under Part C, Medigap will not pay.

Medicare Part D provides prescription drug benefits. Under Part D, a patient pays an initial deductible of $325 and is subject to a co-pay of 25 percent for amounts up to $2,970. The patient must pay all costs incurred between $2,970 and $4,750, but is required to pay only 5 percent of drug costs over $4,750.

III. The Intersection of Medicare to Medicaid

Without planning, the elderly are at significant risk of losing an entire life's savings in the event of catastrophic illness following the expiration of Medicare hospitalization and nursing care benefits. At that point, the choice for extended care is in general either Medicaid or payment out of pocket. Many who opt for private payment of long-term care costs will risk exhausting their resources. This loss will have implications for other family members as well. (It should be noted that long term health care insurance has generally been less than effective in managing these costs, for a variety of reasons.)

The principal difference between Medicare and Medicaid is that Medicaid is need-based and Medicare is (theoretically) entitlement based. While Medicare is federally funded and administered, Medicaid is a federal program jointly funded and administered by the states. Financial resources play no role in determining Medicare eligibility. Medicaid eligibility is limited to persons with limited income and limited financial resources. Medicaid covers more health care services than Medicare and unlike Medicare, will cover long-term care for elderly and disabled persons who cannot afford such care.

IV. Medicaid Eligibility

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Elderly and disabled persons are more likely to require continuing long-term care not covered by Medicare. For example, a serious illness such as a stroke could require a long period of convalescence, the costs of which are not covered by Medicare. Medicaid will cover many long term health costs that Medicare will not. Medicaid now pays for about half of all nursing home costs incurred in the country.

Ownership of substantial assets or in some states the right to monthly income above certain thresholds ("resources") will preclude Medicaid qualification. Before qualifying for Medicaid, a person with substantial assets would be required to deplete ("spend down") those assets.

To avoid the scenario in which nearly all of one's assets might be required to be paid to a nursing home before becoming eligible for Medicaid, some persons choose to transfer in advance assets that would impair Medicaid eligibility. Such transfers might be outright to a spouse, or to other family members such as children, or to a trust.

Recognizing the increased cost to the government of intentional transfers made to become eligible for Medicaid, Congress, in the Deficit Reduction Act of 2005 (DRA), created a five-year "look back" period relating to the transfer of assets either outright or in trust. Essentially, any transfers made during the five-year period preceding a Medicaid application are ignored for purposes of determining eligibility. Despite the existence of a five year look-back period, courts have upheld Medicaid planning as an appropriate objective, and have held that such transfers do not violate public policy or constitute fraudulent transfers.

Under pre-DRA law, the five-year period of ineligibility began on the date of the transfer. Under DRA the period of ineligibility does not commence until the person is in the nursing home and applies for Medicaid. Therefore, if within five years after making a transfer of assets to qualify for future Medicaid a person requires Medicaid assistance, the transferred assets must be "repaid" before Medicaid payments will commence. The upshot is that if long-term care appears likely in the foreseeable future, transferring assets to qualify for future Medicaid eligibility may actually be counterproductive, as it will trigger a penalty.

Transfer penalties are based on the monthly cost of nursing home care in the applicant's state. If the cost of nursing home care in New York is $7,000 per month and the person transferred $70,000, he would be ineligible for Medicaid for a period of ten months (*i.e.,* the amount transferred divided by the cost per month of nursing home care). An exception provides that transferring assets, including one's house, to a spouse will not trigger the transfer penalty.

Nursing homes will generally be unaware of the transfer prior to admission. As a result, the facility may have no source for reimbursement during the penalty period. Federal law prohibits a nursing home from discharging a patient unless it has found replacement care.

Determining the appropriate amount of assets to transfer is important. Transferring many assets, while helpful for future Medicaid eligibility purposes, may leave future applicant with insufficient assets. Transferring too few assets will create a larger reserve to be "paid down" after the five year look-back period ends and Medicaid would, but for the reserve, begin to pay.

Federal law requires states to investigate gifts made during the look-back period. New York does not specify a threshold amount, but some counties will examine all transfers over $1,000. Even common gifts, such as those made for birthdays, for tuition, or for weddings may be considered an available asset for Medicaid purposes. Care must be taken to ensure that gifts made under a power of attorney do not have unintended and deleterious Medicaid implications.

V. Medicaid Exempt Assets

Certain resources are exempt in determining Medicaid eligibility. New York Medicaid exempts up to $786,000 in home equity. If the residence is worth substantially more than this amount, the home may be gifted, but the five-year look back period will apply.

If the home is gifted but the transferor retains a special power of appointment, the transfer will achieve the objective of starting the commencement of the five-year look-back period. In addition, although the transfer will be complete for Medicaid purposes, it will be incomplete for federal estate tax purposes. This means that children will benefit from a stepped up basis at the death of the parent.

A spouse may also transfer title to the other spouse without risking Medicaid eligibility. A residence may also be transferred to a sibling with an equity interest who has lived in the residence for more than one year, or to a child who has been a caregiver and lived in the home for at least two years before the parent enters a nursing home.

There are advantages to using a trust. If an irrevocable income-only trust is used, the parent may continue to live in the house, or sell it. (See discussion below.)

