

# Report #3 (Monday, Cont'd)

A complete listing of the proceedings and speakers is available on [the Institute's Web site](#)

=====  
This Report contains additional coverage of the Monday Recent Developments session, first by Reporter Gene Zuspahn and then by Reporter Jeff Weiler

=====  
Monday, 1/10/05 - Introduction and Recent Developments Steve R. Akers Esq.  
Pam H. Schneider Esq.  
Jonathan G. Blattmachr Esq.  
Outline Materials by Dick Covey Esq. and Dan Hastings Esq.

Report by Gene Zuspahn Esq.

The authors of the materials are Dick Covey and Dan Hastings. Per SA, the materials are excellent. The speakers covered some of the materials but had much information to add that were not included in the book.

JB - where are we on the estate tax?

The question now is whether the estate tax will be repealed in 2010 or 2007. JB anticipates passage in 2006. The Administration believes that it currently has 59-60 Senators. They need 60 to override Byrd rule. At a minimum, and even if they cannot get full repeal, the 7y can at least extend the repeal to 2015. The IRS had problem recruiting new employees after 2001 changes in laws. The current feeling is that the extension would effectively kill the estate and gift tax because of the time delay and to rehabilitate the law in 2015 would not be possible.

However, the contrary position has several points: 1. The deficit is large and the estate tax in 2010 is projected to produce \$50 billion of revenue (assuming a 50% maximum rate with a \$2 million applicable exclusion). 2. Bush had said that his primary agenda is to fix Social Security. JB proposed leaving the estate tax at this rate to help fix Social Security. Another suggestion is that the estate tax should be earmarked to fund wars - IRAQ, Afghanistan, because estate tax has historically a tax used to pay for wars.

JB has been told that carryover basis as drafted cannot work.

He discussed the blue ribbon panel studying the estate tax.

One alternative or new tax will be a value added tax (VAT). JB feels that it is more likely that a VAT will be adopted, at least to some extent. He believes this has more chance in passing than a national sales tax. One reason is that it is already an accepted tax in much of the rest of the world.

Tom DeLay is promoting HB 25 - fire the IRS, eliminate the income tax and have a nation wide sales

tax. It would be paid on every transaction in which property changes hands and would even be imputed in some transactions. It would be paid on goods and services. The stated rate is 23% but it is a tax inclusive rate - the effective rate is 28%. It would also cover medical insurance, food and rent.

SA - Proposals will include changes in the private foundation rules that are dramatic.

PS - Discussed the IRS Priority Guidance Plan items under the heading Gifts, Estates and Trusts.  
Walton regs under 2702

Final regulations under §664 regarding dividends and capital gains for CRT's

Guidance under 2036 regarding transfers with retained life estates.

Guidance under 2704 regarding the liquidation of an interest

200441024 regarding complete termination of a CRT (commutation) JB. - Amer Jobs creation Act  
Loaded with provisions for businesses Collateral provisions

There is now a alternative deduction for a sales tax rather than income tax (However, JB pointed out that Bush now proposes that there should be no deduction for income taxes or sales taxes)

There was a change in the §754 election - This is now mandatory if there is a significant loss

A family member may elect under S-corp to treat all of the family as one shareholder.

Notice 2005-1. Stock appreciation rights. Almost all plans you have done have to be reviewed.

Changes to Circular 230

Penalties on listed transactions - cannot be waived by IRS

Tax opinion letter changes in Circular 230- may not rely on tax opinion letter

PS Circular 230

Circular 230 now applies to estate planners. Effective 6/20/05.

The publication now includes best practices and covered opinions. The revision is tighter than the proposed regulation. PS believes this includes almost everything we have in writing, including e-mail.

Procedures must be put in at firms that give tax advice

It provides disciplinary rules

It contains vague rules regarding other written advice.

Authorizes the creation of advisory boards within the Service.

Provisions to punish willful violations of the rules other than best practices rules.

Best practices: The categories pertain to client communications, factual and legal due diligence, providing accurate advice, and acting fairly before the IRS. The client should be told what the import of the opinion is. Attorneys need to take steps to put procedures in place to insure compliance.

Tax shelters involve stricter standard. There are different levels of opinions.

