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As we have done in January for the last twenty one 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 52nd Annual Philip E. Heckerling Institute on Estate Planning that is being held on January 22-26, 2018 at the Orlando World Center Marriott Resort and Convention Center in Florida. A complete listing of the proceedings and the Institute's 2018 brochure are available at www.law.miami.edu/heckering. Introduction Part 1 issued on 1/11/18 covered the Institute Opening Reception, its Scope, the Faculty, the Advisory Committee, the Sponsors and the Vendors, plus general information at the end about the Institute. Introduction Part 2 issued on 1/12/18 contained a complete listing of all of the proceedings of this Institute. This Report continues our coverage of the proceedings.

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. The Reports from 2000 to 2017 can now be found at URL http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling.htm. 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.

Announcement: The Purposeful Planning Institute based in Denver, Colorado held a Primer on Purposeful Trusts and Gifts Workshop in Orlando on Monday morning, January 22nd, the opening day of the Heckerling Institute. Their promotional materials said how these Trusts are "antidotes for the toxicities of long-term trusts and large gifts." They said you would learn "what wealth psychologists are suggesting our clients need to be doing to avoid negative outcomes in the next generations of their families when designing and implementing dynasty and asset protection trusts or large gifts," all built around the 5 "toxicities" of trusts and the 7 keys of Purposeful Trusts. A 130 page handbook and related materials were made available to those who paid the fee to attend. Sounds pretty interesting, especially given the recent changes in the tax laws. For more information, contact the PPI at www.purposefulplanninginstitute.com.

Summary: This Report #12 completes our coverage of the Thursday afternoon Special Sessions, those being an errata reprint of 4-A on the magic age of 70 1/2 that was in report 11, plus 4-C on working with real estate investors, 4-D on the exercise of discretion, and 4-F on the new partnership audit rules.

The next Report #13 will contain our coverage of Fundamentals #3 on demystifying international tax planning and the three Friday morning final
General Sessions.

ERRATA RE REPORT 11: We mistakenly published the report for Natalie Choate's Friday morning General Session on ROTHs as the report for her Thursday afternoon Special Session 4-A on the Magic of Age 70 1/2, that was in Report #11. Below is the correct report for her Special Session 4-A. The report on her Friday General Session will be reported again at that time.

3:50-5:20 SPECIAL SESSIONS IV

ERRATA
Session IV-A - REVISED REPORT
The Magic Age Is 70½ [ELD][FIN]
Presenter: Natalie B. Choate
Reporter: Kimon Karas

At 70 1/2 your IRA tax shelter becomes a tax nightmare. Help older clients minimize or eliminate RMDs. Plus, when and how to take RMDs, and where to take them from.

The Tax Act made no changes to the law regarding RMDs.

Computing RMDs.

1. List all retirement plan and accounts as one - will need to compute RMD separately for each plan/account.

2. Separate plans that do not have an RMD requirement.
   a. Roth IRAs. Roth owner not required to take distributions from Roth IRA during lifetime.
   b. A participant in a qualified plan who is still working and is not a 5% owner.
   c. Annuitized IRA.
   d. The first distribution year is the year the person attains 70 ½.

Computing the distribution.

1. Determine prior year-end balance. Value is fair market value. If the account has hard to value assets it will be more difficult to determine FMV. IRS requires IRA provider to report to IRS each year (Form 5498) whether IRA holds assets that do not have readily ascertainable market value. Note, if one fails to satisfy the year’s RMD it comes with a 50% penalty for each year that one fails to take RMD.

2. Watch year-end adjustment if funds are being transferred at year end from one account to another. It is possible that there may be a zero balance in account at year end. Special rule for
such a transfer - it must be added into the prior year-end balance of the account that receives the transfer for purposes of computing RMD.

3. The computation is determined by dividing the year end account balance by one’s age. Age is determined to be one’s age at end of applicable year. For most people they will refer to IRS Table III, IRS Pub 590-B. However, if the sole beneficiary of IRA is a spouse, and spouse is more than 10 years younger, then computation will be based on IRS Table II.

4. Although rare, the RMD cannot exceed the account balance. For example account value can drop between year-end and when distribution is made. Another example is if a big portion of IRA was awarded to ex-spouse in a divorce after prior year-end and prior to taking RMD.

