Is Treasury Regulation Sec. 25.2702-3(e), Example 5 valid?
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Trusts & Estates; Dec 2000; 139, 12; ProQuest Direct Complete
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Is Treasury Regulation Sec. 25.2702-3(e), Example 5 Valid?

TREASURY REGULATION SEC. 25.2702-3(e), Example 5 represents one of the most technically challenging provisions issued by the U.S. Treasury in administration of the federal estate and gift tax system. It also represents one of the most controversial provisions issued by Treasury. Most estate planners wish it didn't exist, while many believe it represents a corruption of IRC Sec. 2702, the statute it's meant to interpret. Until Congress changes the law or Treasury changes its policy, Example 5 is here to stay unless it is overturned upon judicial review. This is a distinct possibility.

The Internal Revenue Code imposes a transfer tax on the transfer of property by gift to any taxpayer.[1] The value of transferred property as of the date of the gift "shall be considered the amount of the gift."[2] As a general rule, where property is transferred in trust where the donor retains an interest in such trust, the value of the gift is the value of the property transferred less the value of the donor's retained interest.[3] The exception to this general rule is codified in Sec. 2702.

The value of a gift where the donor transfers property to trust in which she retains an interest will not be determined by subtracting the value of the donor's retained interest from the value of the property transferred where such gift in trust is to a family member. Instead, the value of the gift will generally be equal to the full value of the property transferred to the trust unless the interest retained by the donor is a "qualified interest" under Sec. 2702.

A "qualified interest" is defined in Sec. 2702 as 1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (often referred to as an annuity interest), 2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the value of the property in the trust (often referred to as a unitrust interest), and 3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described at (1) or (2).[4] Only the value of qualified interests retained by the donor may be deducted from the property's full value in measuring the gift for transfer tax purposes where the transfer is made in trust to family members.

Sec. 2702 was enacted by Congress in an effort to curb certain abuses perceived by the Internal Revenue Service. Before the enactment of Sec. 2702 taxpayers would often make gifts to family members in trust retaining an income interest only. The value of the income interest could be deducted from the value of the property transferred often resulting in an unusually reduced gift tax value of the gift for transfer tax purposes. This technique was also typically structured so that the investment characteristics of the property transferred to the trust would produce a transfer having an economic value to the remainderman which exceeded the value of the gift as computed prior to the enactment of Sec. 2702. This concern is revealed in the legislative history of Sec. 2702 as follows:

> In addition, the committee is concerned about the undervaluation of gifts valued pursuant to Treasury tables. Based on average rates of return and life expectancy, those tables are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of Treasury tables undervalues the transferred interests, in the aggregate, more often than not.
>
> Therefore, the committee determines that the valuation problems inherent in trusts and term interests in property are best addressed by valuing retained interests at zero unless they take an easily valued form — as an annuity or unitrust interest. By doing so, the bill draws upon present law rules valuing split inter-

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Treasury Reg. Sec. 25.2702-3(e)
IRC Sec. 2702

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ests in property for purposes of the charitable deduction.[5]

Regulation Sec. 25.2702-3(e), Example 5

The U.S. Treasury promulgated proposed regulations under Sec. 2702 on April 9, 1991.[6] Proposed Regulation Sec. 25.2702-3(e), Example 5 stated:

A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest for the full 10-year term.

On January 28, 1992, however, Treasury issued final regulations under Sec. 2702.[7] Curiously, the last sentence of Example 5 in the final regulations was changed from its original appearance in the proposed regulations to read:

A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.

This change was troubling to many in the estate planning community since it meant that taxpayers would not be able to "zero-out" a gift in trust under Sec. 2702.

In its proposed form, Example 5 would allow a donor to create a unitrust or annuity interest so that its value, based on its payout rate, term, and discount rate (determined under Sec. 7520), was equal to the value of the property transferred to trust. This was an appealing result from an estate planning standpoint because donors could transfer property in trust and retain an annuity interest[8] under Sec. 2702 sufficiently large so that no gift resulted. The transfer was therefore risk-free from a gift tax perspective. If the donor made a zeroed-out transfer in trust and the property experienced growth at a rate of return greater than that used to value the annuity interest (the Sec. 7520 rate in effect at the time of the transfer) then there would be property remaining in the trust to be passed on to family members at the end of the trust's term. If the property didn't appreciate at a rate of return greater than that used to value the annuity interest then no property would be left in the trust to pass on to family members at the end of the trust's term. This was of no real concern to the donor, however, because she never paid any gift tax upon the transfer to the trust. In other words, the best case scenario for the donor was that a tax-free gift of property could be made to family members at the end of the trust's term. The worst case scenario for the donor was that she received all of the trust property back with none left in the trust to pass onto family members.

