

# Estate Planning Review

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## ESTATE TAX REFORM SAGA CONTINUES

With the chances for permanent repeal of the federal estate tax fading and with mid-term elections only four months away, House and Senate members are staking out positions on possible estate tax reform proposals. Sen. John Kyl (R. Arizona) was arguably the first to indicate a willingness to accept some form of compromise when he proposed

*Following the failure of a Senate vote on permanent repeal of the federal estate tax, lawmakers turned their attention to the possibility of a compromise reform proposal. However, the road to such a compromise remains a bumpy one as legislators return to Washington after the July 4th recess.*

that the current applicable exclusion amount be raised to \$5 million (effectively \$10 million for a married couple) beginning in 2010 and that taxable estates above that amount

be taxed at 15 percent, a rate equivalent to the current maximum rate on long-term capital gains. Sen. Kyl's proposal would have left the gift tax with its current law \$1 million exclusion amount and, as would be the case under current law in 2010, a 35-percent rate. The basic parameters of Sen. Kyl's proposal have actually been discussed for some time, however, it has never received a very enthusiastic response from the other side of the aisle, particularly in light of its projected revenue loss, which has been estimated at approximately 90 percent of what would occur with full repeal according to the Congressional Research Service and the Urban-Brookings Tax Policy Center (see CRS RL32818, June 22, 2006, p. 20). A revised proposal by Sen. Kyle would have added a second 30-percent rate for estates over \$30 million and is projected to lose approximately 86 percent of the revenue as compared to full repeal.

### Ways and Means Committee Enters the Picture

Shortly after the failed June 8 vote, Senate Majority Leader William Frist (R. Tennessee) suggested that, in light of the apparently tough prospects for permanent repeal of the estate tax, the House should take up its own reform proposal. In response, House Ways and Means Committee Chairman William Thomas (R. California)

introduced his attempt at this strategy in the form of the Permanent Estate Tax Relief Act of 2006 (H.R. 5638). H.R. 5638 was passed by the full House on June 22. The bill's major components include the following points.

- Retention of federal estate and generation-skipping transfer taxes beyond 2009 using long-term capital gain tax rates (15 or 20 percent depending upon whether current law rates are retained) for estates up to \$25 million and 30 or 40 percent on amounts greater than that.
- "Reunification" of estate and gift taxes by way of a \$5 million per-person applicable exclusion amount that would be both indexed for inflation and "portable," meaning that the unused portion of the exclusion available to the first to die of a married couple would effectively be passed to his or her surviving spouse.
- Retention of current law stepped-up basis after 2009.
- Elimination of the Code Sec. 2058 deduction state death taxes beginning in 2010.

The House proposal also included a provision unrelated to estate or gift taxes that was intended as a "sweetener" to induce certain fence-sitting Senators to vote in favor

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of the bill. That provision, involving special capital gains treatment for certain sales or exchanges of timber, had been sought previously by a number of the targeted Senators. However, following passage of the bill in the House, there was no clear indication that it had achieved its stated goal. Even with the elimination of the deduction for state death taxes, the overall revenue loss from the proposal was pegged at approximately 83 percent of full repeal (or 77 percent if current capital gains rates were allowed to expire). One of the Senators whose favorable vote was purportedly being sought, Maria Cantwell (D. Washington), stated that the overall price of the bill was too high and, to make matters worse, the elimination of the Code Sec. 2058 deduction could have a negative impact on the revenues of her home state.

Another Senator who has stated a willingness to accept a compromise on estate tax reform, Mary Landrieu (D. Louisiana), decided to enter the fray in a more direct way by introducing her own reform proposal, which includes a \$5 million estate tax exclusion, a flat 35-percent rate above that amount, plus a five-percent surtax on estates in excess of \$100 million. Sen. Landrieu's proposal would not reunify estate and gift taxes as H.R. 5638 would. Her proposal would, however, restore a modified version of the qualified family-owned business interest deduction under repealed Code Sec. 2057 and would also increase the Code Sec. 2032A special use valuation maximum reduction amount to \$5 million (currently inflation-adjusted at \$900,000).