Covered opinion. PS believes that much of what we (estate planners) do is a covered opinion.

Principal purpose is the avoidance of federal tax.

The attorney must use reasonable efforts to obtain reasonable facts and may not base an opinion on unreasonable facts or representations. The opinion should not discuss audits or chance of success if settled.

SA believes that this change may be the most important thing that has happened last year. JB - the cost of complying with this makes it much more expensive. PS - there is a limited opinion - may have to use this often.

Note: At this point, the panel started into the materials. All of the above was discussed by the panelists but not included in the materials. The panel moved quickly and covered much more than the information included above.

JB - §643 regs

This is huge area of the law where the state law effects the income tax consequences.

The regs govern the switch from a straight income trust to a unitrust or from a power to adjust trust to a unitrust. The taxpayer may have a taxable exchange unless the conversion qualifies.

The conversion must be done pursuant to a state statute that authorizes the conversion. If the state does not have a statute, get a PLR or switch the situs and the governing law to a state with such authority.

At the moment, the payout is limited to 3-5%. See PLR.

2004-17-014 for a state statute allowing the trustee to select the % within the range.

Two broad rules re capital gains - one for when cap gains become part of trust accounting income and one for when cap gains become part of DNI. An example of an instance when you want cap gains in accounting income - QDOT. Must be done as allowed by state law and the governing instrument. To get to DNI, the regs are inconsistent. May also use the old regs.

Cap gains for a unitrust - there a different set of rules determine whether DNI. Trustee can be given discretion, instrument directs or state law. The trustee must be consistent.

JB suggests, that if the instrument contains a power to invade, that you do not want to do a conversion. You have much greater control as to when you put cap gains into DNI because the trustee can deem it. No consistency is required with regard to the election with different assets. Just because the trustee deems Microsoft stock sale as DNI, it does not have to be consistent as to IBM, GM or land. These are separate elections.

JB - Rev Rul 2004-64; Sec 671 & 2036.

“Good news rev ruling.”

Income imputed to the grantor from a grantor trust, where the grantor pays the tax – there is no gift. However, a mandatory reimbursement provision causes inclusion under 2036. If discretionary reimbursement then you have estate tax inclusion if there was a deal or if under state law creditors can attach the trust for the amount of the reimbursement.

JB mentioned a problem an attorney had with 675()(C) - a power to reacquire the trust corpus by substituting other property of an equivalent value. A PLR requested for 2 years was finally withdrawn. The Service would not agree that this power would not cause estate tax inclusion. Jb recommended creating your grantor trust using some other means.

SA - very quickly discussed valuation issues

He mentioned 2 cases - the Green case (25%) and the Thompson case (30%)- and the discounts.

He quickly discussed several other cases, and mentioned Helen Noble - TCM 2005-2 involving events shortly before death. Two early gifts were revalued by a sale after death for substantially more.

Therefore, do not sell an asset before the estate tax audit is finished.

SA - FLP cases - Kimbell, Thompson and Strangi - all deal with 2036. Pg 50 -

Strangi I - Judge Cohen substantially expanded the area by including under 2036(a)(2).

Kimbell went off on fair consideration. It analyzed the issue using a 2 part test - bona fide and fair consideration. Tax court included “arms length transaction - circuit court did not require this.

Strangi still on appeal to Fifth Circuit. Hearing March 7. ACTEC filed a brief and discusses the 2036 (a)(2) issue raised by Judge Cohen.

SA says that Carlyn uses a trust as the GP. The client should not be the Trustee but may have the right to remove and replace the Trustee.

JB - Letter ruling 200432015. How not to form an LLC to hold a life insurance policy

John David Smith v Comm., 04-20194 (5th Cir) - no discount on estate tax return for income tax on IRA.

PS - GST

Five regs/procedures were announced

- Proposed amendments to regs dealing with automatic allocation of gst exemption and election out. Narrowed a little bit but not affect most of us. Pam's advice - always make the election the first year and make them if any doubt at all and make them for current transfer and, maybe, for future transfers. 2 rev procs that simplify 9100 relief in very narrow circumstances

- Rev Proc 2004-46. A simplified alternate method to obtain an extension of time to make an allocation of GST exemption. It has to be filed before the due date of the estate tax return, but may be done after death.