The final regulations changed this result. Since Example 5 now requires that a qualified interest represent an annuity payment for a term of years "or until [donor's] prior death" a donor will never be able to zero-out a transfer in trust.[9] This is so because there will always be some actuarial probability that the donor could die before the end of the trust's term, no matter how short that term may be. Because there is always some probability the donor may die before the expiration of the trust's term, the annuity interest can never be made large enough so that its actuarial value is equal to the value of the property upon its transfer to trust. As a result, there will always be some measurable gift, and possibly the payment of gift tax, in a transfer to trust where Sec. 2702 applies. Pursuant to Example 5, the proposition of making transfers in trust is no longer risk-free under Sec. 2702. Under the worst case scenario the donor could receive all of the trust property back at the end of the trust's term, with none left in the trust to pass onto family members, despite having paid gift tax upon the initial transfer of the property into the trust.

This result was so troubling to some in the estate planning community that many began to decry that Example 5 was invalid. Some hold that Example 5, which incorporates Regulation Sec. 25.2702-3(d)(3)'s requirement that a qualified annuity interest be for 1) the life of the annuitant, 2) a specified term of years, or 3) the shorter of those two periods, adds a requirement not imposed by the statute.[10] Sec. 2702(b)(1) does not attempt to limit the term over which the annuity is payable to a "shorter of" period. Others point out that Example 5 is inconsistent with the Sec. 2702 requirement that Sec. 7520 be relied upon in determining the value of the qualified annuity interest.[11] Regulation Sec. 20.7520-3(b)(2)(i) requires that an annuity for a "definite term of years" be tested by using a term of years factor, not a factor for the shorter of a term of years or the life of the annuitant. The conviction that Example 5 is invalid is so strong that it has led certain taxpayers, acting upon the counsel of some of the most respected estate planning practitioners in the field, to litigate this issue in U.S. Tax Court.

Walton v. Commissioner

On February 23, 1999 Audrey J. Walton, former spouse of James Walton, the brother of the founder of Wal-Mart, Sam Walton, filed a petition in U.S. Tax Court contesting a notice of deficiency issued by the Service requiring the payment of over $4.5 million in additional gift taxes related to the formation of two grantor retained annuity trusts (GRATs) in 1993.[12] Mrs. Walton was advised by Richard Covey, faculty member of The University of Miami's Philip E. Heckerling Institute on Estate Planning for over 30 years, to file her 1993 gift tax return reporting the gift of Wal-Mart stock to the GRATs using a valuation of her retained annuity interests that ignored Example 5.[13] As of the date of this article, opening and reply briefs for both the petitioner and respondent have been filed, but the case has not yet been decided or settled.

In 1993 Mrs. Walton established two substantially identical GRATs, one for each of her daughters, each for a two-year term and fund-

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ed with $100 million of Wal-Mart common stock.[14] Mrs. Walton's retained annuity interests were sufficiently large so that their value, computed under Sec. 2702, but without reference to Example 5 (taking into consideration the possibility of her death within the two-year term of the GRATs), almost equaled the entire amount of the transfers to each GRAT. Consequently no gift tax was reported or paid on Mrs. Walton's 1993 gift tax return.[15] Mrs. Walton's 1993 gift tax return included the following disclosure in support of its computation of her retained annuity interests:

> **Treas. Reg. Sec. 25.2702-3(e), Example 5, is inconsistent with IRC Sec. 2702 because the interest of the grantor's estate is a "qualified interest" as defined in IRC Sec. 2702(b).**[16]

The Service was not persuaded by Mrs. Walton's contention and computed the value of her retained annuity interests pursuant to Example 5 finding that such value did not equal the value of the property transferred into each GRAT, but instead resulted in a taxable gift of over $3.8 million for each GRAT.[17] Consequently, a total gift tax deficiency for the taxable gifts resulting in the transfer to both GRATs exceeded $4.5 million.

The brief filed on behalf of Mrs. Walton in support of her petition to U.S. Tax Court argues that Example 5 is in conflict with Sec. 2702 and with other provisions of the final regulations issued under Sec. 2702. The brief also contends that Example 5 is inconsistent with the regulations governing the valuation of charitable split interests to which the legislative history appealed in the enactment of Sec. 2702. In the final analysis, the brief argues that Example 5 is invalid because it is unreasonable.[18] Acknowledging the authority of *Chevron U.S.A. v. Natural Resources Defense Council Inc.*,[19] which requires that a regulation must be sustained unless it is unreasonable, the brief maintains that Example 5, in consideration of its numerous inconsistencies, is patently unreasonable and therefore invalid.