### What to Look For

The stated position of a number of potentially agreeable Democrats, including Senators Landrieu and Ken Salazar (D. Colorado), would require a proposal that is scored to produce a revenue loss of approximately 50 percent as compared to that resulting from full repeal. The difficulties in achieving such a compromise are considerable. Although lowering the exclusion amount below \$5 million and raising the tax rate(s) would be one obvious avenue, such a route would be threatened by the loss of votes from many full repeal proponents. So far, the only proposal that comes close to the 50-percent goal is one suggested by Sen. Tom Carper (D. Delaware) that would simply extend the 2009 exclusion amount of \$3.5 million and the 45-percent top rate. Another possibility, that to date we have not seen proposed or scored, would be a hybrid proposal involving a postponement of any major change to the transfer tax rates and exclusion amounts, somewhat like what was done with the phased-in changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). Such a proposal would effectively freeze the 2009 exclusion amount and top tax rate as Sen. Carper's bill would, but only for two or three years, before again raising the exclusion amount and further lowering the applicable rate(s).

The next Senate adjournment is currently scheduled to begin August 7. However, there are many issues competing for time on the agenda including additional tax proposals, such as the long-anticipated pension reform package and a number of significant tax extenders. As we go to press, the Senate has not yet scheduled a vote on any of the estate tax reform proposals put forth to date. ♦

## ESTATE TAX

### Guidance On Determining Active Trade Or Business

Using five different scenarios, the IRS has provided safe harbors and a non-exclusive list of factors to be used in determining the level of a decedent's activity with respect to certain real property interests necessary to constitute a

*The IRS has issued guidance providing safe harbors as well as a list of factors relevant to the determination of whether a decedent's activities with respect to certain real property interests were sufficient to constitute an interest in a closely held business for purposes of Code Sec. 6166.*

closely held business interest for purposes of obtaining an extension of time to pay estate taxes under Code Sec. 6166 (Rev. Rul. 2006-34,

2006-26 I.R.B. 1171). Among other requirements, in order to qualify for the extension, a decedent must be must engaged in, or hold an interest in an entity (partnership, limited liability company, or corporation) that carries on, an active trade or business. In each scenario presented by the IRS, the other eligibility requirements to obtain the extension with respect to the value of the interest exceeding 35-percent of the adjusted gross estate and the number of partners, members, or shareholders, or the percentage of capital interest in the entity were met.

## Estate Planning Review

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In determining whether a decedent's activities are sufficient to be considered an active trade or business, the IRS stated that it will examine all facts and circumstances, including the activities of the agents and employees of the decedent or the entity, activities of management companies or other third parties, and the decedent's ownership interest in such management companies or third parties. Even if some activities are performed by third parties (e.g., independent contractors) who are not agents or employees, a business may still be found to be an active trade or business provided that the activities of the third party do not reduce the activities of the decedent or entity to that of merely holding investment property. For example, in the first scenario, the decedent, owner of a strip mall consisting of 10 stores, handled the day-to-day operation, management, and maintenance of the mall. However, the decedent hired an independent contractor to perform repairs that the decedent was unable to perform. Since the decedent reviewed and approved of all work performed by the contractor, the decedent's activities were considered to be sufficient to constitute an active trade or business. The occasional use of third party contractors, who are not agents or employees, to perform repairs will not prevent a decedent's activities from rising to the level of conduct necessary to meet that requirement.

Conversely, when the daily operation and activities of managing the property are performed by an independent property management company in which the decedent has no interest, the finding of an active trade or business, as illustrated by scenario 2, is not likely. In that situation, the decedent owned a small office park consisting of five, two-story buildings with multiple tenants that were managed by an independent property management company. The management company's duties included advertising, showing of properties, negotiating and administering leases, collecting rent, and hiring independent contractors to maintain the buildings and grounds. The management company also provided the decedent with a monthly accounting along with a check for rental income less expenses and fees. The decedent's lack of significant participation resulted in the decedent not being considered a proprietor in an active trade or business as well as the decedent's interest in the office park not qualifying as a closely held business interest. However, if the decedent owned a significant interest in the management company, for example, 20 percent of the stock, as was the case in scenario 3, the activities of the company were sufficient to allow the decedent's interest to qualify as a closely held business interest.