- Reverse QTIP election under Rev. Proc. 2004-47. A valid QTIP election must have been made, the TP relied on a tax practitioner and the tax practitioner failed to advise about the reverse QTIP election.

- Prop regs have been issued under §2642(a)(3) governing qualified severance of trusts.

- the trust must be divided on a fractional basis, however the trusts need not be funded with a pro rata share of each asset held by the original trust, nor that the income tax basis be divided proportionately. However, the governing instrument or a state statute must authorize non-prorata funding.

- a state statute or the governing instrument must also authorize the severance.

- the regs create many more problems that they solve

- you must give notice to the IRS to be effective but PS discussed instances in which you may not want to give notice.

- severance must create a trust with an inclusion ratio of zero and one with an inclusion ratio of one.

Proposed regs have been issued on the predeceased parent exception to the GST tax.

JB - Grat regs.

Overall these are good regs.

Overruled the Schott case in the 9th circuit.

More important case was the revision of the regs held invalid in the Walton case. §25.2702-3(e), ex. 5.

- However, it does not say you can reduce the value to zero. JB uses a formula to reduce the gift to a small amount and file a gift tax return.

- The regs do not clarify the ability to use a 2 year GRAT (the term issue).

- Grat payments must continue for the term - reversion is not sufficient. Do not stop the payments after the death of the grantor.

- Annuity must be greater of the acctg income or the

- the instrument needs to make a specific bequest of the annuity immediately after death

- do not have the GRAT revert to the grantor's estate - a QTIP should be created under a separate

document - JB does this in the grat document.

SA §2703 - Blount case and the requirements for a valid buy-sell agreement

The decedent modified to the buy-sell agreement after learning of his impending death without the consent of the other shareholder. The court did not honor the change and also required life insurance paid to the corp to be included in the value

True Case - pg 134

Penalty seems extremely unfair. Old law had allowed a book value sale price in buy-sell agreements the valuation method followed. The court held the TP did not act in good faith.

There was no professional appraisal.

The price was not appropriate when the agreement was entered into.

There was no negotiation when the contract was entered into.

SA - Uniform Trust Code -

The materials contain a 93 page summary of the UTC. SA did not follow the materials, but summarized the areas of controversy. The materials are an update of the articles previously published in Practical Drafting.

He discussed the activity in the UTC during the last year and referred to changes in the law. SA mentioned several areas of concern - duty to inform (Sec 813), power to modify or terminate (410, 411), inability of a settlor to change the duties or the obligations of the trustees in several areas (105 (b) and 105(b)(9)), creditors rights (Article 5), and the remedies for breach of trust. He also mentioned the ability to forum shop (107). This was a quick summary without time for detailed discussion.

Diversification of investments. - pg 261 SA - The Dumont case and duty to diversify. The instrument contained language that the Eastman Kodak stock was not to be sold and was to be distributed to the ultimate beneficiaries unless there was "some compelling reason other than diversification of investment for doing so." The Court held this language was only a direction and would not protect the trustee from failure to diversify. Court held that duty to diversify was compelling given the fact of the case. All three panelists commented on this decision and the overriding duty to diversify, even if the language in the trust directs that the investment be held. SA had discussed this issue with an attorney drafting a trust and suggested the only way to avoid this was to add language that the investment could never be sold, and the attorney commented that he would never put such a provision in the document. JB suggested this may be a non-tax reason to create a LP to hold the stock and give the trustee LP units.

The session was very good with much added to the published materials by the panel. The pace was very rapid and getting down much of the presentation was virtually impossible.

=====

Report by Jeffrey L. Weiler Esq.

Jonathan: Estate tax repeal.

Rumors are circulating that it is a sure thing. Poll of Senators shows 59 probable votes for repeal with 60 votes needed to overcome the Bryd rule.

There is trouble recruiting employees for senior government positions because of possibility of repeal. However, repeal may not happen. Cost is high - with exemption of \$2,000,000 cost is projected at \$50 billion (per year I think). Transfer tax revenues are about 1 ½ % of total US government revenues.