Alternatively, the brief argues that Example 5 is not effective since it was issued in violation of the Administrative Procedures Act (APA).[20] Because the Example 5 which appeared in the final regulations was diametrically opposed to the Example 5 which appeared in the proposed regulations, the petitioner was foreclosed from commenting on final Example 5. This occurred because the taxpayer was only aware of Example 5 as it appeared in the proposed regulations. She had no basis to comment on Example 5 as it appeared in the final regulations issued after the close of the comment period. The brief also notes that similar regulatory "bait and switch" tactics have been criticized by the U.S. Tax Court. In *Schwalbach v. Commissioner*[21] the Court observed that the APA's policy requiring comment "is not adequately served, on the other hand, where interested persons could not reasonably anticipate the final rules from the proposed rules."[22] The Court in *Schwalbach* goes on to conclude that where "the final rules deviate too sharply from the proposed rules, notice is inadequate."[23]

Dick v. Commissioner

On October 27, 1999 Helen Dick filed a petition in U.S. Tax Court similar to that filed by Mrs. Walton.[24] The stakes in Mrs. Dick's case, however, aren't quite as high as those in Mrs. Walton's case. Mrs. Dick contests a notice of deficiency issued by the Service requiring the payment of only $22,000 in additional gift taxes related to the formation of a GRAT by her husband. Like Mrs. Walton, Mrs. Dick's husband filed a 1994 gift tax return reporting a transfer of over $4 million of publicly-traded common stock to a two-year GRAT. No gift was reported on the return as filed since the retained annuity interest was valued using a valuation methodology that ignored Example 5. The Service argued that, pursuant to Example 5, the transfer resulted in a taxable gift of over $107,000. As of the date of this article the case has not yet been decided or settled nor have any briefs been filed.

Judicial Review of Treasury Regulations

Whether or not Mrs. Walton or Mrs. Dick will be successful in their litigation will depend upon their ability to show that Example 5 is invalid and should thus be rendered impotent. The starting point in this analysis is identifying the standard of review that a court should apply to a Treasury regulation in determining its validity. According to the Eighth Circuit, "the standards applicable to determining the validity of Treasury regulations are well established."[25] Unfortunately this statement suggests that these standards are clearly articulated and uniformly applied. Nothing could be further from the truth. The complicated issue is not whether the "standards" are "well established," but rather which of the standards are appropriate and how they should they be applied to the specific regulation in determining its validity.

Amid the confusion, the standards of review applied by courts in determining the validity of Treasury regulations can be generally organized under two primary standards. The traditional standard of review is used most widely by courts and has specific application to Treasury regulations. The other primary standard is based on the U.S. Supreme Court decision *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[26] which upheld the validity of a regulation promulgated by the Environmental Protection Agency (EPA). The *Chevron* standard of review has purported applicability to all federal agency interpretations of Congressional statutes including Treasury regulations.

The Traditional Approach

In applying the traditional approach in reviewing the validity of a Treasury regulation, two steps have generally been identified in the analysis. The first step involves a determination as to whether the subject regulation represents a "legislative regulation" or an "interpretive regulation." Once the

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regulation has been classified as either legislative or interpretive, the second step in the traditional paradigm requires application of the appropriate standard of review to the regulation based on its classification. Generally, legislative regulations are entitled to greater deference by the judiciary than interpretive regulations in determining their validity.

Legislative regulations are Treasury regulations issued under a specific grant of rulemaking authority to the Secretary by Congress.[27] As a result, legislative regulations have the legal effect of a statute.[28] In addition, legislative regulations are valid only if the Treasury strictly follows the notice and comment procedures required by the APA in adopting the regulation.[29] On review, courts typically consider whether the regulation exceeds the statutory delegation of authority, thus invalidating those regulations that are "arbitrary, capricious, or manifestly contrary to the statute."[30]