In the ruling, the IRS set forth a non-exclusive list of factors that will be considered when determining whether the decedent's real property interest is an interest in an active trade or business. It is important to note that no one factor is dispositive of the determination, rather a combination of the factors will be applied. The factors include:

- 1) the amount of time the decedent or the agents and employees of the decedent, partnership, LLC, or corporation devoted to the trade or business;
- 2) whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated and whether the office maintained regular business hours for that purpose;
- 3) the extent to which the decedent or agents and employees of the decedent, partnership, LLC, or corporation was actively involved in finding new tenants and negotiating and executing leases;
- 4) the extent to which the decedent or agents and employees of the decedent, partnership, LLC, or corporation provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
- 5) the extent to which the decedent or agents and employees of the decedent, partnership, LLC, or corporation personally made, arranged for, performed, or supervised repairs and maintenance to the property; and
- 6) the extent to which the decedent or agents and employees of the decedent, partnership, LLC, or corporation handled tenant repair requests and complaints.

The remaining two scenarios illustrate how the factors are applied to determine whether the decedent holds an interest in an entity engaged in an active trade or business. For example, in scenario 4, a limited partnership's activities are examined. The assets of the limited partnership, in which the decedent held a one-percent general partnership interest and a 20-percent limited partnership interest, consisted of three strip malls. According to the partnership agreement, the decedent, as general partner was charged with the day-to-day operation and management of the malls for which the decedent received an annual salary. The decedent, along with employees or agents, maintained and repaired the properties, negotiated leases, collected rent and made decisions regarding renovations to the properties. The IRS concluded that the limited partnership, through the activities performed by its general partner, carried on an active trade or business, thus the decedent's interest in the limited partnership was an interest in a closely held business.

In the last scenario, not only was the decedent's solely owned corporation, an automobile dealership business, found to be an active trade or business, but the decedent's separately owned interest in the underlying real property was as well. The corporation was considered an active trade or business because of the activities of the decedent who managed the day-to-day operation of the business, including the advertising, inventory, and personnel. The

*continued on p. 54*

## PLANNING TECHNIQUES

# Dynasty Trusts: Opportunities For Multi-Generational Planning

**CCH:** What is a dynasty trust and what amount of or type of assets are best suited for funding a dynasty trust?

*The dynasty trust provides an opportunity to shelter wealth from transfer taxes while also protecting that wealth in trust for future generations. Traditionally, the common law Rule Against Perpetuities imposed limits on the duration of a "perpetual" dynasty trust. More recently, a growing number of states have been taking legislative measures to limit or abolish durational restrictions on trusts. In the following interview, attorney Steven J. Oshins discusses the asset protection, tax and other features of dynasty trusts. Mr. Oshins is a Member of the Law Offices of Oshins & Associates, LLC, Las Vegas, Nevada ([www.oshins.com](http://www.oshins.com)), a nationally recognized firm specializing in estate planning and asset protection, and recently worked with the Nevada legislature in 2005 to amend Nevada law to allow 365-year dynasty trusts.*

In addition to the estate tax savings that can be obtained, if the trust is drafted correctly the trust assets are protected from the creditors and divorcing spouses of the trust beneficiaries.

The most suitable assets for a dynasty trust are those assets that are expected to grow in value because the growth will occur inside of a vehicle that is protected from estate taxes, creditors and divorcing spouses. Assets which are expected to be consumed or spent are better suited for a trust that is not exempt from generation-skipping transfer (GST) taxes since those assets would otherwise waste the valuable GST tax exemption.

**CCH:** How is it possible for a dynasty trust to avoid estate, gift, and GST taxes?

**Mr. Oshins:** As long as the GST tax exemption (currently \$2 million) is allocated to the dynasty trust, the trust can continue for as long as applicable state law allows. In order to avoid gift taxes for lifetime transfers to a dynasty trust, the settlor can allocate his or her gift

**Mr. Oshins:** A dynasty trust is an irrevocable trust that continues for as long as applicable state law allows without being subjected to estate taxes. In seventeen states and Washington, D.C., a dynasty trust can continue perpetually. In five additional states, a dynasty trust can continue for a term of years that is longer than the traditional amount of years allowed by the majority of states.

tax exemption (currently \$1 million) to the trust and also make annual exclusion gifts (currently \$12,000 per beneficiary) to the trust. For bequests at death, the settlor's estate tax exemption (currently \$2 million) can be allocated to the trust.

**CCH:** How can you leverage those exemptions to move more wealth into a dynasty trust?

**Mr. Oshins:** There are a number of techniques available to leverage one's GST tax exemption. In fact, about ten of my law firm's clients have been able to move in excess of \$100 million into dynasty trusts without paying any transfer tax by using these leveraging techniques. Those were not typical clients though. Each had the ability to turn a small amount of wealth into a lot of wealth in a relatively short period of time.

