Report #8A

This message varies in format from the others sent in the past The materials from John Warnick are a collection of notes from Tues, Wed. and Thurs that John forwarded to me in one file. This report is sent in two parts due to its large size.

Although some of the material has been covered in other reports, the views of several people seems better than those of just one so all material received is included, even though it is repetitive.

There are a couple of other reports still to be sent, but due to problems in Miami, no one was left to handle these.

- Gene Zuspann

As we have done in January for the last six years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting to this list throughout the coming week highlights of the proceedings of the 37th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 6-10, 2003 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida.
A complete listing of the proceedings and speakers is available on the Institute's Web site.
The URL for that site is http://www.law.miami.edu/heckerling.
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REPORT NO. 8A

The following are the John Warnick's notes covering presentations over three days. John has some page references to the materials. I have left these, both for those that were in Miami and have the materials, and those that were not, but get the proceedings from Matthew Bender.

JONATHAN BLATTMACHR – Some Fundamental and Fine Points in Uses of Life Insurance in Estate and Financial Planning.

Cascading Crummey Powers – hanging powers aren't always the best thing. Why not let the power lapse immediately so that that the child will be considered to be the transferor for the amount which will be treated as a release and hence as a gift by the donee. This should permit approximately 80% of the gift that the parent makes to the ILIT for the child to be treated as a transfer from the child to the grandchildren. Because the trust will be treated as separate trusts for GST purposes this will permit the trustee to make distributions to the child from the portion that the parent is tgreated as transferor for GST purposes. Also, that portion of the trust can be used to make distributions to the grandchildren for health and education because there is an exception for such distributions under the GST tax. But any other distributions to the grandchildren will be made from the roughly 80% which is treated as a separate share and which the child is treated as the transferor for GST purposes.

Note: You can pay for Term Insurance with Pre-Tax Income Which is Never Taxed. Since the profit earned on the cash value component of a life insurance policy is not subject to income tax until the profit is withdrawn. By using those earnings to pay for the term cost of the insurance, it should be possible to pay for life insurance with income which will never be subject to tax. That is as good, if not better, than making those premiums tax deductible.

Split Dollar arrangement – increases the leverage of cascading crummy powers.

PLR 9413045– says that Allen (10th Cir. 1961) doesn't apply to the sale of a life insurance policy to a trust. It may offer a vehicle for defeating the three year pullback rule where the insured is the owner of a policy and we want to transfer it to an ILIT.

LAWRENCE P. KATZENSTEIN – Turning the Tables: When Do the IRS Acturial Tables Not Apply.

If you have a bunch of people in a car who are trying to figure out where to go, the one looking out the rearview window is the actuary. He is trying to get to where we need to be by looking at where we have already been.

We have a lot more freedom to argue when the tables should apply or should not apply then what we thought we would have when the tables were first introduced in a statutory context through Sec. 7520.

The interest rates are rounded to every two-tenths of one percent to save printing costs.

He would propose using an average of the last five or ten years rather than what current rates are. But what the current rules permit us to do is to take advantage of anomalies in interest rates by using the techniques which are most favorable given the current interest rate climate.

Why do we use the tables at all? Estate of Benjamin Shapiro TC-Memo 1993-483, 66 T.C.M. 1067: acturial tables…are an administrative convenience in that they provide a "bright line" approach to valuation making it unnecessary to hypothesize as to the facts and circumstances surrounding each case."

Cases where the Code directs the Tables Should Not Apply:

Retirement Plan:

Regulatory Exception: Does this mean that the Service can't depart from the tables unless it goes through the formal regulatory process. Maybe Congress meant that the Service can't depart from the tables unless they do so by regulation rather than by the use of rulings and procedures.

Effective Date: The regulations didn't become effective until 1995. What happens for the first six years, between 1989 and 1995, while we were waiting for the IRS to issue the regulations? The Service takes the position that 7520 didn't abrogate all the case law that had developed in the prior 50 years. But if you read the statute it appears that is exactly what Congress intended to do.

If you have a simultaneous death or unproductive property case during the 1989 to 1995 period,

you may have a very good case that you still should be able to use the table.