Interpretive regulations, on the other hand, are issued under the general authority granted by Congress to Treasury under IRC Sec. 7805(a), which authorizes the Service to promulgate "all needful rules and regulations" required to enforce the Internal Revenue Code.[31] Interpretive regulations are labeled as such because they merely interpret statutes enacted by Congress. It is the position of Treasury that interpretive regulations are not subject to the notice and comment procedures required by the APA on the basis that such regulations qualify for the interpretive rule exception under APA Sec. 553(b)(A).[32] Despite this position, Treasury attempts to utilize the notice and comment provisions required under the APA even in issuing interpretive regulations.[33] On review, interpretive regulations are upheld only if they are in harmony "with the plain language of the statute, its origin, and its purpose."[34] Since interpretive regulations are issued under general grant of authority by Congress, rather than specific grant of authority, they are entitled to much less deference by courts than legislative regulations. Consequently, courts may strike Treasury regulations down even if they are compatible with the statute and are not arbitrary and capricious.[35] Unlike legislative regulations, interpretive regulations are "not controlling upon the courts by reason of their authority."[36]

Once a Treasury regulation has been classified as legislative or interpretive, the appropriate standard of review can be applied. A legislative regulation will be overturned only if it is unreasonable.[37] An interpretive regulation does not have to be unreasonable to be overturned. Instead, under the traditional approach, a number of factors are typically considered in determining whether or not the regulation is valid. The factors most often considered are those identified by the Supreme Court in *National Muffler Dealers Assn., Inc. v. United States*.[38] These factors include "the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute."[39] Although *National Muffler* is not the sole authority in reviewing interpretive regulations under the traditional paradigm, the factor analysis employed in the case and the frequency of its appearance in other cases where the validity of a Treasury regulation is in question has led the resulting standard to sometimes be called the *National Muffler* standard.[40] In addition to the factors cited in *National Muffler*, courts have also looked to legislative history in deciding whether to overturn or uphold an interpretive regulation.[41]

Lastly, one significant obstacle which impacts any analysis pursued under the traditional approach is correctly classifying a Treasury regulation as legislative or interpretive. The distinction between legislative and interpretive regulations remains unclear and neither the courts nor commentators agree on how exactly to dif-

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ferentiate between the two. One commentator has noted that the "cases that attempt to make the distinction are legion and inconsistent."[42] As a result, determination of whether regulations are interpretive or legislative has been "one of the most frequently litigated administrative law issues of the last two decades."[43]

The *Chevron* Approach

The standard formulated by the U.S. Supreme Court in *Chevron* is applicable to regulations issued by all federal agencies even though *Chevron* involved the validity of an EPA regulation. The *Chevron* standard is more strict than the traditional standard because it extends greater deference to an agency regulation making it more difficult to demonstrate the regulation's invalidity. Like the traditional standard, the *Chevron* standard requires analysis using a two step approach.

The first step in the analysis requires the reviewing court to look solely at the statute and use traditional tools of construction to determine if the statute directly speaks to the precise issue. If the intent of Congress is clear, as expressed in the statute alone, any further inquiry is terminated and the court "must give effect to the unambiguously expressed intent of Congress."[44] Consequently, the first step looks only to the statutory text and not to other traditional supplements like legislative history. Although this step may appear to constrain any activism by the reviewing court, it may in fact be that when reviewing the statute "courts presume a meaning plain to the judge writing the opinion."[45] As a result, courts may construct their own meaning with respect to any given statute rather than attempt to find the meaning by evaluating intent as demonstrated by legislative history.[46]

Only if the statute does not clearly and directly speak to the precise issue will a court then proceed to step two. If the court determines that the statute is silent or ambiguous concerning the specific issue, step two requires the court to discern whether the agency's interpretation of the statute is based on a permissible construction of the statute.[47] A court may not substitute its own construction of a statutory provision for a reasonable interpretation of the agency.[48] Consequently the agency is unrestrained to adopt any reasonable interpretation of the statute and to defend such interpretation on any basis.[49] *Chevron* thus treats any ambiguity in the statute as an extension of policy-making authority to the agency charged with administering the statute. The agency interpretation therefore enjoys the highest form of deference.