In my opinion, the best technique to create a lot of wealth inside a dynasty trust is a technique called "opportunity shifting." The concept is to start new business and investment opportunities in a dynasty trust from the inception using seed money that is already in the trust. In fact, this technique can be used by a client for the client's own benefit by having the client's parent establish the dynasty trust for the benefit of the client and the client's descendants. For the purpose of initiating a new business venture, the parent makes a small gift to the trust that the client, acting as trustee, uses in order to form a new business entity as an asset wholly owned by the dynasty trust. Using just a little seed money, the client is often able to move millions of dollars of wealth out of his estate that he otherwise would have retained inside his estate where it would have been exposed to estate taxes, creditors and divorcing spouses. Advisors often focus solely on a client's existing wealth, whereas future wealth to be received through new business opportunities often makes up the majority of a client's estate.

**CCH:** Are there any other techniques you use?

**Mr. Oshins:** Yes, there are a few other techniques and some variations. One method used to move wealth into a dynasty trust is the "installment sale to a defective trust" technique. With this technique, the dynasty trust is drafted as an intentionally defective trust for income tax purposes making either the settlor or the primary beneficiary the owner of the trust for income tax purposes. Since that person and the trust are one in the same for income tax purposes, any transactions between the individual and the trust are disregarded for income tax purposes. Assets subject to a valuation discount are sold to the trust in exchange for a promissory note. This technique generally removes millions of dollars from the person's estate because of a combination of the



valuation discount and the relatively low interest rate allowed by the IRS on the promissory note.

**CCH:** For clients who are not concerned with estate and GST tax avoidance, is the dynasty trust still an important planning tool? Why or why not?

**Mr. Oshins:** Absolutely. As much as estate and GST tax reform and repeal has been discussed for so many years, not even once have I heard anything about repealing lawsuits and divorces. In fact, most of my clients are more concerned with creditors and divorcing spouses than they are with estate taxes. If estate taxes were repealed, I doubt that even one of my clients would want to terminate a dynasty trust.

**CCH:** What are the asset protection features of dynasty trusts? For example, can they provide creditor protection or protection in divorce situations?

**Mr. Oshins:** There are two basic ways of drafting the dynasty trust: as a support trust or as a discretionary trust. I almost always draft my dynasty trusts as discretionary trusts, yet nearly every dynasty trust I have seen drafted by other law firms is drafted as a support trust. Drafting the trust as a support trust is a huge error in my opinion.

A “support trust” directs the trustee to apply the trust’s income and/or principal for the health, education, maintenance and support, or other standard, of the beneficiaries. The beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for the beneficiary’s health, education, maintenance and support, or whatever other standard is contained in the trust. If the beneficiary has a property right in the trust because of a support standard, then the trust must be reviewed to see if it has a spendthrift clause. A spendthrift clause generally protects a beneficiary’s interest from creditors. However, certain exception creditors can penetrate a support trust. For example, divorcing spouses are one type of possible exception creditor. You have to

look at applicable state law to see which exception creditors will be recognized.

A “discretionary trust” allows the trustee complete and uncontrolled discretion to make distributions of trust funds if and when the trustee deems appropriate. The beneficiaries have no property interest in the trust since they have no right to a distribution. If the beneficiaries have no property interest, then the creditors of the beneficiaries have no right of recovery against the trust. A discretionary trust does not need to rely on a spendthrift clause to protect its assets. Since a discretionary trust is protected from all creditors, in my opinion this should be the chosen structure for most dynasty trusts. Using this structure, the primary beneficiary will generally be the investment trustee and the primary beneficiary’s close friend will often be the distribution trustee. Alternatively, a bank or trust company might be the distribution trustee.

**CCH:** Is there any tension between asset protection objectives and transfer tax avoidance goals?

**Mr. Oshins:** Yes, the “health, education, maintenance and support” language in a support trust comes directly from Code Sec. 2041, which is designed to avoid a general power of appointment which would cause the trust assets to be included in the powerholder’s estate. This is ideal drafting if estate tax avoidance is the only objective. However, if estate tax avoidance, creditor protection and divorce protection are all important to the client, then a support trust is inadequate.