When to take RMD.

Once RMD for the year is determined must take RMD sometime during that calendar year, by December 31. Distribution must be taken between 1/1 and 12/31. Exception in the year one turns 70 1/2, person can take distribution during the year or anytime up until April 1 of following year. The decision then is when in the year to take the distribution and from.

1. Take distribution early in the year.

2. Take distribution in monthly installments.

3. Take distribution late in the year.

4. As to when in the first distribution year, one can take distribution during the first distribution year or at any time up until April 1 of the following year. April 1 date is the required beginning date, RBD. If one is still working and not a 5% owner, the first distribution year is the year one retires if later than the date one reaches age 70 ½. In that case the RMD for the company plan with be the later of April 1 of the year after reaching age 70 ½ or April 1 of the year after retirement. This special rule does not apply to an employee who owns more than 5% of the employer who sponsors the plan. The question whether to take the distribution in the first distribution year or defer until and up to April 1 of following year “depends.” It is not an all or nothing, so one can take a portion in first distribution year and remainder by April 1 of following year. Remember postponing the first year’s distribution means there will be a double RMD in the second year. Also, note one cannot rollover an RMD. If for example one is retiring from a company once person has reached 70 ½, need to take RMD prior to any rollover.

From which account should one take RMD. Generally, one has no choice as must take RMD for each plan or account. Exception when one has multiple IRAs or multiple 403(b)s. However, inherited IRAs cannot be lumped together for this exception.

Distributions can be made:

1. In cash.
2. In property in kind. Assets received by owner will obtain tax cost basis.

3. Use RMD to pay estimated taxes. Income taxes withheld from retirement plans (similar to income taxes withheld from wages) are treated as if paid equally on the estimated payment dates.

4. Qualified charitable contribution (QCD). This is a tax favored way for certain individuals to transfer funds directly from IRA to charity.

How the QCD works in operation. An over age 70 ½ IRA owner can, in any calendar year transfer up to $100,000 directly from an IRA to one or more charities. The amount transferred is not includible in gross income of IRA owner and counts towards satisfying owner’s RMD. A QCD counts towards one’s RMD. Except for that there is no relation between QCD and RMD. Consequently the QCD bypasses IRA owner’s tax return completely. A benefit of a QCD since it does not count toward one’s gross income and consequently one’s AGI which can increase one’s taxes and Medicare premiums. With the new Tax Act and the increase in the standard deduction, the QCD can in effect act as “deductible contribution” for someone who does not itemize. The IRA owner can satisfy charitable gifts with QCD, exclude that distribution from income, and still take the standard deduction against other income.

Requirements to qualify for a QCD.

1. Only individuals who are age 70 ½ can make QCDs.

2. QCD can only be made from an IRA, not from any other form of plan.

3. Maximum amount anyone person can give is $100,000 in any one calendar year. A husband and wife who each have separate IRAs and are both over 70 ½ can each transfer up to $100,000.

4. QCD must be made directly to a charity, i.e. a charity that one can make a tax-deductible contribution. Exception - a donor advised fund nor a supporting organization qualify as charities for this purpose.

5. The QCD must be made to charity with no right by owner to “get anything back” from the charity for the gift.

6. Money must go directly from IRA to charity.

A couple of concerns with QCD. The IRA provider has no reporting obligation. The obligation to account for the QCD and report it to IRS falls on the IRA owner. Also, do the projections to determine whether the QCD is an effective way to make donation.

Vehicles to consider in reducing RMDs, more appropriately deferring the RMD.

1. If individual is still working and less than 5% owner, roll the IRA into plan.
2. Continue making contributions to employer plan.

3. If individual is self-employed with no other employees consider a solo 401k plan. A solo 401k plan could also allow for Roth accounts. Although that does not reduce current income tax it allows for future tax-free growth. Same with voluntary nondeductible employee contributions and in plan conversions.

Session IV-C

Getting Your Hands Dirty with Real Estate Investors

[CHB]

Presenters: Farhad Aghdami + Sarah Moore Johnson

Reporter: Craig Dreyer

This program focused on practical tax and non-tax considerations when representing real estate investors, such as choosing the right trustees after the Aragona case, dealing with negative capital accounts, managing capital gains and avoiding “dealer” status, valuation and transfers of promote interests, and much, much more! This session builds on Mr. Aghdami's Thursday morning General Session on the same basic topic. Here is the reporter's report on the highlights of this presentation.

