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Heckerling 2017

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http://www.law.miami.edu/heckerling

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NOTICE: Although audio tapes of all of the substantive session at the Miami Institute currently are only made available to Institute registrants for purchase, the entire proceeding of the Institute other than the afternoon special sessions are published annually by Lexis/Nexis. For further information, go to their Web site at http://www.lexisnexis.com/productsandservices. The text of these proceedings is also available on CD ROM from Authority On-Demand by LexisNexis Matthew Bender. For further information, contact your sales representative, or call (800) 833-9844, or fax (518) 487-3584, or go to http://www.bender.com, or write to Matthew Bender & Co., Inc., Attn: Order Fulfillment Dept., 1275 Broadway, Albany, NY 12204.

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Heckerling 2017 – Report No. 3

As we have done in January for the last twenty years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 51st Annual Philip E. Heckerling Institute on Estate Planning that is being held on January 9-13, 2017 at the Orlando World Center Marriott Resort and Convention Center in Florida. A complete listing of the proceedings and the Institute's 2017 brochure are available at www.law.miami.edu/heckerling and the listing of the proceedings was also published as part of **Introduction Part 2** that was distributed on 1/4/17.

We also will be posting the full text of each of these Reports on the ABA RPTE Section's Heckerling Reports Website, as we have since the 2000 Institute. Those Reports from 2000 to 2016 can now be found at URL http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling_reports.html. In addition, each Report from 2006 to date can also be accessed at any time from the ABA-PTL Discussion List's Web-based Archive that now only goes as far back as January of 2006 and is located at URL http://mail.americanbar.org/archives/aba-ptl.html.

Editor's Comments:

Today with this Report #3 we begin our coverage of the Tuesday all-day Main sessions. Included in this report are four sessions, one on Placebo Planning, one on GRAT Results, one on Preferred Partnership Freezes, and one on Avoiding Trustee Pitfalls.

Further coverage of the Tuesday Main sessions will continue tomorrow starting with Report #4

Thompson Reuters is exhibiting at Booth 100. In addition to featuring their new Checkpoint tax system that replaces their prior Tax Guide service effective as of 1/1/17, if you visit during the afternoon break on Wednesday (3:40-3:55 pm) you can fuel up with some espresso, or you can stop by anytime for a demo while you fill up at their candy bar and register to win an Apple Watch or take advantage of their 10% trade show discount. Unfortunately you missed their luncheon today where Howard Zaritsky was the featured speaker on the Proposed Section 2704 Regulations.

Tuesday, January 10th, 9:00 to 9:50 am
Placebo Planning
Presenter: Jeffrey N. Pennell
Reporter: Kimon Karas

On a spectrum, some traditional planning is both harmful and useless, some is just benign, and some is useful but not for the reasons routinely touted. This session illustrated the benefits that are generated by several common techniques, and explored the circumstances in which particular approaches are viable and valuable.

Jeff prefaced his presentation by announcing that this was going to be his final presentation at the Heckerling Institute.

Jeff's first stated that his presentation was intended to focus on planning concepts and primarily the underlying basis of certain freeze techniques in an existing flat wealth transfer tax environment of 40%. Jeff cited a quote about art collectors relating to estate freezes. "The primary transfer tax advantage of making lifetime gifts of art is that the value is frozen for transfer tax purposes, and any future appreciation will not be includable in the collector's estate." His stated theory is that if the tax is flat that it should not matter whether the transfer tax is incurred currently at a low value versus at a later higher value.

Jeff started his presentation discussing what potential estate tax repeal could mean. He suggested that repeal might include both the estate and GST taxes but retention of the gift tax. He also suggested the cost for repeal could include either carryover basis or capital gains at death with an exemption amount.

Jeff then discussed the IDGT. The transaction is a sale of an appreciating asset for a note; there is leverage of the unified credit/GST; freezes value; shifts post-sale appreciation; no gain or loss to the trust and grantor pays the income tax. The touted benefit of this planning is that the donor's payment of income tax is not a gift. Jeff compared the sale to IDGT with grantor retaining the asset, paying the income tax on the income, and donor transferring the same amount of that income the IDGT generated to the donee. Under either scenario the grantor is paying the same income tax with or without IDGT. The shift is if any of any appreciation is of the remainder because of a valuation opportunity.

Jeff, then referred to 3 examples illustrating that it does not matter when the transfer tax is paid. The examples illustrated a scenario where all assets on first spouse's death used portability; second scenario where optimum marital/credit shelter trust is used; and third scenario attempting equalization by accelerating tax at first death. The examples ignore income tax basis. If asset values do not change between timing of deaths all three approaches generate no transfer tax difference. If assets double between deaths portability plan is not as effective as the other two scenarios. It assets depreciate by time of second death portability plan is better.