Reconciling the Standards

The traditional and *Chevron* approaches to review of Treasury regulations appear to have more similarities than differences. *Chevron* is basically equivalent to the deference afforded to legislative regulations under the traditional approach.[50] In fact, the distinction between legislative and interpretive regulations under *Chevron* "is an anachronism."[51] This is so because any agency regulation under *Chevron* enjoys a form of super deference. It has also been suggested that there may be no real difference between the two approaches. The U.S. Tax Court has commented in one case where it reviewed and upheld a challenged Treasury regulation that it did not need to "dissect the differences, if any, between *Chevron* and *National Muffler* (traditional approach)."[52] In fact, the U.S. Tax Court doesn't recognize *Chevron* as a revolutionary change from the multiple factor analysis under the traditional approach. As Judge Tannenwald observed, "We are inclined to view that the impact of the traditional, i.e., *National Muffler* standard, has not been changed by *Chevron*, but has merely been restated in a practical two-part test with possibly subtle distinctions as to the role of legislative history and the degree of deference to be accorded to a regulation."[53]

Despite the similarities, the traditional standard, as it has historically been applied, nonetheless represents a much less deferential approach than *Chevron* to the consideration of Treasury regulations in resolving a tax dispute. This is good news to those who seek to challenge the validity of a Treasury regulation because the traditional standard appears to be the one still consistently applied.

Courts rarely apply *Chevron*'s two-step analysis to interpretive regulations and they do not attempt to treat ambiguities and gaps in IRC statutes as delegations of policymaking authority to the Treasury, as would be required under *Chevron*.[54] In *Cottage Savings Ass'n v. Commissioner*[55] the Commissioner requested that the *Chevron* standard of review be applied to an interpretive Treasury regulation. The Court ignored the request and instead relied upon *National Muffler* to conduct its review.[56] The 8th Circuit has suggested that *Cottage Savings* stands for the proposition that *National Muffler* is still the appropriate standard of review to apply to interpretive Treasury regulations.[57] Similarly, the 7th Circuit has stated that *National Muffler*, rather than *Chevron*, represents the appropriate standard of review for Treasury regulations.[58]

One commentator has speculated that the explanation for the failure of courts to apply the *Chevron* standard of review to Treasury regulations lies in the "sociology" of the tax bar and bench.[59] Since the tax bar is so highly specialized and its members rarely litigate cases challenging non-tax regulations it is quite possible that senior tax lawyers may simply be unaware of *Chevron*.[60] Consequently, the tax bar may have led courts, through the process of tax litigation post-*Chevron*, to come to a conclusion, somewhat unknowingly, that *Chevron* isn't controlling in tax controversies.

The Validity of Example 5

Congress has not provided any specific grant of authority to Treasury under Sec. 2702(b) for clarifying the statute's definition of "qualified interest." Example 5 was promulgated pursuant to Treasury's general authority to prescribe "all

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needful rules and regulations" under Sec. 7805(a). Since Example 5 represents an interpretive Treasury regulation, a challenging taxpayer would not be required to show that it is unreasonable, arbitrary, or capricious in overturning it assuming that a court would apply the traditional standard of review in determining its validity. A *Chevron* type of review, requiring that the regulation be found unreasonable in order to be determined invalid, would only be applicable under the traditional standard for the review of a legislative Treasury regulation.

Based on application of some of the factors identified in *National Muffler* and other tax cases employing the traditional standard of review, Example 5 appears suspect. The Commissioner's interpretation of Sec. 2702 as manifested by Example 5 has been quite inconsistent. As earlier mentioned, the language and effect of Example 5 changed dramatically from its first appearance in proposed form to its later issuance in final form. In addition, while the legislative history in support of the enactment of Sec. 2702 explains that the statute "draws upon present law rules valuing split interests in property for purposes of the charitable deduction,"[61] the charitable split interest provisions do not require a "shorter of" a term of years or prior death valuation of a retained annuity interest in arriving at the income tax charitable deduction.[62] The "shorter of" methodology imposed by Example 5 on Sec. 2702 doesn't reconcile with the methodology prescribed by the charitable split interest provisions. Finally, Example 5 has been in effect for a relatively short period of time in the spectrum of existing tax law and it is already the subject of an onslaught of litigation. This tends to create the implication that Example 5 may not be a reasonable interpretation of Sec. 2702.

Curiously, Mrs. Walton has proposed that the U.S. Tax Court consider *Chevron*, rather than *National Muffler*, in conducting its review of Example 5.[63] Although invoking the *Chevron* standard of review will require a showing of no less than unreasonableness in overturning Example 5, Mrs. Walton argues that Example 5 is in fact invalid because it is unreasonable.

Cook v. Commissioner

If Example 5 is invalid, the U.S. Tax Court isn't aware of it. On July 25, 2000 the Court decided *Cook v. Commissioner*[64] which considered an issue very similar to that currently before the Court in *Walton* and *Dick*. Mr. and Mrs. Cook each created two GRATs retaining an annuity for a stated number of years. The GRATs provided that if the grantor died before the expiration of the stated term of years and was survived by a spouse, the annuity would continue for the surviving spouse until the earlier of his or her death or the expiration of the original term. If either grantor died before the expiration of the stated term of years and was not survived by a spouse, the annuity would end upon the death of the grantor.