Pres. Bush's Panel to recommend tax reform will not issue report until 2006. Pres. Bush is pushing making tax cuts permanent (including repeal of estate tax) as a 2005 project. Social Security reform will be expensive and could impair repeal prospects. Carryover basis as currently enacted for 2010 will not work and must be revised. Could be value added tax paid by providers of services and manufacturers. Also, a national sales tax with repeal of IRC has been proposed (HB 25).

Steve: Likely to be dramatic changes proposed by Senate Finance Committee concerning oversight of charities.

Pam: Reviewed some of items on Treas Dept/IRS 2004-2005 Guidance Plan. Some interesting areas to watch: guidance under 2036 - transfers with retained life estates (probably FLP's), 2704 - liquidation of an interest, 2702 - qualified interests.

Jonathan: 2004 Jobs Act. Reason for enactment was WTO ruling related to US companies with overseas sales. It allows personal itemized deduction for sales tax in lieu of state and local income taxes. Pres. Bush may propose eliminating deduction for both state and local income tax as well as the new sales tax deductions as revenue raisers. Also, new law requires 754 election if value of entity assets are below basis by \$250,000. S corporation rules for number of shareholders liberalized by treating family tree as one shareholder.

Jonathan: Notice 2005-1 will require revisions to deferred compensation arrangement to get deferral (almost all plans need work).

Pam: Circular 230 revisions. (Jonathan: one of most important 2004 developments).

New Regs issued Dec 17, 2004 to be effective June 20, 2005. They have much broader coverage than merely tax shelters and will impact the way we practice law in the estate planning area. Best practices requirements do not create exposure to penalties but could be used in malpractice claims. Requirements imposed for "covered opinions". This everything in writing that provides legal advice - letters, memos, emails. Law firms must have a person to enforce the rules and discipline non compliance. Note that IRC 6662 for tax shelters applies to income tax. However, the Cir 230 rules apply to any tax. Where advice is given, must investigate all aspects of the arrangement (which will take more time and higher charges to clients).

Much of what estate planner do is providing a "reliance opinion". Planning: avoid giving % probability of success, avoid "more likely than not" opinions. Also, can state prominently that the opinion is not for reliance (which clients are not going to appreciate - what are they paying for?). Certain requirements are set forth that must be included in opinions and restriction imposed on what can be relied on. Steve: this is the most dramatic development of 2004! Jonathan: will increase cost of legal services. Providing a limited scope opinion may help.

Pam: Qualified Severance Proposed Regs (GST). She finds some problems in proposed regs that she hopes will be fixed before they become final. One problem is with effective date (12-31-00). ACTEC comments on treatment of discretionary pecuniary discretionary divisions.

The speakers next commented on portions of the outline.

Jonathan: FSA and RR 2004-5 allow a trust to receive a charitable deduction for a flow through from a partnership. Trust has no provisions authorizing charitable deduction.

Jonathan: 653 (b) final regs definition of trust income.

Effective for tax years ending after Jan 2, 1994 (sic.) - which means 2004.

Capital gain issues: allocating capital gain income to fiduciary accounting income, and allocating capital gain to DNI. State law authority is needed and governing instrument authorization or discretion.

Jonathan: 671 and 2036 - tax reimbursement provisions in grantor trusts - RR 2004-64.

If mandatory reimbursement required and not made, there is an additional gift. Will be inclusion in gross estate of grantor if grantor's creditors can get at trust assets. Suggests prohibiting reimbursement in trust terms.

Problem (and indigestion) concerning creating income tax defective grantor trusts. Many (if not most) estate planner use non fid substitution of assets based on Jordahl case. IRS refused to rule that this does not cause inclusion in gross estate. Using this approach may create a fight with IRS. Suggests use substitution of beneficiary or give right to substitute to spouse.

Steve: Post death events and impact on valuation. Helen Noble TCM 2005-2 - Tax Court used post death sale (13 months after death) as valuation factor. Suggests - wait for conclusion of IRS audit before selling assets.

Steve: 2032 Prop Regs. for alternate valuation date. 9100 relief is available if 709 is filed within 1 year of its due date. PLR 2004-52-030 allowed 9100 relief.

Steve: Kimbell taxpayer showed 13 objective factors to support its position and CA 5 enumerated 3 tests: interest credited to partner's account was proportional to fmV of assets contributed, assets properly credited to proper capital account, at termination or liquidation distributions to partners from respective capital accounts. Having bona fide sale on formation will not prevent inclusion concerning later gifts of partnership interests. Partnership assets may not be in gross estate, but gift of partnership interest is at risk.