Rev. Rul. 96-3 –

Harrison case. The Tax Court has been much more favorable for the IRS than other courts.

Other Regulatory Exceptions – Reg. Section 1.7520-3(a)

1. Retirement plans.
2. Section 72 (annuity rules) however note that charitable annuities and gift annuities are taxed under Section 72 but the income tax charitable deduction is computed under 7520.

Marketability Discount: The regulations don't address the creditworthiness of the payor of the annuity or other obligation.

Trust Exhaustion – He thinks the IRS is just wrong on this. Shapiro is the pre-7520 law on that point. Example 5 of Reg. 25.7520-3(b)(2)(v), in Katzenstein's opinion, misunderstands the nature of exhaustion. What gift is there to a remainder beneficiary if the trust is going to be exhausted? There is nothing left for the remaindermen. This is also inconsistent with Rev. Rul. 77-374.

Unproductive and Underproductive Property. The IRS is very clear that we can't use the tables with unproductive property except in limited circumstances. The IRS won't permit the tables to be used with unproductive property unless the income beneficiary has the right under either state law or the trust instrument to make the trust productive. The IRS doesn't treat underproductive property any more favorably. Katzenstein believes the 1990 Tax Court opinion in the O'Reilly case (95 T.C. 646) should be good law and should survive enactment of 7520. In the regulations the IRS says that Congress didn't intend to supercede prior case law.

How do we deal with an income interest where there is a power of invasion. It is clear that we can't use the tables if the power of invasion is unrestricted. But the IRS in the regulations seem to suggest that we can deal with such interests using nonstandard tables if the power of invasion is governed by ascertainable standards.

Judicial Exceptions

The Lottery Cases

In California the lottery payments can't be assigned. Amazingly, the 9th Circuit held that we don't have to value the lottery payments for estate tax purposes under the actuarial tables. 2001-2 USTC ¶60,356. The Tax Court has disagreed in a Connecticut lottery case. 116 TC 142.

RALPH E. LERNER What To Do With Art and Other Valuable Stuff.

The Step Donation – Give away an undivided 25% interest to a museum. Then a few years later give away another 25%. That 25% will be worth more now because once the initial gift is made to the museum it will be listed on the list maintained by the auction houses and museums. That listing generally means the value of the painting will go up. The museum will usually insist on a gift promise that you will leave them the balance of the art upon your death so that they won't end

up as co-owner with squabbling siblings.

Charitable remainder Unitrust – The 170(a)(3) problem.

PLR 9452026 creates an opportunity if you sell the item within the first year. The deduction is allowed under 170(a)(3) at the time the art is sold. The amount of the deduction will probably be limited to the collector's cost since the contribution would not satisfy the related use rule.

Private Operating Foundation. This may be a viable alternative for certain collectors. Very humorous story about a wealthy collector's willingness to grant public access to his collection.

Copyright. In preparing a will for a collector an attorney should take care to make sure that if the collector does own any copyright interest it is transferred to the charitable organization along with the work of art to avoid the possibility of running afoul of the related use rule of section 2055(e)(4)(C).

Quedlinburg Treasures case.

Using Rev. Proc. 96-15 to obtain an advance valuation ruling on a gift. But remember that it can also be used for an estate to obtain an early valuation of art work. This can be a tremendous advantage for the estate.

Edward J. Beckwith – A Reexamination of Charitable Lead Trusts.

The gift tax value of a $4 Million 6% payout CLAT for 15 years would be slightly more than the applicable exclusion amount. If the trust can achieve a return equal or greater to the 6% Payout there will be at least $4 million at the end of the 15 years.

PLR 199927031 illustrates the IRS approval of a formula used to fund the CLT at death. The only variable to be determined at death was the amount of the interest rate.

Operating a CLT as the Family's Charitable Pocketbook.

Funding the Family Foundation with a Charitable Lead Trust – PLR 200138018.

Drafting After EGTRRA (and other recent developments): How Different Is It?

Panel discussion led by Pam Schneider with Paul Frimmer and Carol Harrington

They consider the outline very much a work in progress.

What changes have you made as a result of EGTRRA?

Frimmer: has made almost no changes. Typically gives an independent trustee broad powers. In almost all situations an independent trustee will not do anything without broad consensus from the beneficiaries.