A retirement account may also be an exempt asset if it is in "payout" status. So too, an automobile may be an exempt asset. If the applicant is in a nursing home, the applicant's residence remains an exempt asset provided the applicant has a "subjective intent" to return to his home.

Exempt assets may be transferred without penalty because such assets would not impair Medicaid eligibility even if not transferred. Therefore, if government assistance will be required within 60 months, excess resources could be converted into exempt assets. For example, a residence

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could be improved, a mortgage on the residence repaid, or other exempt assets could be purchased.

New York may impose a lien on a personal residence even though ownership of the residence would not impair Medicaid eligibility. However, no lien may be imposed unless the person is permanently absent and is not reasonably expected to be discharged. N.Y. Soc. Serv. Law §369(2)(a)(ii); 18 N.Y.C.R.R. §360-7.11(a)(3)(ii). Prior to filing a lien, New York must satisfy notice and due process requirements, and must show that the person cannot reasonably be expected to return home. 42 U.S.C. §1396p(a)(2). If the person does return home, the lien is vanquished by operation of law. 18 N.Y.C.R.R. §360-7.11(a)(3)(i).

Conversion of cash into an annuity may reduce the available resources available that would otherwise be required to be "paid down" before becoming eligible for Medicaid. Such annuities must be structured so that (i) their payout period is not longer than the actuarial life of the annuitant; (ii) payments are made in equal installments; and (iii) the annuities are paid to the state following the death of the annuitant to the extent required to reimburse the state for amounts paid for Medicaid benefits.

VI. Recovery From Estate

New York has the right to recover from the estate exempt assets that had no bearing on Medicaid eligibility. However, no recovery from an estate may be made until the death of a surviving spouse. N.Y. Soc. Serv. Law §366(2)b(ii). For purposes of New York Medicaid recovery, the term "estate" means property passing by will or by intestacy. No right of recovery exists with respect to property passing in trust, by right of survivorship in a joint tenancy, or to the beneficiary of a bank or retirement account. Therefore, to avoid recovery of estate assets, avoidance of probate and intestacy are paramount.

The amount that may be recovered from an estate for a lien against a personal residence cannot exceed the value of services provided while the Medicaid recipient was absent from the home. N.Y. Soc. Serv. Law §369(2)(a)(ii). A lien may be waived in cases of undue hardship. N.Y. Soc. Serv. Law §369(5).

VII. Medicaid Trusts

A Medicaid trust provides income to the grantor or to the grantor's spouse. Transfers to a Medicaid trust may facilitate eligibility for Medicaid since assets so transferred are excluded when determining Medicaid eligibility (provided the five year look-back period is satisfied). Furthermore, transfer to an irrevocable trust will effectively bar any right of recovery by New York if a lien had been placed on the residence or other asset.

Most trusts created to facilitate Medicaid planning will be drafted to be irrevocable, since assets transferred to a revocable trust can be reacquired by the settlor, and Medicaid can reach anything the settlor can reach. Therefore, avoidance of probate is not enough: The transferor must also be unable to reacquire the assets.

If a residence is transferred to a Medicaid trust, the "income" permitted to be paid to the grantor will consist of the grantor's retained right to reside in the residence. If the Medicaid trust is structured as a grantor trust, the capital gains exclusion provided by IRC §121 will be available if the residence is sold by the trust.

The grantor of a Medicaid trust will want the assets to be included in his or her estate at death in order to receive a basis step up under IRC §1014. This can be achieved if the grantor retains a limited power of appointment. Retaining a limited power of appointment will also enable the grantor to retain the ability to direct which beneficiaries will ultimately receive trust assets.

Irrevocable trusts granting the trustee discretion to distribute income or principal pursuant to an ascertainable standard are effective in asset protection, but are ineffective for purposes of Medicaid: Federal law treats all assets in discretionary trusts in which the applicant or his spouse is a discretionary beneficiary of principal or income as an available resource for purposes of determining Medicaid eligibility. The trust may provide that the grantor or spouse has a right to a fixed income amount, but that will be considered an available resource.

The trust may provide for discretionary trust distributions to beneficiaries (other than the grantor or the grantor's spouse) during the grantor's lifetime or at death, and may provide that upon the death of the grantor, the trust corpus will be distributed outright to beneficiaries, or held in further trust.

Inclusion of trust assets in the estate of a Medicaid recipient will ordinary not be problematic since the federal estate tax exemption is $5 million and the NYS lifetime exemption is $1 million. If outright gifts and transfers to a Medicaid trust are both anticipated, transferring low basis property to the trust will be preferable, since a step up in basis will be possible with respect to those assets if the trust is includible in the applicant's estate (unless the trust has been structured as a grantor trust). The recipients of lifetime gifts, on the other hand, will take a transferred basis in the gifted assets.

The trustee of a Medicaid trust should be persons other than the grantor or the grantor's spouse. However, the trust may allow the grantor to replace the trustee. Since assets transferred to a Medicaid trust are transferred irrevocably, it is important that the grantor and his or her spouse consider the nature and extent of assets to be retained, since assets must remain to provide for daily living expenses.

VIII. Special Needs Trusts

A Special (or "Supplemental") Needs Trust (SNT) established for a

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person with severe and chronic disabilities may enable a parent or family member to supplement Medicaid or Supplemental Security Income (SSI), without adversely affecting eligibility under these programs, both of which impose restrictions on the amount of "income" or "resources" which the beneficiary may possess. 42 U.S.C. § 1382a. Assets owned by the SNT will not be deemed to be owned by the beneficiary.