The panel opened noting that the focus of the session would be on the income tax and legal issues for dealing with real estate. The main change in the 2017 Tax Act is 199A. 1st issue is what qualifies as QBI. It only includes ordinary income from an active trade or business. They went on to discuss how real estate investors can avail themselves to the 20% deduction under 199A. Next, they went through the calculation to determine whether a real investor meets the QBI deduction threshold if they make over the specified amount. They noted that the reference to 167(a) is not entirely clear what depreciation number they are referring to under the statute. The panel also discussed some potential workarounds to allow real estate developers to allocate employees in the 199A context by using section 3306 regarding common pay master with S-corps, or a common pay agent under section 3504.

Under both new and old law, depreciation is still 15 years for improvements, 27.5 years for residential property, and 39 years for commercial property. Nothing changed here. However, before the 2017 Tax Act, businesses could make leasehold improvements, retail improvements, and restaurant improvements to property that could be depreciated over 15 years instead of 39 years if it was done pursuant to a lease and the building had been in service for over 3 years. Under 168(k) businesses could deduct 50% in year 1 of the cost incurred, and the remaining amount over the next 15 years. In 2015 qualified improvement property was added. Qualified improvement property had a 39-year life. The 2017 Tax Act increased qualified improvement property deduction from 50% to 100%, and qualified improvement property has no term of years under the 2017 Tax Act, but the intent was to make it 15 years. Any depreciable property held for 20 years or less is now eligible for 100% expensing. Therefore, it combined all the previous improvements into one category. The panel discussed that businesses earning more than 25
million per year may be limited to an interest deduction of 30%, or they may have to give up bonus depreciation.

The promote or carried interest portion of an investment is now only available for capital gain after three years rather than the old rule of one. The panel also noted that the 1031 exchange applies only to real estate, and no longer applies to other types of property. The panel also noted it may important to account for fixtures separately in a 1031 exchange under the 2017 Tax Act.

The panel then discussed various scenarios to implement with real estate investments. They began by discussing what is the best ownership for a primary residence. They noted tenants by the entirety ("TBE") is usually the best option for married couples. They discussed that TBE is a full bar to creditors in some states like FL, MD, Washington DC where neither spouse can act unilaterally on TBE property. However, in states such as NY, MA, and NJ either spouse can alienate TBE property which is a modified bar state. In a modified bar state, creditors must accommodate the remaining spouse (i.e. if the house is rented the creditor must give the spouse half the rent), and there is little else the creditor can do to get repaid.

**Vacation house.** The panel then discussed the ownership of a vacation house owned by multiple siblings as tenants in common. They discussed various expenses on rental property, and generally if one person pays all the expenses for their siblings they can only deduct portion to their actual interest, but with expenses that run with the land they can often deduct the full amount since they are joint and several in most states, though as some states override this joint and several liabilities by statute. The panel then discussed the benefit of transferring to an LLC, or if the clients want to do a joint tenancy agreement is another option. The panel went on to note that if you want someone to use a house without the risk of gift tax you could always give them a small tenant in common interest to avoid any gift tax issues. The panel then discussed ways to ensure you could deduct the property taxes by renting it out and using it for 14 days or less, or alternatively, no more than 10% of the time the property is used as a rental. Meeting this requirement allows them to deduct property taxes, even if an individual already has used up their 10,000 SALT deduction.

**Investment Property.** The panel then discussed the typical real estate deal that involves three parties: The Developer, Equity investor, and Lender. The panel also discussed various types financing for investment deals such as mezzanine loans, A&D loans, and construction loans. The panel then went on to discuss the role of preferred returns and promote interests. Preferred loans get a return of capital and a return on capital. Then there is the promote return which is commonly referred to as the carried interest portion. In addition to the preferred return and promote fee most deals involve development fees, which is treated as ordinary income and not capital gains. In dealing with debt, the panel also noted the difference between recourse and non-recourse debt, and how recourse debt may provide additional basis to take losses, while non-recourse debt does not give this ability to a developer. The panel then went on to discuss various types of financing.