Jeff then discussed two alternatives of what he called "all hot example" (where estate is highly appreciating assets) versus half hot example (where 50% estate has no growth). In the all hot example whether tax paid early or late there is no wealth tax difference. On the half hot example using non-appreciating assets to prepay tax ends up with a better wealth transfer result. These examples illustrate the unexpected reality and one that is central to Jeff's presentation. "The tax saving here is attributable to payment of tax with assets that will not appreciate in value, in order to protect the growth in assets that will appreciate." Jeff states: "The key is not estate freezing. Instead if at first estate there is a ready source of nonappreciating liquid assets, the source of saving is use of frozen value assets to accelerate payment of the tax."

Jeff then discussed and compared an IRA with an IRA Roth conversion. The facts used $100,000 invested in an IRA invested for 20 years with rolling over an IRA of $100,000 to a Roth and paying the income tax from the Roth. Under either scenario at the end of the 20-years the value is the same. The difference where the Roth is better if the income tax on conversion is paid from outside sources and the entire $100,000 is invested. There would be opportunity cost by paying the tax on the Roth conversion from outside sources. Jeff's conclusion with the IRA examples is to reflect it is not necessarily the freeze but rather the source of payment of the tax.

Jeff next discussed if the law is changed with the repeal of the estate tax with a capital gains at death with an exemption amount, how to use the exemption. Jeff suggested to allocate exemption to assets that are intended to be sold and also to assets that can be depreciated.

Jeff concluded his presentation with a review of the 5 and 5 power and the assumption by some that granting such a power is harmless. It is except in the year of death when decedent dies with a power that has not lapsed that will cause inclusion of the amount that could have been withdrawn as of date of death. In order to limit this exposure some drafters limit the power to being exercisable only one day of the year to prevent the power from causing inclusion if the power holder dies on any other day of the year. Jeff sees no reason this drafting should not work.

For a more comprehensive review of Jeff's theories and analysis your Reporter refers you to Jeff's more complete outline and analysis.

Tuesday, January 10th, 9:50 to 10:40 am
Getting Gratifying GRAT Results [FS]
Presenter: Carlyn S. McCaffrey
Reporter: Michael Sneeringer

This presentation focused on techniques for enhancing the likelihood that a grantor retained annuity trust ("GRAT") produces a positive balance at the end of the term, including the use of split-interest and leveraged GRATs. It also explored the possibilities of protecting a GRAT's positive balance from the generation-skipping transfer ("GST") tax. Reported here are some of the more significant highlights from this particular presentation.

Ms. McCaffrey educated the audience on all things Grantor Retained Annuity Trusts. She answered the following important questions: (1) what drafting techniques should be used; (2) what funding techniques could be utilized; and (3) how does an attorney successfully administer a GRAT?

Ms. McCaffrey's initial comments described GRATs as her favorite technique. She indicated that it is a great technique when interest rates are low.

She then went through the mechanics of a GRAT. She indicated how a GRAT works following the end of the annuity term.

She then pointed to various provisions that she would include in the governing document, which can be found in her outline on pages 2-4 through 2-12.

Ms. McCaffrey then described why good drafting techniques are important: how can attorneys draft GRATs compliant with the Internal Revenue Code and Treasury Regulations?

She then discussed drafting techniques to reduce mortality risk. She indicated that it is important that the GRAT interest qualify for the marital deduction.

Following this, she noted outside of her outline materials that even if there is no estate tax, there is still an income tax risk with GRATs. She indicated that a solution to the income tax risk might be that the grantor bequeaths his or her annuity payments to a new trust and the trustee of the GRAT would have the right to withdraw annuity payments. Under the Regulations, this would cause the GRAT to be the owner of the new trust.

Ms. McCaffrey noted that her research showed that the use of several short term GRATs would probably outperform the use of one long term GRAT.

Ms. McCaffrey next discussed funding. She indicated that if the grantor has more than one (1) asset, multiple GRATs should be used so that underperforming assets do not pull down the performance of performing assets.

She then discussed funding with fractional interests. She indicated that this might depress the value in the short term; a fractional interest will be valued at substantially less. She referred the audience to her outline for an example of this point using a family with a manufacturing business (page 2-19 of her materials).

She also discussed funding a GRAT with preferred interests. She indicated that attorneys can help their clients create preferred interests (as opposed to obtaining them on the open market).

Ms. McCaffrey then discussed the administration and monitoring of GRATs. She reminded the audience that the goal of the GRAT is to beat the Code Section 7520 rate. She wondered whose responsibility it is to monitor the GRAT: accountant, attorney, family office, or someone else?

Ms. McCaffrey then discussed the sale of the remainder interest; whether the GRAT is underperforming or performing. She pointed out pages 2-21 and 2-22 of her materials for examples of this discussion.