Federal law authorizes the creation of SNTs that will not be considered "resources" for purposes of determining SSI or Medicaid eligibility where the disabled beneficiary is under age 65, provided the trust is established by a parent, grandparent, legal guardian, or a court. Thus, personal injury recoveries may be set aside to supplement state assistance. The beneficiary's income (which includes gifts, inheritances and additions to trusts) will reduce available SSI benefits.

The SNT may be created by either an *inter vivos* or testamentary instrument. If an *inter vivos* trust is used, the trust may, but is not required to be, irrevocable. Provided the beneficiary may not revoke the trust, trust assets will not constitute income or resources for SSI or Medicaid purposes.

A revocable *inter vivos* trust could permit the parent or grandparent, for example, to modify the trust to meet changing circumstances. If the trust is revocable the trust assets will be included in the settlor's estate under IRC §2038. The trust may be funded with life insurance or gifts, or bequests.

An SNT may be established at the death of a surviving parent for a disabled adult child. Such trust may be established either by will or by revocable *inter vivos* trust. An SNT may even be formed by a court. In *Matter of Ciraolo*, NYLJ Feb. 9, 2001 (Sur. Ct. Kings Cty), the court allowed reformation of a will to create an SNT out of an outright residuary bequest for a chronically disabled beneficiary. Neither the beneficiary nor the beneficiary's spouse should be named as trustee, as this might result in a failure to qualify under the SSI and Medicare resource and income rules. A family member or a professional trustee would be a preferable choices as trustee.

The trustee may make disbursements for items not paid by government programs. These could include dental care or clothing, or a case manager or companion.

EPTL 7-1.12 expressly provides for special needs trusts and includes suggested trust language. The statute imposes certain requirements for the trust. The trust must (i) evidence the creator's intent to supplement, rather than impair, government benefits; (ii) prohibit the trustee from expending trust assets that might in any way impair government benefits; (iii) contain a spendthrift provision; and (iv) not be self-settled (except in narrowly defined circumstances).

EPTL 7-1.12 further provides that notwithstanding the general prohibition imposed on the trustee from making distributions that might impair qualification under federal programs, the trustee may have discretionary power to make distributions in the best interests of the beneficiary. However, distributions should not be made directly to the beneficiary, as this could disqualify the beneficiary from receiving governmental assistance.

A "payback" provision mandates that on trust termination the trustee must reimburse Medicaid for benefits paid to the beneficiary. Only a "first-party" (self-settled) SNT, which is an SNT funded by the beneficiary himself, must include a payback provision. However, a first-party SNT funded by a personal injury award will not be required to pay back Medicaid.

A "third party" SNT is a trust created by a person other than the beneficiary (*e.g.,* a parent for a developmentally disabled child). Third party SNTs do not require a "payback" provision. Inclusion of a payback provision requiring Medicaid reimbursement in a third party SNT is unnecessary, and its inclusion where none is required could result in a windfall to Medicaid at the expense of remainder beneficiaries.

The purpose of a special needs trust will be obviated if the beneficiary receives gifts or bequests outright. Therefore, it is imperative that the beneficiary not receive gifts, bequests, intestate legacies, or be made the beneficiary of a retirement account. No trust should be established for these purposes under the Uniform Transfer to Minors Act. All of these intended gifts (except an intestate legacy) should instead be made payable directly to the SNT.

USE OF DISCLAIMERS, CONT.

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For a disclaimer to achieve the intended federal tax result, it must constitute a qualified disclaimer under IRC §2518. If the disclaimer is not a qualified disclaimer, the disclaimant is treated as having received the property and then having made a taxable gift. Treas. Regs. §25.2518-1(b). Under EPTL, as well as under most states' laws, the person disclaiming is treated as if he had predeceased the donor, or died before the date on which the transfer creating the interest was made. Neither New York nor Florida is among the ten states which have adopted the Uniform Disclaimer of Property Interests Act (UDPIA).

II. Requirements for Qualified Disclaimer

For a disclaimer to be qualified under IRC § 2518, the disclaimer must be (i) irrevocable and unqualified; (ii) in writing, identifying the property disclaimed and signed by the disclaimant or by his legal representative; (iii) delivered to either the transferor or his attorney, the holder of legal title, or the person in possession; (iv) made within 9 months of the date of transfer or, if later, within 9 months of the date when the disclaimant attains the age of 21; (v) made at a time when the disclaimant had not accepted the interest disclaimed or enjoyed any of its benefits; and (vi) be valid under state law, such that it passes to either the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer. Under EPTL § 2-1.11 (f), the right to disclaim may be waived if in writing.

With respect to (i), PLR 200234017 ruled that a surviving spouse who had been granted a general power of appointment had not made a qualified disclaimer of that power by making a QTIP election on the estate tax return, since the estate tax return did not evidence an irrevocable and unqualified refusal to accept the general power of appointment.

With respect to (iii), copies of the disclaimer must be filed with the surrogates court having jurisdiction over the estate. If the disclaimer concerns nontestamentary property, the disclaimer must be sent via certified mail to the trustee or other person holding legal title to, or who is in possession of, the disclaimed property.