**Dealer v. Investor.** The panel discussed how a dealer gets ordinary income treatment while and investor does not. They noted that 1221(a)(1) does not include property held in ordinary course of trade or business. They went on to discuss the factors that differentiate a dealer v. investor such as what was the nature of the investment and purpose and whether there are property sales...
over an extended period. The panel then discussed whether the actions of a co-tenant could be imputed to another co-tenant. Evaluate the extent of the sale transition. (9th Cir case held motives of other owners are not imputed to the owner). Real Estate investment dealer can hold investment property, but it must be treated differently from other property.

**Deductibility of Losses.** Passive investors in real estate losses are disallowed. Section 469 was designed to prevent offsetting losses of one activity against another. 469(c)(2) rental activity is always passive; however, 469(c)(7) does not apply if taxpayer is a real estate professional and the taxpayer materially participates in the asset. The test for real estate professional says taxpayers performs 750 or more hours in real estate activity, and more than half activity is in a real estate trade or business. This includes development, rental, brokerage, or leasing. This means a lawyer will have difficulty deducting losses from a real estate enterprise. If you put over 500 hours into a rental property you can aggregate activities and deduct losses.

**1031 Exchange.** The panel went on to discuss 1031 exchanges which provide no gain on the sale of real estate if reinvested in a like kind exchange. The panel noted that residential real property and commercial real property are treated as like kind. The 2017 Tax Act however now only applies to real estate.

**2701 and Derivate Contacts.** The panel then discussed how gifting preferred interests is tempting but runs afoul of the section 2701 rules, unless you use a vertical slice (by taking an equal slice of the common and preferred interests is one exception to 2701). However, liquidation and vesting issues may also cause problems. One option is to use a derivative carry contract that the trust enters for distributions over a certain threshold. The panel noted that there is a lot of opportunity and risk in this area.

**Net Investment Income Tax (NIIT).** How to make trust property not subject to NIIT by making sure the trustee is active in the trade or business. The panel went on to discuss the section 469 material participation rules and several court cases.

The panel wrapped up by discussing principal and income act issues that come up with real estate investors, and how the 754 election is great for small issues but has significant costs moving forward in accounting fees.

**Session IV-D**

**How Much and When? A Panel Discussion on the Legal and Practical Considerations of the Exercise of Discretion [TRU]**

Presenters: Amy K. Kanyuk + William T. Hennessey + R. Hugh Magill

Reporter: Patrick Duffey

Using a series of hypothetical examples covering a range of topics, the panel provided practical advice and guidance from their respective perspectives—that of an estate
planner, a litigator, and a trust officer—regarding the exercise of a trustee’s discretion and the scope of a beneficiary’s rights with respect to a discretionary trust.

Discretionary trusts create an expectancy and not a specific right. Trustees face significant and extensive considerations in determining whether to make a distribution and, when making distributions, how much to distribute.

**Example 1: A beneficiary with a potential substance abuse issue.** The trust provides for mandatory income with discretionary principal distributions under a “best interests” standard. The beneficiary has been acting strangely and was recently arrested with drugs in his car. The trustee is aware of all of the behavior and the arrest, but has no “medical proof” of a substance abuse issue. Bill Hennessey discussed the general principles of the exercise of fiduciary standard.

The trust, Hennessey noted, has some common problematic provisions: specifically, in order to withhold distributions, the trustee must “reasonably believe” that a beneficiary is abusing drugs or alcohol. Some questions raised include whether the trustee could condition distributions on the beneficiary entering into rehab or requiring the beneficiary execute a limited HIPAA release to give information to the trustee. Hennessey opined that the answer to both of those questions is “yes,” provided that the trustee was acting in the beneficiary’s best interest and not acting in its own interests.

Amy Kanyuk discussed the circumstances where substance abuse or other problems were not anticipated. The issue here is that the income beneficiaries are mandatory and those could be substantial. Kanyuk mentioned that she always provides in her trusts that an independent trustee has a “second bite at the apple” with respect to otherwise mandatory distributions.

Hugh Magill weighed in on the practical considerations of “intrusive responsibilities” such as requiring the fiduciary to look into whether a beneficiary is abusing drugs or alcohol. These types of provisions put a trustee in the position of acting in an almost law enforcement-type capacity. That complicates already difficult family dynamics and can be difficult as a practical matter.