**CCH:** Are some jurisdictions more favorable than others for setting up dynasty trusts and, if so, where are they and what makes them so favorable?

**Mr. Oshins:** There are two primary objectives in selecting the appropriate jurisdiction. One objective is to select a jurisdiction that has no state income tax on its trusts. Another objective is that the jurisdiction allow for a long perpetuities period. The jurisdictions that seem to compete for most of the dynasty trust business are Alaska, Delaware, Nevada, and South Dakota. Florida and Wyoming are a couple of other good jurisdictions, but there does not appear to be the same degree of marketing push for those jurisdictions. I am prone to using Nevada in most cases now that I was able to get the law passed last year to allow 365-year dynasty trusts, since very often the client comes in because of hearing about the change to our law.

**CCH:** Are there any residency requirements for those who would like to establish a dynasty trust in a different, more favorable jurisdiction?

*...most of my clients are more concerned with creditors and divorcing spouses than they are with estate taxes. If estate taxes were repealed, I doubt that even one of my clients would want to terminate a dynasty trust.*

**Mr. Oshins:** Yes, the trust needs to have some degree of minimum contacts with the chosen jurisdiction. This is done by having a trustee or co-trustee named that is often a bank or trust company located in that jurisdiction. To do this, I will often add a third trustee to my trusts called an Administrative Trustee, which is typically a bank or trust company that is given minimal powers, yet sufficient powers to establish jurisdiction.

**CCH:** How can flexibility be incorporated into a dynasty trust for the benefit of future generations or to address unanticipated circumstances?

**Mr. Oshins:** Many people have the incorrect belief that a dynasty trust is an inflexible document that locks the donor's family into an irrevocable set

of provisions that keep the assets away from the beneficiaries and does not allow any flexibility. However, since the primary beneficiary can be given the control over the trust as trustee and can have a nongeneral power of appointment at death in order to make any desired modifications for spouses, children and other beneficiaries, inflexibility should not be a concern. Furthermore, somebody other than a beneficiary, such as the primary beneficiary's close friend, can be given the power to amend the trust to take advantage of any unanticipated changes in the laws calling for language that the family may want added to the trust provisions.

**CCH:** Please comment on the likelihood of future legislation limiting the attractiveness of dynasty trusts, such as the proposal put forth in 2005 by the Joint Committee on Taxation in its Report, "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-2-05, page 392), which would have limited allocation of the GST tax exemption with respect to perpetual dynasty trusts.

**Mr. Oshins:** There are still very few attorneys drafting dynasty trusts for their clients, so I doubt that dynasty trusts are the legislators' biggest concern. However,

*Many people have the incorrect belief that a dynasty trust is an inflexible document that locks the donor's family into an irrevocable set of provisions that keep the assets away from the beneficiaries and does not allow any flexibility.*

because the Joint Committee added dynasty trusts to its 2005 Report, we have to take this possibility seriously. Anyone with sufficient wealth to begin making transfers to or for their family should establish a dynasty trust and fund it with some or most of their gift tax exemption now in case we wake up one day and find that Congress has taken away some of our opportunities. ♦

## Determination of Active Trade or Business

*Continued from page 51*

decendent also leased the property to the dealership for its exclusive use and improved the property with unique features for the dealership business. Because the dealership employees maintained and repaired the property, the activities of the business with respect to the real property constituted active management.

This ruling revokes Rev. Rul. 75-365, 1975-2 CB 471, and Rev. Rul. 75-367, 1975-2 CB 472, in part. ♦

## Estimated Tax Was Deposit, Not Payment

The decedent, Helen Walbridge, in *H. Blom*, DC Pa., 2006-1 USTC ¶160,527, died on March 1, 1996, and her niece, Helene

*A U.S. district court has concluded that the remittance of estimated estate taxes by the executrix was a deposit rather than a payment, resulting in the estate's refund claim not being time-barred by the statute of limitations.*

Blom was named the executrix of her estate. At that time, the executrix believed that the estate consisted of approximately \$600,000 of

the decedent's assets and an additional \$400,000 of her predeceased husband's assets that he left in trust. The trustees of that trust refused to transfer the trust's assets to the decedent's estate and litigation ensued over disbursement of the trust. However, prior to commencing the litigation, the executrix filed for an extension of time to file the federal estate tax return and remitted two checks, one from the trust and the other from the estate, as payment of estimated taxes. The IRS granted the extension until June 1, 1997. The executrix failed to file the return on the extended date because the estate was still involved in litigation. In response to several delinquency notices, the executrix wrote to the IRS indicating that she intended to wait until the conclusion of the litigation before filing the return. On September 9, 2002, an estate tax return was filed showing that no tax was due. Treating the filing of the return as a request for a refund, the IRS declined to return the \$140,000 paid because the request was made after the three-year statute of limitations had run.