Harrington: Surprised to see that there are so many different patterns and permutations. So there isn't necessarily an efficient way to deal with EGTRRA. It is troubling to her because it is so time-consuming and client-sensitive.

Schneider: She had always stressed the philosophy of not letting the tax tail wag the dog. But now the choices are unlimited. It is very difficult to have a very efficient client meeting as a result.

How much attention are you paying to the Carry-over Basis Rules:

Frimmer: has done nothing. Carryover basis seems to be an allocation post-mortem process. If there is going to be contention, he is uncertain what to do to make it easier. He has included some language at page 6-15. He is using a Bad Faith standard and putting the burden on the beneficiary to show that the fiduciary has used bad faith. Frimmer gives an independent trustee power to make distributions even over the QTIP so as to facilitate post-mortem estate planning.

Harrington: Has tried to introduce flexibility into her documents. But hasn't felt that it makes a lot of sense to spend a lot of time on the carry-over basis because she doesn't have a great deal of confidence that we really know what is going to happen. She gives some specific examples of clauses to ensure flexibility at Pages 6-13 to 6-14. In addition to size of the trust, they have now included changes in tax law or family circumstances as factors that justify termination of the trust. In B at 6-13 she included a power in the independent trustee to amend the trust to carry out the grantor's purposes. There is a savings clause that protects against adversely affecting either the marital or charitable deductions. In C at page 6-14 she gives the independent trustee discretion to make distributions. Paul noted that sometimes he has given this independent trustee the power to amend the trust during an elderly client's incapacity.

Schneider: There are some forms at page 25 of the Recent Developments materials. But she hasn't done a great deal other than to make sure that the fiduciaries are indemnified against any claims as a result of their exercise of the allocation choices they make.

Frimmer: Ira Lustgarten used the ultimate ambulatory estate planning document: a will that left everything to the surviving spouse with disclaimer trusts that accomplished a variety of different objectives. Then it permitted the surviving spouse to pick and choose at the first spouse's death.

Formula Clauses:

Schneider: Pg. 6-1 A contains the Cap/Floor approach. In 3 at page 6-2 Pam offers two different alternatives to deal with the definition of the IRC which will define the size of the marital share in the event of repeal. A relies on an independent trustee to interpret what should be done. B refers to a specific point in time.

Harrington: At page 6-3 in ¶4 1.03 Carol attempts to define whether the estate tax or GST tax has been repealed. Then 1.01 and 1.02 deal with the possibilities of what to do if the taxes are repealed at my death or at my spouse's death. In ¶ 5 at the bottom of page 6-3 second line should read "husband/wife's later death"

Frimmer Another approach would be to give everything to a credit shelter trust that could qualify as a QTIP and then give the independent trustee the power to terminate the trust in favor of the surviving spouse.

What Do You Say In Your Marital Deduction Formula About The Repeal Of The State Death Tax Credit?
Schneider There are two variables. 1) what tax are we trying to eliminate? Is it just the Federal

estate tax or is it both the federal and state death taxes?

2) Do we take state death taxes into consideration or only if they would be increased?

Take a look at your current language. Is it a bit ambiguous?

This problem is going to go away in 2005 because there won't be a state death tax credit at that time.

If you are dealing with a state that has a true pick-up tax and has decoupled, then use ¶ B1 on pages 6-4.

On the other hand look at the two options in ¶B2 a or b on pages 6-4 and 6-5. This would apply to states which have frozen its pick-up tax at the rates in existence and/or the unified credit available at some time before 2002. ¶a bets on repeal or that there will be too small of an estate at the survivor's death to incur any tax. The opposite example is ¶b which seeks to eliminate federal tax even if it means an increase in state tax.

You need to be aware that this is changing day by day as the various states try to sort out what they can or want to do.

Pennsylvania has decoupled but there are many people who feel that this is unconstitutional because the PA constitution requires that there be no discrimination in tax burden between individuals. Since the death tax may not be a flat tax perhaps it won't pass constitutional muster in PA.

Frimmer – note that a Section 529 plan can be a problem for a marital deduction bequest because it may not qualify for the marital deduction. We used to use language to protect the marital deduction. But many people have deleted that language. Look at the language at ¶ C2 on page 6-5.