With respect to (iv), it is possible that a disclaimer might be effective under the EPTL, but not under the Internal Revenue Code. For example, under EPTL §2-1.11(a)(2) and (b)(2), the time for making a valid disclaimer may be extended until "the date [when] beneficiary is finally ascertained," which may be more than 9 months of the date of the transfer. In such a case, the disclaimer would be effective under New York law but would result in a taxable gift for purposes of federal tax law.

With respect to (v), consideration received in exchange for making a disclaimer would constitute a prohibited acceptance of benefits under EPTL §2-1.11(f).

With respect to (vi), EPTL §2-1.11(g) provides that a beneficiary may accept one disposition and renounce another, and may renounce a disposition in whole or in part. One must be careful to disclaim all interests, since the disclaimant may also have a right to receive the property by reason of being an heir at law, a residuary legatee or by other means. In this case, if disclaimant does not effectively disclaim all of these rights, the disclaimer will not be a qualified disclaimer with respect to the portion of the disclaimed property which the disclaimant continues to have the right to receive. IRC §2518-2(e)(3).

IRC § 2518(c) provides for what is termed a "transfer disclaimer." The statute provides that a written transfer which meets requirements similar to IRC § 2518(b)(2) (timing and delivery) and IRC § 2518(b)(3) (no acceptance) and which is to a person who would have received the property had the transferor made a qualified disclaimer, will be treated as a qualified disclaimer for purposes of IRC §2518. The usefulness of IRC § 2518(c) becomes apparent in cases where federal tax law would permit a disclaimer, yet state law would not.

To illustrate, in *Estate of Lee*, 589 N.Y.S.2d 753 (Surr. Ct. 1992), the residuary beneficiary signed a disclaimer within 9 months, but the attorney neglected to file it with the Surrogates Court. The beneficiary sought permission to file the late renunciation with the court, but was concerned that the failure to file within 9 months would result in a nonqualified disclaimer for federal tax purposes. The Surrogates Court accepted the late filing and opined (perhaps gratuitously, since the IRS is not bound by the decision of the Surrogates Court) that the transfer met the requirements of IRC § 2518(c). [Note that in the converse situation, eleven states, but not New York or Florida, provide that if a disclaimer is valid under IRC § 2518, then it is valid under state law.]

III. Uses of Qualified Disclaimers

Charitable Deductions

Treas. Reg. § 20.2055-2(c) provides that a charitable deduction is available for property which passes directly to a charity by virtue of a qualified disclaimer. If the disclaimed property passes to a private foundation of which the disclaimant is an officer, he should resign, or at a minimum not have any power to direct the disposition of the disclaimed property. The testator may wish to give family members discretion to disclaim property to a charity, but yet may not wish to name the charity as a residuary legatee. In this case, without specific language, the disclaimed property would not pass to the charity. To solve this problem, the will could provide that if the beneficiary disclaims certain property, the property would pass to a specified charity.

Marital Disclaimers

Many wills contain "formula"

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clauses which allocate to the credit shelter trust — or give outright — the maximum amount of money or property that can pass to beneficiaries (other than the surviving spouse) without the imposition of federal estate tax. With the applicable exclusion amount now $5.25 million, situations will arise where the surviving spouse may be disinherited if the beneficiaries of the credit shelter trust do not renounce part of their interest under such a formula clause. If such an interest is disclaimed and it passes to the surviving spouse, it will qualify for the marital deduction. Another use of the disclaimer in a similar situation is where either the surviving spouse or a trustee renounces a power of appointment so that the trust will qualify as a QTIP trust.

A surviving spouse who is granted a general power of appointment over property intended to qualify for the marital deduction under IRC § 2056(b)(5) may disclaim the general power, thereby enabling the executor to make a partial QTIP election. This ability to alter the amount of the marital deduction allows the executor to finely tune the credit shelter amount. If both spouses die within 9 months of one another, a qualifying disclaimer by the estate of the surviving spouse can effect an equalization of estates, thereby reducing or avoiding estate tax.

Consider the effect of a qualified disclaimer executed within nine months by a surviving spouse of her lifetime right to income from a credit shelter trust providing for an outright distribution to the children upon her death. If, within nine months of her spouse's death, the surviving spouse decides that she does not need distributions during her life from the credit shelter trust and she disclaims, she will treated as if she predeceased her husband. If the will of the predeceasing spouse provides for an outright distribution of the estate to the children if wife does not survive, then the disclaimer will have the effect of enabling the children to receive the property that would have funded the credit shelter trust at the death of the first spouse.

Assume the surviving spouse paid no consideration for certain property held jointly with her predeceasing spouse. If she dies within 9 months and her estate disclaims, then the property would pass through the predeceasing spouse's probate estate. In that case, a full basis step up would become available. If the property would then pass to the surviving spouse under the will of the predeceasing spouse, this planning technique becomes invaluable, as it creates a stepped up basis for assets which would not otherwise receive such a step up if the disclaimer were not made.