**Example 2: Distributions subject to consideration of a beneficiary’s other resources.** A credit shelter trust benefits the spouse and provides for distributions to her of income based on an ascertainable standard. The settlor’s children are also beneficiaries and may receive income not paid to the spouse. Principal distributions are allowed to both classes of beneficiaries based on an ascertainable standard. In making distributions the trustee “may, but need not, consider the beneficiaries’ other resources.”

Kanyuk discussed the meaning of support and maintenance and noted that the standard is subjective, insofar as it requires a fiduciary to look at the beneficiary’s current standard of living. She opined that the trust was primarily for the benefit of the surviving spouse, which should guide the trustee’s analysis. After considering a beneficiary’s current standard of living, Kanyuk would advise the fiduciary to do some due diligence in getting financial information from the beneficiary in order to determine the extent of that beneficiary’s resources. Under the facts of the hypothetical, Kanyuk would advise making distributions to support the surviving spouse but would not make such extensive distributions to the children.
Kanyuk suggested that a better approach—from the planning stage—might be making the spouse the sole beneficiary of the trust and providing her with a power of appointment in order to allow her to direct trust assets to the children. That would permit the trustee to focus on her interests (as she is the primary beneficiary) rather than those of the children (who would be remainderman).

Hennessey read the example differently and opined that the trust—at least, under its terms—was actually for the primary benefit of the spouse. Rather, he believed that an attorney for the children would argue that the spouse and children should be treated essentially equally.

Magill pointed out that at common law, an assumption could be made that more senior generations of beneficiaries had priority over less senior generations. While it would be clearer to name the surviving spouse as the primary beneficiary in the trust instrument, a fiduciary could rely on that common law in making distribution decisions.

**Example 3:** *Beneficiary circumstances and the duty of impartiality.* One beneficiary of a family trust benefiting five adult siblings sought a distribution to cover his bail. The distribution standard was “best interests.” The panel took a vote and decided to make the distribution. Subsequently, the beneficiary was arrested again and the panel voted to leave him in jail. Context ended up being important and the trustee in this example (which is based on a real-life case) got more information about the arrested beneficiary after making disclosure of the original distribution to the other beneficiaries.

Magill discussed the challenge inherent in balancing the duty of impartiality with the duty to disclose. In this instance, Magill felt that disclosing the distribution and quoting the purpose for which it was made (i.e. “best interests”) was enough to preserve the arrested beneficiary’s privacy while still making adequate disclosure to the remaining beneficiaries.

Kanyuk commented that, in drafting, she often waives the duty of impartiality—typically expressly in the instrument. Doing so, she feels, helps with administration from a practical perspective.

Hennessey noted that in advising fiduciaries, he considers whether he would rather defend making a given distribution or *not* making that distribution—the circumstances would guide that analysis.

**Example 4:** *Hostility between trustees and beneficiaries.* The Trust was a QTIP trust benefiting the surviving spouse during her life and then children from a prior marriage as remainders. The trustee of the trust was one of those children. The distribution standard required income, with principal distributions based on an ascertainable standard and the ability (but not duty) to consider the surviving spouse’s other resources.

Hennessey focused on sticking to a process in administration, including making distributions. As a practical matter, client management becomes important in such an emotionally charged situation. Often communications should go through the attorney. There should be a thought-out process so that any decisions can later be explained through documentation.
Kanyuk points out that a conflict is virtually inevitable in this situation. In drafting a trust, it’s important to capture the grantor’s intent and may be advisable to avoid “boilerplate” language—including the ascertainable standard used here.

Magill was struck by the imbalance here between the interests due to the differentiation in ages of the beneficiaries. During the planning process, it’s important to structure it in such a way as to avoid pitting beneficiaries against one another.

**Example 5: Distributions for a personal residence.** The surviving spouse is the primary beneficiary of a trust that provides for income and principal distributions in her best interests; descendants are secondary beneficiaries under the same standard. The spouse sought a distribution to purchase and furnish a new home.

Kanyuk felt that such a distribution would be appropriate as would distributions for maintenance of the home. Distributions for improvements to the home are a “closer call” but would likely be permissible. One alternative, Kanyuk suggested, would be for the trust to purchase the home and hold it in trust while permitting the surviving spouse to live there rent free. In her practice, Kanyuk has done this subject to a “use agreement” for the beneficiary, requiring them to pay basic carrying costs such as taxes, repairs, and maintenance.