The Destructible Marital Trust may make a lot of sense in many smaller estates.

There are distinct disadvantages of not using a QTIP other than the Ramon/Ramona problem. One is the PTP credit under 2013 and the other is the Mellinger discount opportunity. The surviving spouse could disclaim the power to revoke within nine months and preserve the opportunity to take advantage of Mellinger/Bonner valuation opportunities for a fractionalized interest. The 15 months…when coupled with the nine month disclaimer period…takes you out to the full 24 months for the 100% PTP credit.

The clauses at ¶ E1 on pages 6-6 through 6-8 permit the survivor to create a reverse QTIP and a Credit Shelter Trust through disclaimer but still have the opportunity to completely revoke the trust and take all of the assets out of the trust if the survivor lives more than 15 months after the first spouse's death. NOTE: After the Lassater case it is clear that the spouse can make a disclaimer into a trust that the survivor has a power of appointment over **if** that trust will be included in the surviving spouse's taxable estate.

Schneider Pam likes to tie up her definition of available GST Exemption. See her form at ¶ B on page 6-9.

Harrington. Carol doesn't feel the need to protect against the interested fiduciary making the GST elections and allocations.

Frimmer ¶ C2 on page 6-10 deals with one approach to protect against repeal of the GST tax. Another approach is to give the surviving spouse the power to add a deceased child's spouse or another non-skip person as a beneficiary. Yet another alternative is to give the power to an independent trustee the power to add a non-skip beneficiary.

Schneider: Would you add language that makes it obvious that after the GST Tax is repealed the trust can be terminated? Remember that the GST regulations deal with the substitution of a nominal beneficiary merely to avoid the taxable termination of a trust.

Downstream Split of a Trust Now Permitted under the 2001 Act – How Do We Take Advantage of That?

Schneider – If you look at your trust language or at state law, generally you will find that division is permitted only on identical terms. But the new law's flexibility permits the division to be made into trusts that don't have identical terms. Her language and the variations on the theme is found at ¶ D on page 6-10.

Harrington Her language is found at at ¶D5 on pages 6-10 through 6-12. Note: they use the words "adversely affect" rather than just "affect" because they have run into a situation where they wanted to qualify and weren't able to do so because it would affect qualification.

Schneider: Look at at ¶E on page 6-12 . The revised (B) and (C) are suggested because we now have the opportunity to make a qualified severance. She believes the downstream severance rules won't sunset. She believes they will be kept in any future law that replaces EGTRRA.

She puts language on what her intention is to provide some protection against the problem that there is a slip between the lawyer and the CPA. Paragraph ¶F on page 6-12
And 6-13 deals with the situation where you want to see automatic allocation. Paragraph ¶G is just the opposite where you want to opt out of the automatic allocation of GST exemption.

Frimmer: Offers an alternative to the Procter clause in a sales transaction. See the suggestion at the bottom of page 6-17. Schneider offers the more traditional defined value approach in Clause B starting at page 6-16.

Schneider: Expanded definition of descendants to deal with post-death conception. The goal is to have a clause that 90%+ of your clients will like. She doesn't think that it is quite there yet.

Harrington: Final question: what is the generation assignment of a clone?

LOU MEZZULLO Did They Get It Right? The Final Minimum Distribution Rules

The simplest part is the chart at page 7-29 which allows you to determine the applicable distribution period.

This chart deals with three different contingencies. The second column give us the rules if the participant is alive upon the RBD. The third column deals with what happens if the participant dies before the RBD. The fourth column deals with what happens at the time the participant dies

when he/she has lived beyond the RBD. There is a change here for the non-spousal DB from what the 2001 proposed regulations had started with.

Neither the participant's estate nor Beneficiaries who take under a state's anti-lapse statute is considered a beneficiary.

You have three options after the participant dies.

Option #1 – cash out the beneficiary. Make a distribution to the beneficiary to satisfy the bequest.

Option #2 - Disclaimer

Option #3 – establish separate accounts. Final regulations have muddied up the water on what we have to do to establish separate accounts. Majorie Hoffman's comments would indicate you must set up the separate accounts by September 30th of the year following the year of date.