The executrix argued that since she intended for the payment to be a deposit similar to that of a cash bond and not a payment of taxes due, the statute of limitations did not apply. The parties agreed, however, that if the remittance was a payment, the executrix was not entitled to a refund because the refund request was not timely. The court noted that in order for a payment to be treated as a deposit, after a notice of deficiency is mailed, the taxpayer must designate it as such in writing (Rev. Proc. 84-58, 1984-2 CB 50). But where the remittance is made prior to a notice of deficiency being issued, the court must determine its legal characterization under the facts and circumstances test adopted by the U.S. Court of Appeals for the Third Circuit in *A. Fortugno*, CA-3, 65-2 USTC ¶9748, 353 F2d 429. The test looks to the timing of the remittance, the intent of the taxpayer in making the remittance, and the treatment of the remittance by the IRS.

Although the IRS, in this case, did treat the remittance as a payment, the timing of the remittance prior to the issuance of the notices of deficiency by the IRS and the intent of the executrix indicate that the remittance was a deposit. In determining the executrix's intent, the court found that (1) the executrix did not consult with an attorney or accountant to estimate the taxes owed, (2) she had not considered the potential tax liability prior to making the remittance, and (3) she made the remittance to avoid the assessment of penalties against the estate. Further, the court held that because the remittance was "undesignated" and made prior to written notification of the liability, the IRS should have treated the remittance as a deposit pursuant to Rev. Proc. 84-58. ♦

## LIFE INSURANCE

### Insurable Interest Issue Revisited

Eyebrows were raised last year in the estate planning community, when a U.S. district court determined

*A federal appeals court has ruled on an earlier decision which found that an irrevocable insurance trust lacked an insurable interest in the life of the insured-grantor. The appeals court agreed with the lower court that the insurance company could rescind the policy, but vacated the lower court's ruling that the company could do so due to a lack of insurable interest. In addition, Maryland and other states have taken legislative action on the issue.*

that an irrevocable insurance trust did not have an insurable interest in the life of the insured, the grantor of the trust (see ESTATE PLANNING REVIEW, March 22, 2005, page 17, discussing *Chawla v. Transamerica Occidental Life Insurance Company*,

Docket No. 03-1215, February 3, 2005). Applying Maryland law, the U.S. District Court for the Eastern District of Virginia allowed the insurance company to rescind

the policy because (1) material misrepresentations were made on the life insurance application regarding the insured-grantor's medical history and (2) "even absent a material misrepresentation," the trust did not have an insurable interest in the life of the insured-grantor.

The trustee appealed. Recently, the U.S. Court of Appeals for the Fourth Circuit has issued its decision, addressing the "material misrepresentation" and the "insurable interest" portions of the lower court's decision separately (*Chawla v. Transamerica Occidental Life Insurance Company*, 440 F.3d 639 (March 7, 2006)). The Court of Appeals affirmed the district court's decision in favor of the insurance company based on the material misrepresentations. Significantly, however, it vacated as unnecessary the district court's alternative holding regarding the trust's lack of an insurable interest.

### Material Misrepresentations

The majority of the appellate court's decision examined the misrepresentation aspects of the case. According to the Fourth Circuit, the trustee was essentially arguing that the insurance company could not rescind the policy because it had waived its right to assert any material misrepresentations, or, that the trustee's reliance on the policy remaining in force precluded the insurance company from rescinding it. Deciding in favor of the insurance company, the court held that, because the insurance company was not aware that material facts were concealed regarding the grantor's health, it could not have waived its ability to assert that they were misrepresented. Moreover, the insurance company was not precluded, or estopped, from rescinding the policy because the trustee did not prove, as she should have under Maryland law, that the insured-grantor could have obtained life insurance from another company with full knowledge of his health problems. Thus, concluded the court, the misrepresentations in the insurance applications entitled the insurance company to rescind the policy.