Magill discussed the difficulties in dealing with improvements to trust property where the trust instrument is silent. Another issue that has come up in his experience is that a beneficiary seeks to make an improvement to a residence that is held in a GST exempt trust—such an improvement would be a contribution to the trust for tax purposes and create significant complexities.

**Example 6: Trust funding is incompatible with the distribution standard.** The trust is a general power of appointment marital trust funded with assets that would allow for about seven years of distributions to the surviving spouse based on her proposed budget. Magill notes that this can be common in circumstances where a settlor with a significant income has an untimely death. The surviving spouse then has a very high standard of living and insufficient funds to maintain it.

Magill discussed how important disclosures were in these circumstances. Not just for protection of the fiduciary but also to manage the beneficiary’s expectations. Disputes can be almost inevitable where a trust is under-funded with respect to its stated purpose.

Kanyuk noted that this situation almost requires the involvement of a professional fiduciary that is able to act independently and make sufficient disclosures.

**Example 7: Beneficiary budgets.** A substantial trust provided for mandatory income distributions and discretionary principal distributions based on the ascertainable standard. The beneficiary led an extravagant lifestyle, so at the settlor’s death the trustee worked with the beneficiary to put together a budget and made distributions on that basis.

Hennessey opined that it would be a permissible exercise of trustee discretion to make distributions based on a budget rather than looking at individual expenses. Years later, the trust is cut by about a third but the trustee continues to make the same distributions. Hennessey noted...
that could be problematic for the trustee, because it was not responding to the change in circumstances

**Example 9 (#8 was skipped):** *Distributions to augment the surviving spouse’s estate.* The trust provides for mandatory income distributions to the surviving spouse and principal distributions in the trustee’s “sole and uncontrolled” discretion as appropriate for the surviving spouse’s “comfortable support and care.” That standard, Kanyuk noted, is an ascertainable standard. The beneficiary is seeking larger and larger distributions in order to shift wealth to her son from a prior marriage.

While the distribution standard would allow for distribution to maintain the surviving spouse’s lifestyle would be appropriate, Kanyuk opined that excessive distributions (that “augment” her estate) would not be supported under that standard.

### Session IV-E

**Ethics and Negotiations [LIT]**

**Presenters:** Steven K. Mignogna + Jo Ann Engelhardt + Terrence M. Franklin + Richard W. Nenno + Robert D. Steele + Matthew H. Triggs

**Reporter:** Herb Braverman

Ethical challenges arise in any negotiation, especially when intertwined with thorny trust and estate issues. The panel addressed the ethical and strategic implications in negotiating with counsel, clients, and advisors. This program included a mock mediation in which the participants grapple with common yet intriguing – and even entertaining – problems. Here is the reporter's summary of these proceedings.

This rather large panel was very interesting; it was primarily a “skit” in which the participants played roles in a scenario designed to highlight proper and improper behavior by attorneys and others in a required mediation process. The important role of the mediator was covered at some length. He/she must not judge the matter, must not give legal advice, must protect confidential information, must be as clear a possible about any bias he/she might bring to the role...all in an effort to settle a conflict and to reduce the terms of such a settlement into a writing that will allow the parties to move on.

The Model Rules of Professional Conduct apply in this setting and were referenced or discussed during the program. The participants got well into their respective roles and were quite entertaining as well as informative.

The materials were of interest also. There was an excerpt from a book, *MEDIATION FOR ESTATE PLANNERS*, that looked as if it would be quite helpful to a full understanding of this set of issues. Similarly, there was some discussion of certain threats in the process, such as the kind of bullying that some counsel sink to in some difficult situations. This included reference to the Uniform Mediation Act, promulgated...
in 2001 and adopted in many states, so be sure to review the statutes in your state that impact mediation.

Other issues that must be considered were mentioned without resolution; for example, who pays the mediator and how much, attorney fee arrangements, the value of break-out sessions with each side of the dispute, etc.

Special Session IV-F

Why Your Partnership and LLC Agreements Need a Tune-Up 9n 2018: The New Partnership Audit Rules [CHB].