Steve: Thompson CA 3 requires a business purpose. Appears to require a business activity and majority of CA 3 disagrees with Stone and Kimbell.

Question for CA 3 - what about a business activity conducted with only a minority of partnership assets?

Inclusion of partnership assets in gross estate will be a problem with estate tax marital deduction for discounted value of partnership interests but partnership assets in gross estate at full value.

Suggests avoid grantor as sole general partner, allow transfer of general partnership interest (rather than conversion to limited partnership interest) to avoid a lapse of rights.

Also, suggests trust with third party trustee as general partner. Note RR 95-58 that authorizes removal and replacement of trustee.

Jonathan: 2035 (b) gift tax in gross estate. PLR 200432016 confirms that the 3 year period for inclusion begins with the date of the gift and not at the beginning of the calendar year in which the gift

occurred.

Jonathan: PLR 200432015. Transfer of life insurance to FLP and gift of FLP to family member resulted in life insurance in gross estate where death occurred within 3 years of the transfer - it was an "integrated transaction". Also, no marital deduction because life insurance was received by FLP and surviving spouse to not get at the funds.

Steve: Graegan case (56 TCM 387) developments - borrowing to pay estate tax and up front deduction on estate tax return for all future interest expense. Cal case permitted trustees to enter into 25 year loan - Klein v Hughes 2004 WL 838189 (Cal. App. 1 Dist 2004). Estate lost in Rupert (Dist Ct Pa. 2004 no cite provided). Estate could sell assets (right to lottery payments) to raise funds. Estate had burden of showing interest expense was necessary.

Pam: GST exemption.

PLR 200422051 split gift resulted in each spouse being transferor of 1/2 of gift.

Prop Regs on electing out to deemed (automatic) allocation of exemptions.

Reading tax return instructions and studying tax return is going to be easier than reading the prop regs. Suggests election on return for first year applicable to future years and can terminate the election for future years. Automatic applications under prop regs includes a formula allocation.

Simplified 9100 relief is available for late election of application of exemption. Can be after death but must be before estate tax return is due.

Jonathan: 2702, GRATs, proposed regs, Walton cases. Have annuity continue to be paid to estate after death for remaining term under GRAT. For marital deduction have payment from marital deduction trust equal to greater of fiduciary accounting income or annuity payment.

Steve: 2703 Agreements restricting transfers, valuation (buy sell agreement). Blount 87 TCM 1303 (2004) was a pre 2703 case modified after 2703 was adopted. Grandfather status was lost since modification was substantial.

Life insurance payable to company is required to be considered an asset of the company for valuing the company and company's obligation to purchase stock was not a permitted offset to life insurance.

Steve: Uniform Trust Code. (92 outline pages devoted to this topic.)

Major areas of controversy: court's authority to override exercise of trustee's discretion over discretionary distributions, too much info to be given to trust beneficiaries, will irrevocable trusts be included in gross estate due to modification authority, courts ability to override settlor's ability to use trust terms.

Steve: Diversification required of trustee. Dumont, NYLJ, July 13, 2004, page 19. Trustee held liable for loss for failure to diversify trust assets (stock) even though trust agreement authorized retention. Case is on appeal. Very difficult, if not impossible to fully protect trustee from not diversifying through trust provisions.

Jonathan: Suggests that settlor put asset into a FLP and then put FLP interest into trust. Trustee will

not be able to sell FPL with restriction in partnership agreement.

---

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffrey L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

#### GENERAL INFORMATION ABOUT INSTITUTE

##### Inquiries/Registration

Philip E. Heckerling Institute on Estate Planning University of Miami School of Law Center for Continuing Legal Education P.O. Box 248087 Coral Gables, FL 33124-8087

Telephone 305-284-4762 / FAX 305-284-6752

Web site [www.law.miami.edu/heckerling](http://www.law.miami.edu/heckerling)

E-mail [heckerling@law.miami.edu](mailto:heckerling@law.miami.edu)

---

Brought to you by the ABA-PTL Discussion List Moderators