Ms. McCaffrey concluded with a discussion on Generation-skipping transfer ("GST") tax issues and GRATs. She asked whether a grantor's GST exemption can be used. She indicated that the answer turns on the issue of whether the creation of a GRAT may create an estate tax inclusion period ("ETIP") (she noted most commentators think that it does; however, others do not).

She noted in conclusion that attorneys should avoid passing assets to skip persons (for GST tax purposes). She indicated that shifting the identity of the grantor/transferor could suffice to eliminate some of the GST tax issues.

Tuesday, January 10th, 2:00 to 2:50 pm
Warming Up to Preferred Partnership Freezes - Multiple Planning Applications with This Versatile Technique
Presenter: N. Todd Angkatavanich
Reporter: Michael Sneeringer

This presentation focused on the multiple ways to use Section 2701 compliant preferred partnerships to enhance planning. The presentation discussed ways to combine preferred partnerships with GRATs, QTIPs, GSTT exempt trusts, CLATs, foreign non-grantor trust, carried interest transfer planning, and C corporations. It also discussed fundamental structuring considerations under Section 2701 and other relevant Code Sections. Here are some of the more significant highlights from this particular presentation.

Mr. Angkatavanich first led the audience through the complex topic of preferred partnership freezes using props, a PowerPoint and practical information. The PowerPoint he used for his presentation is not in his materials. The PowerPoint combined color graphics and charts in an easy to decipher format to illustrate his various points.

Mr. Angkatavanich began his presentation with a description of the various freeze techniques. He indicated that GRATs and sales to grantor trusts are the more popular flavors of freezes. He noted that GRATs have begun to be audited more frequently. He described the outcomes to the various recent cases involving sales to grantor trusts.

He then opined on what effect estate tax repeal might have on these planning techniques. He indicated that valuation would still be important even if the estate tax was repealed.

Mr. Angkatavanich next discussed the essentials of Code Section 2701. He noted that whenever attorneys are creating a preferred partnership, they have to deal with 2701. He indicated that structuring a freeze with a qualified payment rate is the easiest way to comply with 2701.

Mr. Angkatavanich next discussed freeze partnerships with qualified terminable interest property ("QTIP") trusts. He indicated that even if Code Section 2701 is satisfied, not all gift tax consideration are off the table. He next discussed the adequacy of the coupon. He noted that Revenue Ruling 83-120 and its factors are important for determining this adequacy. He recommended Paul Lee's outline as well as writings from Richard Dees for furthering reading on this topic.

Mr. Angkatavanich then discussed reverse freeze partnerships.

Mr. Angkatavanich next discussed carried interest planning. He described the vertical slice approach for carried interest planning using a discussion and his PowerPoint slide diagram. He noted that there are non-vertical applications too (beyond the scope of the presentation).

He next described grantor retained annuity trusts ("GRAT") and their limitations. He discussed the preferred partnership GRAT, noting its mechanics and use. He described how the requirement of a ten (10) year GRAT would apply to freeze partnerships.

Mr. Angkatavanich next discussed Code Section 457A problems for hedge fund managers. He noted the planning technique available with a charitable lead annuity trust ("CLAT") and private placement life insurance ("PPLI"). He noted another variation called the "Rising Tide CLAT."

Mr. Angkatavanich also highlighted recent articles written on intentionally defective preferred partnership freezes to accompany his discussion on the topic (an article by Michael Gooen and Tracy Snow; and an article by Christopher Pegg and Nicole Seymour).

Lastly Mr. Angkatavanich discussed planning regarding foreign grantor and non-grantor trusts. He indicated the problem with the throwback rules and the mechanics behind a "throwback freeze."

Mr. Angkatavanich concluded his presentation with a discussion on "other considerations" (such as the "disguised sale" rules and qualified payment election). He noted that his outline goes into more details on many of the items discussed during his presentation.

Tuesday, January 10th, 2:50 to 3:40 pm
With Great Power Comes Great Liability: Helping Trustees Avoid Pitfalls in Common Transactions [FS]
Presenter: Lauren J. Wolven
Reporter: Joanne Hindel

Trustees are often asked to engage in loans to related parties or beneficiaries and other transactions with related trusts, closely-held assets and real estate. For a trustee who is not careful, even a seemingly simple act like making a loan to a beneficiary can lead to liability. This session explored methods to reduce fiduciary risk in common trust transactions and was ably reported on by Joanne Hindel who is a Regional Fiduciary Executive with Fifth Third Bank in Cleveland, Ohio.

Lauren started off by saying that she would be providing the "Afternoon scary story time" which was her introduction to her presentation developed from a project dealing with loans from trusts.

Loans to beneficiaries might also be referred to as "chicken trust distributions". There are however good reasons to make loans:

1. An older trust that only allows distribution of income – a loan allows a beneficiary access to principal without an outright distribution.