Presenter: Richard B. Robinson (Robinson, Diss and Clowdus, PC in Denver, Colorado)

Reporter: Beth Anderson

Every partnership (including large, small, and family partnerships) must amend its agreement beginning with its 2018 tax year. Partnerships with trusts, grantor trusts, limited liability companies, other partnership or disregarded entities as partners, cannot elect out of these new rules, and every partnership must appoint a Partnership Representative for each tax year. The new rules create complexity and decisions that must be discussed with every partnership. This program provided an overview of the new rules as well as practical advice on how partnership agreements should be amended to address the issues.

New partnership audit rules went into effect as of January 1, 2018. The presenter recommends amending your partnership agreements and operating agreements in 2018 because there are decisions and consequences that must be addressed in 2018. If you want until the law is settled, the facts and parties may have changed and you may not be able to address all the issues.

Proposed regulations have been released but do not cover all issues. The Service has requested comments on some of the issues. In late December 2017 a portion of final regulations were released.

This presentation started with three observations. First, the purpose of these regulations is for easier audits of partnership income tax returns, and if it’s easier to audit then there will be more audits. Second, partners will likely pay more in taxes as a result of audit than under current rules. Third, these new rules add complexity to handling to partnership audits with new elections and new notices. Complexity creates more potential liability and lawsuits.

I. New Changes with the New Rules

A. Default Rule
The new rules set the deficiency and payments at the partnership level. In the past, the Service has had to track down individual partners in order to assess deficiencies and tax payments. Now it is a partnership level audit and payment of tax deficiency (“imputed underpayment”). Tax is computed by using the highest individual or corp. rate regardless of what the individual partner rates are. There are three modifications that can be requested depending on the nature of the partners: amended return modification, tax-exempt partner modification, and tax rate modification.

1. Amended Return Modification. The amended return modification allows a partner to file an amended return for the review year and report share of adjustments arising under the imputed underpayment. The partnership then gets to request a reduction in the underpayment be accessed in the adjustment year. The partnership almost always wants the partner to make the amended return and file the adjustments because this reduces the partnership liability. The speaker suggested that the amended return option should be a mandatory requirement of all partners if requested by the partnership.

2. Tax-Exempt Partner Modification. If one of the partners is tax-exempt and income is not UBTI to the partner, then the partnership can request a reduction in liability payment to the extent of that partner’s share. The speaker recommends that the Partnership Agreement should mandate partners to supply necessary information upon request by partnership.

3. Tax Rate Modification. A partnership cannot claim a rate adjustment solely because the individual partners’ ordinary income rates are lower, but the partnership can claim a modification if the individual partners income is either qualified dividends (not ordinary income) or if the partner is a c-corp. subject to 21% rate.

B. Administrative Adjustment Requests

Under the new rules, a partnership cannot file an amended return. The partnership must file an administrative adjustment request (AAR). This request must be filed by the Partnership Representative. If there is a deficiency as a result of the AAR, the deficiency is treated as an imputed underpayment payable by the partnership unless the partnership files an election out or push-out election. Then the partners must report the adjustment and there is no imputed underpayment.

C. Partnership Representative

In the past there was a “tax matters partner” who was tasked with handling all audits of the partnership. The tax matters partner had to be a partner, but the authority was not exclusive. A notice partner had the ability to intervene in an audit or tax court case. Under the new rules, the old tax matters partner has been replaced with the Partnership Representative. The Service communicates with only the Partnership Representative. The Service has no duty to communicate to other partners and no one can intervene in an audit, and no one has a right to demand notice or information. Determining who should serve as Partnership Representative is very important because the Service notices will only be sent to the
Partnership Representative, and the regulations provide that the Service will not recognize the resignation or removal of a Partnership Representative until an audit has commenced. Partnerships could be under a review and have notices sent to a person that was formerly the Partnership Representative during that year in review but who is not currently serving as Partnership Representative. Partnership cannot file an AAR merely to change the Partnership Representative.

The Partnership Representative does not have to be a partner. It may be an entity but will need to designate a person to act on behalf of the entity. The Partnership Representative must have a substantial presence in the US, a valid Tax ID, address, and availability to meet with the Service. Do get your Partnership Representative to sign in writing that they meet the substantial presence rules. The speaker suggested putting the requirements in the partnership agreement and having the Partnership Representative sign the partnership agreement certifying that they agree to serve and that they meet all audit and substantiation requirements. The speaker did not recommend having a law firm or CPA firm serve as Partnership Representative for the partnerships they represent because the risks and liabilities are too great.