A qualified disclaimer executed by the surviving spouse may also enable the predeceasing spouse to fully utilize the applicable exclusion amount in situations where a portability election, for whatever reason, is not prudent. For example, assume the will of the predeceasing spouse left the entire estate of $10 million to the surviving spouse in a QTIP trust and nothing to the children. Although the marital deduction would eliminate any estate tax liability on the estate of the first spouse to die, the eventual estate of the surviving spouse could have an estate tax problem if portability had not been elected. This could be the case in a second marriage situation. By disclaiming $5.25 million, the surviving spouse would create a taxable estate in the predeceasing spouse, which could then utilize the full applicable exclusion amount of $5.25 million.

To refine this example, the will of the first spouse to die could provide that if the surviving spouse disclaims, the disclaimed amount would pass to a family trust of which the surviving spouse has a lifetime income interest. The will could further provide that if the spouse were also to disclaim her interest in the family trust, the disclaimed property would pass as if she had predeceased.

General Powers of Appointment

The grantor may wish to ensure that the named trustee will be liberal in making distributions to his children. By giving the child beneficiary the unrestricted right to remove the trustee, this objection can be achieved. However, if the child has the ability to remove the trustee, and the trust grants the trustee the power to make distributions to the child that are not subject to an ascertainable standard, this may cause problems, since the IRS may impute to the child a general power of appointment. If the IRS were successful in this regard, the entire trust might be included in the child's taxable estate. To avoid this result, the child could disclaim the power to remove the trustee. This might, of course, not accord with the child's nontax wishes.

If a surviving spouse is given a "five and five" power over a credit shelter or family trust, 5 percent of the value of the trust will be included in her estate under IRC §2041. However, if the surviving spouse disclaims within 9 months, nothing will be included in her estate.

Eliminating a Trust

At times, all beneficiaries may agree that it would be better if no trust existed. If all current income trust beneficiaries, which might include the surviving spouse and children, disclaim, the trust may be eliminated. In such a case, the property might pass to the surviving spouse and the children outright. Note that if minor children are income beneficiaries, their disclaimers could require the consent of guardians ad litem.

Medicaid, Creditor & Bankruptcy

Under New York law, if one disclaims, and by reason of such disclaimer that person retains Medicaid eligibility, such disclaimer may be treated as an uncompensated transfer

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of assets equal to the value of any interest disclaimed. This could impair Medicaid eligibility.

In some states, if a disclaimer defeats the encumbrance or lien of a creditor, it may be alleged that the disclaimer constitutes a fraudulent transfer. However, this is not so in New York and California, where a disclaimer may be used to defeat the claim of a creditor. In Florida, the result is contra: A disclaimer cannot prevent a creditor from reaching the disclaimed property.

Will a qualified disclaimer defeat a claim of the IRS? No. Prior to a Supreme Court ruling, there had been a split in the circuits. The 2nd Circuit in *United States v. Camparato*, 22 F3d. 455, cert. denied, 115 S.Ct. 481 (1994) held that a federal tax lien attached to the "right to inherit" property, and that a subsequent disclaimer did not affect the federal tax lien under IRC §6321. The Supreme Court, in *Drye v. United States*, 528 U.S. 49 (1999), adopted the view of the Second Circuit, and held that the federal tax lien attached to the property when created, and that any subsequent attempt to defeat the tax lien by disclaimer would not eliminate the lien.

Bankruptcy courts have generally reached the same result as in *Drye*. The disclaimer of a bequest within 180 days of the filing of a bankruptcy petition has in most bankruptcy courts been held to be a transfer which the trustee in bankruptcy can avoid. Many courts have held that even pre-petition disclaimers constitute a fraudulent transfer which the bankruptcy trustee can avoid. If the Drye rationale were applied to bankruptcy cases, it would appear that prepetition bankruptcy disclaimers would, in general, constitute transfers which the bankruptcy trustee could seek to avoid. However, at least one court, *Grassmueck, Inc., v. Nistler* (*In re Nistler*), 259 B.R. 723 (Bankr. D. Or. 2001) held that Drye relied on language in IRC §6321, and should be limited to tax liens.

IV. Frequently Litigated Issues

Acceptance of Benefits

The acceptance of benefits will preclude a disclaimer under state law. EPTL §2-11(b)(2) provides that "a person accepts an interest in property if he voluntarily transfers or encumbers, or contracts to transfer or encumber all or part of such interest, or accepts delivery or payment of, or exercises control as beneficial owner over all or part thereof . . . "

Similarly, a qualified disclaimer for purposes of IRC §2518 will not result if the disclaimant has accepted the interest or any of its benefits prior to making the disclaimer. Treas. Regs. §25.2518-2(d)(1) states that acts "indicative" of acceptance include (i) using the property or interest in the property; (ii) accepting dividends, interest, or rents from the property; or (iii) directing others to act with respect to the property or interest in the property. However, merely taking title to property without accepting any benefits associated therewith does not constitute acceptance. Treas. Regs. §25.2518-2(d)(1). Nor will a disclaimant be considered to have accepted benefits merely because under local law title to property vests immediately in the disclaimant upon the death of the decedent. Treas. Regs. §25.2518-2 (d)(1).

The acceptance of benefits of one interest in the property will not, alone, constitute an acceptance of any other separate interests created by the transferor and held by the disclaimant in the same property. Treas. Regs. §25.2518-2(d)(1).Thus, TAM 8619002 ruled that surviving spouse who accepted $1.75x in benefits from a joint brokerage account effectively disclaimed the remainder since she had not accepted the benefits of the disclaimed portion which did not include the $1.75x in benefits which she had accepted.