2. Beneficiary is successful but has illiquid estate – trustee does not want to increase the beneficiary's taxable estate

3. The trustee might want to ensure that the beneficiary has some "skin in the game"

Loans are investments and the trustee should consider investment return without loan and the impact the loan (and interest rate) has on investment return.

Is the loan authorized under the trust terms and have the right parties executed the loan?

<u>The following basic questions should be asked when evaluating whether a loan is a prudent investment:</u>

-- Would the beneficiary be able to obtain the loan in the market?
-- Are the terms similar to those available from a third party?
-- Will the loan cause a concentrated position?
-- Does the trust waive the duty of diversification or expressly allow the loan?
-- Is the interest rate higher or lower than the rate of return of the assets prior to the loan?
-- Could any other beneficiary complain about the lack of productivity or liquidity of the loaned funds?
-- Are there clear purposes of the trust that would allow for a loan?
-- Can you charge a beneficiary's share of the trust for the outstanding loan amount (watch out for a spendthrift clause)?

A drafting suggestion is to include a provision expressly authorizing loans to a beneficiary for specific purposes.

The doctrine of recoupment may allow a trustee to recover funds owed by a beneficiary for a loan from the trust.

The trustee should also confirm that the authority to make a loan exists:

-- Does the trust agreement or applicable law authorize a loan?
-- What are the minimum requirements for the loan?
-- How much due diligence is required regarding the borrower's ability to pay?
-- Is interest required?
-- Should the trustee receive collateral?
-- Are any further filing (UCC or otherwise) required to secure the loan?

If the trustee collateralizes the loan what due diligence is required?
Generally wise to obtain an appraisal on real estate.
If the beneficiary defaults will the trustee seize the collateral?
Will the trustee really want the collateral or be willing to sue the beneficiary?

Ask yourself: who will sue me if I don't collect and who will sue me if I do collect?

Corporate fiduciaries are held to a higher standard and often have multiple relationships with parties to a trust.

Banks have been held liable when a bank officer promises to make a loan but then doesn't do so.

Make sure all the right parties have signed off on a loan from a trust – for instance, have the designated investment adviser sign off on the making of the loan.

If the beneficiary has his/her own trust have the beneficiary sign both individually and as trustee of his/her own trust.

Be sure to have a non-waiver clause in case the beneficiary pays late.

Always have the trustee sign as trustee to ensure that the trustee is never liable individually.

If making a no interest loan be sure to check the OID rules.

Another checklist to use in considering loans:
-- The loan would be considered prudent if it were being made to a third party.
-- The duty to the beneficiaries is properly balanced with the duty to make prudent investments when the loan is in the trust portfolio.
-- Should the other beneficiaries consent in writing to the transaction and release the trustee from liability for making the loan.

Concentration cases: Kettle and Dumont

Both cases involved Kodak stock- outcome is a warning to not bind the trustee with respect to investments – will only make duty of trustee more difficult.

Both cases involved the concept of “compelling reason” – in Dumont the trustee did not sell and in Kettle the trustee did sell.

In Wood v. U.S. Bank the court held that a trustee does have a duty to diversify even when the trust authorizes retention of a specific asset unless there are special circumstances.

When drafting be very clear- specify that a trustee may hold a concentrated position if that is intended.

In conclusion, Lauren covered additional cases highlighting problems with multiple trustees and adequate insurance coverage for actions as trustees who are also managing business interests.

The Reporters

Our **on-site local reporters** who will be present in Orlando in 2017 are **Joanne Hindel Esq.,** a Vice President with Fifth Third Bank in Cleveland, Ohio; **Kimon Karas Esq.,** an attorney with McCarthy, Lebit, Crystal and Liffman Co. LPA in Cleveland, Ohio; **Craig Dreyer Esq.**, an attorney with Clark Skatoff, PA in Palm Beach Gardens, Florida; **Herb Braverman Esq.,** an attorney with Braverman & Associates in Orange Village, Ohio; **Kristin Dittus Esq.** a solo attorney in Denver, Colorado, **Michael Sneeringer Esq.**, an attorney with Akermn, LLP in Naples, Florida, **Michelle R. Mieras,** a Fiduciary Risk Manager with Bank of the West in Denver, Colorado, **Beth Anderson Esq,** an attorney with Wyatt, Trrant & Combs, LLP in Louisville, Kentucky, **Bruce A. Tannahill Esq,** a Director of Estate and Business Planning in the Mass Mutual Financial Group in Phoenix, Arizona, and **Patrick J, Duffey Esq**, an attorney with Holland & Knight in Tampa, Florida.

The **Report Editor** again in 2017 will be **Joseph G. Hodges Jr. Esq.**, a solo practitioner in Denver, Colorado. He is also the Chief Moderator of the ABA-PTL discussion list.