### Insurable Interest

With respect to the insurable interest issue, the appellate court observed that the district court's reasoning could be interpreted by some to mean that a trust can never have an insurable interest in a person's life under Maryland law. The court also recognized the significant impact this decision could have on both Maryland law and on life insurance companies transacting business in Maryland.

Citing the general legal concept that courts should decide only what is necessary to resolve a case, and noting that the decision on the misrepresentation issue already resolved the case in favor of the insurance company, the appellate court indicated that it was not necessary for the district court to have made an additional, alternative deci-

sion with respect to the insurance company's argument that the grantor lacked an insurable interest. The appellate court opined that, in light of the victory awarded to the insurance company on the misrepresentation issue, the district court's additional alternative ruling on insurable interest "appears to have unnecessarily addressed an important and novel question of Maryland law" (440 F.3d, at 648). Accordingly, the court vacated as unnecessary the district court's alternative ruling that the trust lacked any insurable interest in the insured-grantor's life.

### Future Implications

In vacating the district court's holding on the insurable interest issue, the Court of Appeals reduced much of the uncertainty that had previously existed in the Fourth Circuit. However, for practical purposes, the issue has been raised in the estate planning community. Going forward, what is not entirely predictable is how other courts will rule if faced with the same issue.

### Legislative Activity

Another significant development in Maryland's insurable interest law involves the recent amendments to Section 12-201 of the Insurance Article of the Maryland Code, effective June 1, 2006, which add a new subsection (b)(6), addressing trusts and insurable interests (2006 Md S.B. 300). The new law specifies that the trustee of a trust

has an insurable interest in the life of an individual insured under a life insurance policy owned by the trust if, on the date the policy is issued, certain requirements are met regarding the insured and the policy proceeds. The insured must be either the grantor, the grantor's close relative (by blood or law), or an individual in whom the grantor has an insurable interest. Also, the policy proceeds must primarily benefit trust beneficiaries having an insurable interest in the insured's life.

Also added is a new subsection (b)(7), relating to insurable interests and partnerships, limited partnerships and limited liability companies. This new subsection specifies that a partnership, limited partnership, or limited liability company has an insurable interest in the life of an individual insured under a policy owned by the entity if, on the date the policy is issued, substantially all of the entity owners are: the insured; close relatives (by blood or law) of the insured; or persons having an insurable interest in the life of the insured.

Maryland's new law applies to all trusts existing before, on, or after June 1, 2006, regardless of the effective date of the governing instrument under which the trust was created, but only as to life insurance policies that are in force and for which the insured is alive on or after June 1, 2006. Legislatures in other states, such as Georgia and South Dakota, have considered similar legislation (see 2005 Ga. H.B. 1484 and 2006 S.D. S.B. 69). ♦



## BRIEF IDEAS

### Penalties Imposed for Late Filing, Payment

A federal district court, in *D. Welch, Exr. (O. Kincaid Est.)*, DC N.J., 2006-1 USTC ¶60,526, concluded that the IRS properly imposed penalties upon an estate for failure to timely file the estate tax return and pay the estate tax liability by the extended deadlines. The executor requested and was granted a six-month extension to file the estate tax return and to pay the estate tax liability to February 11, 2002, but did not pay the estate tax liability until March 15, 2002 and file the return until December 4, 2002. The executor argued that the estate qualified for the reasonable cause exception to the imposition of penalties because he relied upon advice provided by an estate and gift tax attorney for the IRS. With respect to the late filing penalty, the executor claimed that the attorney informed him the deadline to file was further extended to June 11, 2002. Even if this were the case, and no evidence was submitted to support this claim, the court found that the deadline was still missed since the return was filed over five months after the date

alleged by the executor. The five-month delay in filing put the estate in the highest percentage level, 25 percent, for calculating the penalty, which is the same level used by the IRS to calculate the penalty.

The executor's argument regarding the qualification of the estate for the reasonable cause exception with regard to the late payment penalty was confusing and misplaced. The contention that the IRS attorney advised the executor that Code Sec. 6161 permitted a six-month extension and payment made within the extension period would forestall the late filing penalty was rejected by the court because it was not relevant to the late payment issue. The only explanation offered by the estate was an unsubstantiated claim that the estate had insufficient assets to pay the taxes because of lengthy negotiations with the local government over sale of the estate's major asset. The was not enough for the court to find the executor had reasonable cause for late payment.