The Cooks requested summary judgement contending that the value of the remainder interest in each GRAT under Sec. 2702 was the value of the transfer to the trust, reduced by the actuarial value of a dual-life annuity under Sec. 7520. The Service argued that only the value of a single-life annuity could be subtracted in arriving at the value of the remainder, i.e. the taxable gift. The Court agreed with the Service and held that the spousal interests in each GRAT were not fixed and ascertainable at the inception of each GRAT (making them contingent interests). In addition, since the retained interests in each GRAT could extend beyond the shorter of a term of years or the period ending upon the death of the grantor in violation of Reg. Sec. 25.2702-3(d)(3), the retained interests were to be valued as single-life annuities rather than dual-life annuities.

In reaching its conclusion, the Court relied specifically on Ex-

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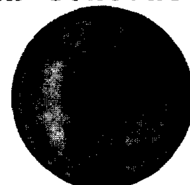

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ample 5. After setting forth the complete text of Example 5 the Court affirmed its effect stating that, "only the retained interest for the shorter of a term of years or the transferor's life is fixed and ascertainable at the creation of the interest and is therefore a qualified interest under Sec. 2702."[65] The Court went on to opine that Example 5 represented a rule which advanced the congressional purpose behind Sec. 2702 since the legislative history of the statute indicated that Congress enacted the statute to deter valuation abuses in gift tax planning.[66] According to the U.S. Tax Court, Example 5 is not only valid, it's responsible for Mr. and Mrs. Cook owing an additional $15 million to the U.S. Treasury for underpaid federal gift tax liabilities.[67]

After examining *Cook* one is left wondering whether or not the Cooks argued the validity of Example 5 in defending their position. The opinion doesn't make any reference to such an argument but alludes to the possibility that it was made in vain by stating, "We have considered other arguments made by the parties, and to the extent not addressed, we find them to be unconvincing, irrelevant, or moot."[68]

However, the pleadings indicate that the Cooks specifically refrained from contending that Example 5 was invalid. Although they soundly criticized the precise application of Example 5 that the Court in *Cook* relied upon in making its decision, they specifically noted that they were "not challenging the validity of the regulations or Example 5 *at this time*."[69] In the same breath, however the Cooks clarified that they would "make this argument [that Example 5 is invalid] in the future if the Service insists that Example 5 is the authority for determining that the retained interests in this case are not qualified."[70] Unfortunately, both the Court and the Service insisted that Example 5 was the primary authority for determining that the retained interests in the case were not qualified. Presumably the Cooks will make this argument to the Court as the litigation proceeds after summary judgement or on appeal. In any event, the question of Example 5's validity survives to be challenged another day.

Conclusion

With the outcome of the *Walton* and *Dick* controversies still at stake, and with the remaining litigation in *Cook*, the future of Example 5 as a valid Treasury regulation is still uncertain. The standard of review to be applied in reviewing the validity of Example 5, whether it be the traditional standard or the *Chevron* standard, is just as uncertain. Unfortunately, despite the current docket of litigation concerning Example 5, the possibility of settlement makes even the specific review of Example 5's validity by a court of law the subject of uncertainty. Until a court addresses the issue directly only one thing is certain; conjecture among estate planners regarding the validity of Example 5 will abound. ◆