The disclaimant's continued use of property already owned is also not, without more, a bar to a qualifying disclaimer. Thus, a joint tenant who continues to reside in jointly held property will not be considered to have accepted the benefit of the property merely because she continued to reside in the property prior to effecting the disclaimer. Treas. Regs. §25.2518-2(d)(1); PLR 9733008.

The existence of an exercised general power of appointment in a will before the death of the testator is not an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). However, if the power holder dies having exercised the power, acceptance of benefits has occurred. TAM 8142008.

The receipt of consideration in exchange for exercising a disclaimer constitutes an acceptance of benefits. However, the mere possibility that a benefit will accrue to the disclaimant in the future is insufficient to constitute an acceptance. Treas. Regs. §25.2518-2(d)(1); TAM 8701001. Actions taken in a fiduciary capacity by a disclaimant to preserve the disclaimed property will not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(2).

Separate & Severable Interests

A disclaimant may make a qualified disclaimer with respect to all or an undivided portion of a separate interest in property, even if the disclaimant has another interest in the same property. Thus, one could disclaim an income interest while retaining an interest in principal. PLR 200029048. So too, the right to remove a trustee is an interest separate from the right to receive principal or a lifetime special power of appointment. PLR 9329025. PLR 200127007 ruled that the benefit conferred by the waiver of the right of recovery under IRC §2207A would constitute a qualified disclaimer.

A disclaimant makes a qualified disclaimer with respect to disclaimed property if the disclaimer relates to severable property. Treas. Regs.

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§25.2518-3(a)(1)(ii). Thus, (i) the disclaimer of a fractional interest in a residuary bequest was a qualified disclaimer (PLR 8326033); (ii) a disclaimer may be made of severable oil, gas and mineral rights (PLR 8326110); and (iii) a disclaimer of the portion of real estate needed to fund the obligation of the residuary estate to pay legacies, debts, funeral and administrative expenses is a severable interest. PLR 8130127.

Interest Passing Without Direction

To constitute a qualified disclaimer under federal tax law, the property must pass to someone other than the disclaimant without any direction on the part of the disclaimant. An important exception to this rule exists where the disclaimant is the surviving spouse: In that case the disclaimed interest may pass to the surviving spouse even if she is the disclaimant. Treas. Reg. §25.2518-2(e); EPTL §2-1.11(e).

For disclaimants (other than a surviving spouse) who are residuary legatees or heirs at law, the disclaimant must therefore be especially careful not only to disclaim the interest in the property itself, but also to disclaim the residuary interest. If not, the disclaimer will not be effective with respect to that portion of the interest which the disclaimant has the right to receive. §25.2518-2(e)(3). To illustrate, in PLR 8824003, a joint tenant (who was not a surviving spouse) was entitled to one-half of the residuary estate. The joint tenant disclaimed his interest in the joint tenancy, but did not disclaim his residuary interest. The result was that only half of the disclaimed interest qualified under IRC §2518. The half that passed to the disclaimant as a residuary legatee did not qualify.

The disclaimant may not have the power, either alone or in conjunction with another, to determine who will receive the disclaimed property, unless the power is subject to an ascertainable standard. However, with respect to a surviving spouse, the rule is more lax: *Estate of Lassiter*, 80 T.C.M. (CCH) 541 (2000) held that Treas. Reg. §25.2518-2(e)(2) does not prohibit a surviving spouse from retaining a power to direct the beneficial enjoyment of the disclaimed property, even if the power is not limited by an ascertainable standard, provided the surviving spouse will ultimately be subject to estate or gift tax with respect to the disclaimed property.

An impermissible power of direction exists if the disclaimant has a power of appointment over a trust receiving the disclaimed property, or if the disclaimant is a fiduciary with respect to the disclaimed property. §25.2518-2(e)(3). However, merely precatory language which is not binding under state law as to who shall receive the disclaimed property will not constitute a prohibited "direction". PLR 9509003.

Disclaimer of Fiduciary Powers

Limits on the power of a fiduciary to disclaim may have profound tax implications. PLR 8409024 stated that the trustees could disclaim administrative powers the exercise of which did not "enlarge or shift any of the beneficial interests in the trust." However, the trustees could not disclaim dispositive fiduciary powers which directly affected the beneficial interest involved. This rule limits the trustee's power to qualify a trust for a QTIP election.

Infants, Minors & Incompetents

In some states, representatives of minors, infants, or incompetents may disclaim without court approval. However, EPTL §2-1.11(c), while permitting renunciation on behalf of an infant, incompetent or minor, provides that such renunciation must be "authorized" by the court having jurisdiction of the estate of the minor, infant or incompetent. In *Estate of Azie*, 694 N.Y.S.2d 912 (Sur. Ct. 1999), two minor children were beneficiaries of a $1 million life insurance policy of their deceased father. The mother, who was the guardian, proposed to disclaim $50,000 of each child. The proposed disclaimer would fund a marital trust and would save $40,000 in estate taxes. The Surrogate, disapproving of the proposed disclaimer, stated that the disclaimer must be advantageous to the children, and not merely to the parent.