Spousal rollover. She may not want to do the rollover before she turns 59 ½ because if she needs a distribution she will be subject to a penalty on a premature distribution.

Having the spouse as the "sole DB" gives you some advantages but at the cost of losing some of the traditional protections associated with having a trust as the beneficiary.

PROFESSOR LAPIANA – State Law Developments – Searching for Revenue and Other Quests

There are three alternatives for dealing with the potential disconnect between federal and state death tax exemption or rates.

Disclaimer
Partial QTIP election
Clayton election – have the trustees hold the portion of the Marital Trust which doesn't qualify for the marital deduction as a separate trust on the same terms and conditions as the Family Trust or Credit Shelter Trust.

STEVE R. AKERS – Worth The Effort Even Beyond The Grave – An Update of Post-Mortem Tax Planning Strategies

Does The 2% Floor Apply to Investment Fees Incurred By a Trustee?

Mellon, O'Neill and Scott. There is a conflict between the circuits and taxpayers may want to consider taking advantage of that conflict. However, taxpayers should expect a challenge on the issues raised in O'Neill and Scott. The Scott case is currently on appeal and the result in Scott may be heavily influenced by local law.

Suggestion by Akers: Trustees might consider charging a higher trustee fee and then paying the investment advice and accounting services separately.

Another point: Estates are not subject to the 3% cutback or the 80% reduction in itemized deductions that individuals are subject to. Therefore, optimal planning would be to pay enough expenses each year to fully offset the estate's gross income. And, in the final year of an estate you

may want to consider optimizing the expenses. This will take careful planning to assure that the estate is terminated in that year and that all of its assets are distributed in time.

Note: the estimated payments made by a trust or estate may, by election, be treated as having been made on behalf of one or more beneficiaries. This election may be made even if the trust or estate has not made an overpayment of tax. This is a change from former law.

Section 645 – Final Regulations issued and effective on 12/24/2002. Changes in the final regulations: It includes a trust which is revocable only with the consent of an adverse party. It is ok to have a foreign trust. Maximum election period – later of two years after date of death or six months after the issuance of a closing letter plus another six months. This is an addition of six months to the period provided in the proposed regulations.

What type of a return does the QRT have to file at the end of the first short year. The proposed regulations had required you file a full return. There was a lot of criticism of the proposed regulations because of the cumbersome task of trying to sort out the income between the short period and the estate's return. The final regulations permit the trustee to merely file an information return for that short year. Even decedents dying before 12/24/02 can rely on the final regulations and avoid filing the full return.

The final regulations do permit the trust to avoid filing estimated income taxes for the first two years.

Alternate Valuation Date complications with a pecuniary marital deduction formula that uses date of distribution. In this case the pecuniary bequest forces the entire loss on the credit shelter trust.

Consider using a marital deduction formula that shifts at least part, if not all, of the depreciation in value against the marital share. But how can you use the alternate valuation date in this situation since it requires that the combined amount of estate tax and GST tax be decreased? Consider making a small disclaimer or a partial QTIP election to force payment of a small amount of tax.

Deduction of Personal Representative Fees as Administration Expenses Limited Because the Bulk of the Assets Passed Under a Revocable Trust. Grant v. Comm'r 294 F.3d (2d Cir. 2002), aff'g T.C. Memo 1999-396.

This case arose under Maryland law and reaches a very bad result. The Second Circuit decision suggests that a big difference in the deductibility of administration expenses turns on whether the assets are passed to the beneficiaries by probate or in a non-probate transfer. Maryland imposes a very low cap on trustee fees. Since most of the assets were in the revocable trust only $1,000 would be allowed for the personal representative fees.

SOLUTION: If your client resides in a state with law similar to Maryland, consider having a pour-up revocable trust. If there are no creditor concerns, this may result in the availability of a larger deduction without adversely impacting the estate.

Note: The Tax Court's analysis suggests that section 2053(b) may not be applicable to assets in a revocable trust. 2053(b) applies to expenses of administering property not subject to claims. Revocable trust assets typically are subject to creditors claims in most states. Therefore, the technically correct Code section for deducting expenses of administration would be section 2053 (b).

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