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ENDNOTES

1. Sec. 2501.
2. Sec. 2512.
3. See Treas. Reg. Sec. 25.2512-5A(e).
4. Sec. 2702(b).
5. 136 Cong. Rec. S15629, S15681 (October 18, 1990).
6. PS-92-90, 56 Fed. Reg. 14321.
7. T.D. 8395, 1992-1 C.B. 316.
8. Unitrust interests are seldom used in a gift tax planning context since the donor hopes that the property gifted in trust will grow at a rate of return greater than the Sec. 7520 rate. If this assumption turns out to be true, more property will remain in the trust at the end of the term (and hence a larger transfer will have been made to family members) if an annuity interest is used. This is so because an annuity interest represents a fixed amount that will not change despite the growth of the value of the property in trust. A unitrust interest, on the other hand, will return a greater amount to the donor (leaving less in trust for family members at the end of the trust's term) since the amount paid to the donor each year will increase as the property in the trust increases.
9. Example 5, last sentence. See also Stephen F. Lappert, "IRC Sec. 2702 GRITs (Including Personal Reesidence Trusts and QPRTs) GRATs and GRUTs", 283 *Practicing Law Institute Tax Law and Estate Planning Course handbook Series* 463, 529 (September-October 2000).
10. See, e.g., Carlyn S. McCaffrey & Pam H. Schneider, "Planning for GRATs and QPRTs", 287 *Practicing Law Institute Tax Law and Estate Planning Course handbook Series* 243, 259 (March 2000).
11. See Leo L. Schmolka, "FLPs and GRATs: What To Do?", *2000 Tax Notes Today* 49-105, n.27 (March 13, 2000).
12. *Audrey J. Walton v. Commissioner*, No. 3824-99 (U.S. Tax Court Feb. 23, 1999).
13. Mr. Covey also represented and advised Mrs. Olsten, the surviving spouse of William Olsten, founder of the nation's third largest temporary help agency, in executing another controversial estate planning technique; the purchase of the remainder interest in the qualified terminable interest property (QTIP) trust established for her benefit under the estate plan of her deceased husband. See Bray and Kearns, "The QTIP Purchase After Revenue Ruling 98-8", 24 *Tax Management Estates, Gifts and Trusts Journal* 123 (March 1999).
14. Petitioner's Opening Brief at 2, *Walton* (No. 3824-99).
15. Respondent's Brief at 10, *Walton* (No. 3824-99).
16. Petitioner's Opening Brief, *supra* Note 14 at 5.
17. Respondent's Brief, *supra* Note 15 at 13.
18. Petitioner's Opening Brief, *supra* Note 14 at 22.
19. 467 U.S. 837, 843-844 (1984).
20. 5 U.S.C. Sec. 553.
21. 111 T.C. 215 (1997).
22. Id. at 228.
23. Id.
24. *Helen E. Dick v. Commissioner*, No. 16773-99 (U.S. Tax Court Oct. 27, 1999).
25. *Miller v. United States*, 65 F. 3d. 687, 689 (8th Cir. 1995).
26. 467 U.S. 837 (1984).
27. See e.g., IRC Sec. 1504(a)(5) which specifies that the Secretary "shall prescribe such regulations as maybe necessary or appropriate to carry out the purposes of this subsection." See also IRC Secs. 469(l) and 337(d).
28. *CWT Farms, Inv. v. Commissioner*, 755 F.2d 790, 800 (11th Cir. 1985).
29. 5 U.S.C. Sec. 553(b).
30. See, e.g., *Archer-Daniels-Midland Co. v. United States*, 798 F.Supp. 505, 509 (C.D. Ill. 1992).
31. IRC Sec. 7805(a).
32. See John F. Coverdale, "Court Review of Tax Regulations and Revenue Rulings In

See Sec. 25.2702-3, p. 66

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a minimum payment of at least 5 percent of the "initial [net] fair market value of the trust assets." That's required by the Code and the regulations. The Court dismissed the estate's contention that the payout requirement should be ignored because it only serves to decrease the charitable contribution and the donor had no need for the payments.

Court's Reasoning — Operational Requirement

Though the terms of the annuity trust met the letter of the statutory requirement providing for distributions equal to 5 percent annually, the trust did not operate in accordance with those terms.

Trust Not Reformable Under IRC Sec. 2055(e)(3) — Court's Reasoning

That reformation deals with an improperly drafted CRAT. "The definition of 'qualified reformation' demonstrates that the reformation is meant to address only those problems arising in the documentation of the trust. ...Here the trust was validly formulated, and its terms were within the statutory threshold requirements. Accordingly, reformation is not needed to 'rewrite' incorrect terms. **The operational failure cannot be corrected by reformation."** [Emphasis supplied]

Tax Court Whips Dead CRAT for Payments to Secondary Beneficiary Who Didn't Pay Her Share of Death Taxes

In addition to operational-failure disqualification for not making the required annuity payments to Donor, the trust is disqualified because it will be necessary to invade the trust to satisfy the estate's obligations, which include estate and death taxes apportionable to Ms. Birchfield's interest in the trust.

The estate's other assets (an administrative trust) are insufficient to pay Donor's debts, the administration expenses, and estate and death taxes. So the shortfall will have to come out of the CRAT. Under IRC Sec. 664(d)(1)(B) no amounts from the trust, other than the annuity [and payments for full and adequate consideration], may be paid to anyone other than a charitable organization.