Timeliness of Disclaimer

Vexing tax issues may arise where a disclaimer would be valid under the EPTL but not under the Internal Revenue Code. EPTL §2-1.11-(b)(2) provides that a renunciation must be filed with the Surrogates court within 9 months after the effective date of the disposition, but that this time may be extended for "reasonable cause." Further, EPTL §2-1.11(a)(2)(C) provides that the effective date of the disposition of a future interest "shall be the date on which it becomes an estate in possession." Since under IRC §2518, a renunciation must be made within 9 months, the grant of an extension by the Surrogates court of the time in which to file a renunciation might result in a valid disclaimer for New York purposes, but not for purposes of federal tax law. Similarly, while the time for making a renunciation of a future interest may be extended under EPTL §2-1.11(a)(2)(C), such an extension would be ineffective for purposes of IRC §2518.

Jointly Owned Property

The rules for disclaiming jointly owned property can generally be divided into two categories: (i) joint bank, brokerage and other investment accounts where the transferor may unilaterally regain his contributions; and (ii) all other jointly held interests. With respect to (i), the surviving cotenant may disclaim within 9 months of the transferor's death, but only to the extent that the survivor did not furnish consideration.

With respect to (ii), for all other

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interests held jointly with right of survivorship or as tenants by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation must be made no later than 9 months after the creation. A qualified disclaimer of an interest to which the disclaimant succeeds upon the death of another (i.e., a survivorship interest) must be made no later than 9 months after the death of the first tenant. This is true (i) regardless of the portion of the property contributed by the disclaimant; (ii) regardless of the portion of the property included in the decedent's gross estate under IRC §2040; and (iii) regardless of whether the property is unilaterally severable under local law.

PORTABILITY OF EXEMPTION, CONT.

(Continued from page 1)

The problem which Congress sought to ameliorate would arise where the predeceasing spouse made a sizeable bequest to the surviving spouse of the entire estate. While this disposition would succeed in eliminating estate tax at the death of the first spouse by virtue of the unlimited marital deduction, it would also entirely waste the lifetime exclusion of the predeceasing spouse.

Before the enactment of the portability statute, spouses who had not done any estate planning could find themselves in a situation where the estate of the surviving spouse could needlessly incur estate tax liability if the estate of the surviving spouse — now augmented by the estate of the predeceasing spouse — exceeded the applicable exclusion amount.

The concept of "portability" allows the estate of the surviving spouse to increase the available lifetime exclusion by the unused portion of the predeceasing spouse's lifetime exclusion. Thus, the applicable exclusion of the surviving spouse is augmented by that of the predeceasing spouse. In technical terms, IRC § 2010 provides that the Deceased Spouse Unused Exclusion Amount ("DSUE," pronounced "dee-sue") equals the lesser of (A) the basic exclusion amount, or (B) the excess of (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over (ii) the amount of the taxable estate plus adjusted taxable gifts of the predeceased spouse.

The basic exclusion amount for 2013 is $5.25 million. If the lifetime exclusion amount were to decrease, the basic exclusion amount would also decrease.

II. Mechanics of Electing Portability

Portability is not automatic. To benefit from portability, the executor of the estate of the first spouse to die must timely file a federal estate tax return, federal Form 706. The mere filing of the form will result in an election to utilize portability — nothing further is required. The election, once made, is irrevocable. If the executor wishes to forego portability, this can be accomplished either by failing to file Form 706 (if no return is otherwise necessary) or by stating on the Form 706 that the election is not being made. If there is no executor, then a "non-appointed executor" may make the election on the timely filed estate tax return.

The statute is quixotic in that a "complete and properly-prepared" estate tax return must be filed without regard to whether or not the decedent's estate plus adjusted taxable gifts exceeded the exclusion amount at the time of the decedent's death, thereby requiring a return. However, if a return is not otherwise required, the executor may estimate the size of the gross estate to the nearest $250,000. Similarly, if property qualifies for the marital or charitable deduction, the executor must only provide information sufficient to establish the estate's right to the deduction.

III. Calculating the DSUE Amount

Form 706 now includes a worksheet on which the DSUE amount is calculated. The DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts: (i) the basic exclusion amount in effect in the year of the death of the decedent; or (ii) the excess of — (A) the decedent's applicable exclusion amount; over (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

For example, if the decedent spouse died with an estate of $1 million having made adjusted taxable gifts of $1 million at a time when the applicable exclusion amount was $5 million, his DSUE amount would be $5 million less $2 million, or $3 million.

The DSUE amount of the surviving spouse may change if the surviving spouse remarries. In the event of remarriage, two possibilities exist: Either the surviving spouse will predecease the new spouse or the new spouse will predecease surviving spouse. If the surviving spouse predeceases, her DSUE amount will be the same as if she had not remarried.

On the other hand, if her new spouse predeceases her, then the DSUE amount will be calculated by reference to the estate of the new spouse. This could be of significant consequence if, prior to his death, the new spouse had made lifetime gifts and exhausted his lifetime exclusion amount.

There is a further limitation: When calculating the unused exclusion amount of the predeceasing spouse, *only that portion of the predeceasing spouse's own basic exclusion amount may be used.* In other words, the predeceasing spouse's unused exclusion amount will not include any portion of that spouse's "inherited" unused exclusion.