II. Elections

The audit procedure for partnerships under the new rules stays relatively the same as under the old rules. Then partnership will receive notice of proposed partnership adjustment which opens the widow for negotiations. Notice of final adjustments (like a deficiency notice) gives the partnership the ability to contest the matter in tax court. When the tax court decision is final, then the deficiency must be paid.

**Push Out Election.** In 90% of the cases, this election is a good idea. This election can help prevent economic distortion because it relates back to the partners at the time the audit started, not the current partners. It must be made within 45 days of receipt of notice of final partnership adjustment and there is no extension period. There must be a separate election for each year under audit and the Partnership Representative has 90 days from receipt of the final partnership adjustment to decide to challenge the adjustment in court. If the Partnership Representative does not challenge the adjustment, then the adjustment becomes the final determination. The Partnership Representative has 60 days to send out the Push-Out Election to the Service and to each partner information. The Partnership Representative must provide all information necessary for partners to determine and report amount of payment on their returns.

**Election Out.** Final regulations have been released on this election. This is an annual election filed by Partnership Representative when the Partnership files its tax return. If the partnership files to elect out, then there is not a partnership level tax and determination. Not every partnership is eligible to make this election. The partnership must have 100 or fewer partners. The number of partners is determined by number of K-1 issued to eligible partners. Eligible partners are individuals, corporations, certain foreign entities, S corporations (shareholders are counted separately for the 100 partners requirement), and estates of deceased taxpayers. Ineligible partners include partnerships, trusts, disregarded
entities and other types of estates (bankruptcy estates). The partnership cannot elect out if partnership has ineligible partners. With respect to S-corp. partners, the regulations provide that you only look through for the number of partners not the type. A s-corp. partner with shareholders that are trusts or other ineligible partners does not make the s-corp. an ineligible partner.

III. Drafting Considerations

The speaker commented that the easiest part of this process is understanding the rules. It’s much harder to draft provisions to apply or draft around these provisions. He then discussed whether a partnership agreement should address certain topics related to the new audit rules. The speaker recommends having different provisions in different kinds of partnerships based on number and types of partners and assets held in the partnership.

The speaker recommended making amendments to the Partnership Agreements to address the following areas:

• Resignation, Removal, Responsibilities, Authority, Indemnification, Standard of Care, Liability, etc. of Partnership Representative

• Election Out and Push-Out Elections

• Imputed Underpayment Modifications

• Economic Distortions Including Responsibility for Imputed Underpayment, Basis and Capital Account

• Duties of Partners to Partnership Representative and to the Partnership

With respect to elections, the speaker recommends mandatory election so long as there is an eligible partnership and partners because it eliminates many problems and complexities. The partnership agreement needs to contain restrictions on transfers to ineligible partners especially if the election is going to be mandatory. Make an ineligible transfer null and void so that the Partnership Representative does not have to worry about rogue transfers.

The Partnership Agreement should address anomalies when the review year Partnership Representative is different from the adjustment year Partnership Representative and cannot resign because audit has not commenced. The Partnership Agreement should require the review year Partnership Representative to be contractually bound to represent the partnership in the audit until resignation or removal. Consider whether the Partnership Representative’s decisions can be made alone or in conjunction with the consent of others. The Partnership Agreement should provide that the Partnership Representative has a duty to provide audit information to the partners or former partners that might be affected by the outcome of the audit.
The Reporters:
Our on-site local Reporters who are present in Orlando in 2018 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 the Dreyer Law Firm in Stuart, Florida; Herb Braverman Esq., an attorney with Braverman & Associates in Orange Village, Ohio; Kristin Dittus Esq., a solo attorney with offices in Denver, Colorado, Michael Sneeringer Esq., an attorney with Porter, Wright, Morris and Arthur, 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, Tarrant & 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 Editors in 2018 are Joseph G. Hodges Jr. Esq., a solo practitioner in Denver, Colorado, who is the Chief Moderator of the ABA-PTL discussion list. He is being ably assisted in those duties this year by Reporter Bruce A Tannahill Esq.