Donor's Estate Argued Over the Size of the Charitable Deduction

Forget about the example of *chutzpah* being the fellow who killed his parents and asked the court to have mercy because he was an orphan. The estate maintained that the CRAT not only qualified for a charitable deduction, but that the estate is entitled to a refund. A larger charitable deduction should have been allowed because the trustee had an affidavit from Ms. Birchfield's doctor stating that she had less than a five-year life expectancy. She died three years and 10 months after the trust started for her. The estate initially calculated the charitable deduction based on her actuarial life expectancy, but in the Tax Court the estate said that the calculation was incorrect. A shorter life expectancy should have been used, resulting in a greater charitable deduction for the remainder interest. That's academic, said the Court, because no deduction at all is allowable.

Did the Donor Get Off Easy?

As we have seen, the estate tax charitable deduction was at issue. Her inter vivos trust was to (but didn't) pay her for life, and then pay successor beneficiaries.

Applying the Court's rationale, IRS would also succeed in denying the income and gift tax charitable deductions for failure to make required payments. And because the trust was disqualified for not operating properly, it wouldn't be tax exempt. Thus income and capital gains (ordinarily not taxed, except for amounts distributed and taxable to the trust beneficiary) would be taxable.

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ENDNOTES

1. A honko-second is the shortest measure of time — the time that elapses between the traffic light turning green and the driver in the car behind you hitting the horn.
2. "To lose one parent, Mr. Worthing, may be regarded as a misfortune; to lose both looks like carelessness."
— Oscar Wilde, *The Importance of Being Earnest*

Sec. 25.2702-3, Continued from p. 64

The *Chevron* Era", 64 *Geo. Wash. L. Rev.* 35, 55 (1995).

33. Id.
34. *Rowan Cos. v. United States*, 455 U.S. 247, 253 (1981).
35. See Coverdale, *supra* note 32, at 44.
36. *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).
37. See Coverdale, *supra* note 32, at 44.
38. 440 U.S. 472 (1979). See also Naftali Z. Dembitzer, "Beyond the IRS Restructuring and Reform Act of 1998: Perceived Abuses of the Treasury Department's Rulemaking Authority", *52 Tax Laywer* 501, 503 (1999).
39. *National Muffler*, 440 U.S. at 476.
40. See e.g., Dembitzer, *supra* note 38, at n.16.
41. See *Pacific First Federal Savings v. Commissioner*, 94 T.C. 101 (1990), rev'd, 961 F.2d 800 (9th Cir. 1992).
42. Coverdale, *supra* note 32, at 49.
43. Michael Asimow, "Public Participation in the Adoption of Temporary Tax Regulations", 44 *Tax Lawyer* 343, 353 (1991).
44. *Chevron* at 842. See also Ellen P. Aprill, "Muffled *Chevron*: Judicial Review of Tax Regulations", 3 *Fla. Tax Rev.* 51, 63 (1996).
45. Aprill, *supra* note 44, at 66.
46. See id.
47. See Coverdale, *supra* note 32, at 41.
48. *Chevron* at 844.
49. See Aprill, *supra* note 44, at 66.
50. See Coverdale, *supra* note 32, at 45.
51. Coverdale, *supra* note 32, at 48 (quoting *EEOC v. Arabian Am. Oil Co.*, 499 U.S. at 260 (1991)).
52. *Central Pennsylvania Savings Ass'n v. Commissioner*, 104 T.C. 384, 392 (1995).
53. Id.
54. See Coverdale, *supra* note 32, at 57.
55. 499 U.S. 554 (1991).
56. Id. at 560.
57. *St. Jude Medical Inc. v. Commissioner*, 34 F.3d 1394, 1400 n.10 (8th Cir. 1994).
58. *Bell Fed. Sav. & Loan Ass'n v. Commissioner*, 40 F.3d 224, 227 (7th Cir. 1994).
59. See Coverdale, *supra* note 32, at 53, n.121.
60. Id.
61. 136 Cong. Rec. S15629, S15681 (October 18, 1990).
62. See Treas. Reg. Secs. 1.664-2(c) and 20.2031-7.
63. Petitioner's Opening Brief at 22, *Walton* (No. 3824-99).
64. 115 T.C. No. 2 (2000).
65. Id. ¶31.
66. *Cook* ¶33.
67. See *Cook* ¶19.
68. *Cook* ¶40.
69. Memorandum of Points and Authorities in Support of Petitioners' Motion for Partial Summary Judgement at 9, *Cook*, 115 T.C. No. 2 (2000) (emphasis added).
70. Id. at n.40.

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