The upshot of the manner in which portability is calculated is that issues of portability should now be considered in drafting prenuptial or post-nuptial agreements in second or third marriages. While portability was intended to simplify estate planning, many issues involving portability necessitate further planning.

At the death of a surviving spouse whose estate tax return claims a DSUE amount, the IRS may examine the earlier estate tax return of the predeceased spouse for the purpose of adjusting the DSUE amount calculated on that return. However, if the three-year statute of limitations on assessment has run on the return, no changes to the estate tax liability of the predeceasing spouse may be made. IRC § 2010(c)(5)(B).

IV. Advantages of Portability

One situation where portability

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is clearly desirable is where assets are jointly owned. If all marital assets (*e.g.,* real estate, brokerage, and bank accounts) are jointly titled, portability will ensure that the exemption amount of both spouses is utilized to the extent of one-half of the value of the ointly-held property at the date of death of the first spouse.

Portability is useful where no planning has been done, and the will contains no credit shelter trust. In this situation, portability can act as a proxy for a credit shelter trust. Even where planning has been undertaken, some assets, such as a retirement account, may not be ideally suited for funding a credit shelter trust. Here as well, portability can significantly ease problems of estate administration.

Neither New York nor any other state has yet to enact an analogue of portability at the state level. New York has a $1 million estate tax exemption. Spouses considering portability should consider disposing of at least $1 million by means of QTIP trust or outright disposition at the death of the first spouse to avoid wasting the $1 million NYS exclusion.

V. Disadvantages of Portability

If the surviving spouse is young, then future appreciation in inherited assets will not escape the estate tax, as they would if a credit shelter trust were employed at the death of the first spouse. This is because the assets will be included in the estate of the surviving spouse at her death.

It has been suggested that this problem can be mitigated by having the surviving spouse make a gift of the DSUE amount to a defective grantor trust. This gift would presumably solve the problem of future appreciation and would have the added benefit of enabling the surviving spouse to pick up the annual income tax tab of the trust without incurring gift tax liability. The assets in the trust would grow without the yearly imposition of income taxes.

The problem with this approach is that the if estate tax disappears in 10 or 20 years — as many now expect — the IRS will likely concentrate its compliance efforts on increasing revenue from income tax audits.

Assume that in 10 or 20 years the surviving spouse dies at a time when there is no estate tax. Assume further that Congress or the IRS decides that a realization event for income tax purposes occurs when the grantor of a grantor trust dies. In that case, immense amounts of appreciation will become subject to capital gains tax at the death of the grantor.

The principal problem with foregoing the credit shelter trust in favor of the gift by a surviving spouse to a grantor trust is that a substantial tax risk is assumed in exchange for accomplishing little economically. Why should a taxpayer needlessly incur the risk of an income tax event when not much is to be gained by taking the risk? In the case of a young spouse whose death may not occur until after the estate tax is repealed, electing portability is simply not prudent.

If a credit shelter trust is employed, full use of both exclusions could be assured. There is of course a basis trade off with the use of a credit shelter trust. While portability will ensure that all of the assets included in the estate of the second spouse will receive a step up in basis, the assets funding a credit shelter trust will continue to appreciate and will not receive a basis step up when the second spouse dies.

Although Congress provided for portability of the estate tax exemption, and the provision is coordinated with lifetime gifts, Congress did not elect to include in the concept of portability the generation skipping tax (GST) exemption. This could be a significant drawback in estates requiring the use of the GST exemption to increase the amount of assets passing in trust to grandchildren and future descendants.

A catch 22 may arise where an estate tax return is necessary only to calculate the DSUE amount for the surviving spouse. The executor may not wish to incur the cost of filing the estate tax return, since only the surviving spouse will benefit from the filing. If discord exists between the surviving spouse and the children of the deceased spouse, and one of the children is executor, he might decide not to incur the expense of an estate tax return.

Although there was hope that the IRS would provide a "short form" 706, this has not yet occurred. It is unclear what remedy, if any, the surviving spouse would have in this situation. It is clear that if no estate tax return is filed, the deceased spousal unused exclusion amount will be unavailable to the estate of the surviving spouse.

Another problem could arise if the predeceasing spouse has children from a prior marriage, and utilizes a QTIP. If a QTIP trust is implemented for the benefit of the surviving spouse, and a portability election was made, the surviving spouse would get the benefit of the DSUE upon her death. During his or her lifetime, he or she could makes gifts which would exhaust his or her applicable exclusion amount plus the inherited DSUE.

At the death of the surviving spouse, the QTIP would be included in the his or her estate, and estate tax liability would arise. Those responsible for the payment of the estate tax would be the QTIP beneficiaries — the children of the first spouse to die. If the exclusion plus the inherited DSUE were exhausted, estate tax liability would arise, and the children would be liable for that estate tax. If, on the other hand, a credit shelter trust had been in place at the death of the first spouse, the children would have benefitted from the applicable exclusion amount available to their estate of their parent.

The credit shelter trust may also be preferable to portability with respect to the issue of IRS audits. Since the IRS is less likely to audit an estate that will produce no estate tax revenue, assets funding a credit shelter

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trust would appear less likely to attract an IRS audit. On the other hand, the IRS would be free to audit the estate of the second spouse where portability had been elected.