INTRODUCTION

As we did in January of 1997, 1998 and 1999, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting to this list throughout the coming week highlights of the proceedings of the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 2000 at the Fontainebleau Hilton in Miami Beach, Florida.

Our **on-site local reporters** there in Miami will include:

Theodore B. Atlass Esq. of Denver, Colorado - tatlass@atlass.com

Stephan R. Leimberg Esq. of Bryn Mawr, PA - leimberg@home.com

Alan F. Rothschild Jr. Esq. of Columbus, GA - ar@hatcherstubbs.com

Bruce Stone Esq. of Miami, FL - Brucestone@aol.com

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For those of you without access to the Web, here are the core parts of the schedule:

Scope of Institute

The "Miami Institute" is widely recognized as the premier estate planning program in the country. It is designed for sophisticated attorneys, trust officers, accountants, insurance and financial planners who, through years of experience and practice, are familiar with the principles of estate planning. Its faculty is drawn from the nation's leading estate planning experts, and the papers they produce are considered authoritative on their subjects.

The Institute offers something of interest to every member of the estate planning team. This year's program features a new Case Study series that will illustrate and provide practical guidance on how to implement sophisticated estate planning techniques. Also new this year is the recent developments panel on Monday afternoon featuring three of the nation's foremost estate planning experts, who will guide you through the year's developments on the tax front. The same distinguished panel of experts will be available to answer your questions the next morning during the first of two question and answer sessions. In addition, this year's Institute includes our popular Fundamentals Program, which begins with an optional pre-conference session on planning and drafting for life insurance. The other two fundamentals sessions will be offered during our regular programming schedule, and will cover tax-related drafting and the mathematics of estate planning. The remainder of the program features a wide variety of lectures, workshops, and panel discussions on topics of timely interest to estate planning professionals.

Because of the scope and quality of its program, the Institute has grown to be the largest such gathering of estate planning professionals in the country. Over the past several years attendance at the Institute has risen dramatically, with a record number of over 2,200 estate planning professionals from around the nation in attendance at last year's program. This concentration of estate planning talent has led the Institute to have some of the better characteristics of a national convention of estate planners. Attendees have the opportunity to exchange ideas, to network, and to review the latest in technology and services made available to estate planners by more than 80 book and software publishers, auction houses, trust companies, and other service providers exhibiting at the Institute.

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Coral Gables, Florida

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Robert B. Wolf, Esq.

Tener, Van Kirk, Wolf & Moore, P.C.

Pittsburgh, Pennsylvania

PROGRAM SCHEDULE:

Sunday, January 9

12:00 6:00 p.m.

Registration

Monday, January 10

8:00 a.m. 2:00 p.m.

Registration

8:00 a.m. 9:00 a.m.

Complimentary Continental Breakfast

9:00 a.m. 10:30 a.m. and

10:45 a.m. - 12:15 p.m.

Optional Pre-Conference Fundamentals Program

The Fundamentals of Using Life Insurance in Estate Planning, Including

Planning and Drafting Irrevocable Insurance Trusts. Lawrence Brody

Donald O. Jansen

10:30 a.m. 10:45 a.m.

Break

2:00 - 2:10 p.m.

Introductory Remarks

Tina Hestrom Portuondo, Esq.

Director C Philip E. Heckerling Institute

2:10 3:30 p.m.

Recent Developments in Estate, Gift and

Income Taxation - 1999 - Part One

Richard B. Covey, Esq.

S. Stacy Eastland

Malcolm A. Moore

3:30 3:45 p.m.

Break

3:45 5:15 p.m.

Recent Developments in Estate, Gift and

Income Taxation - 1999 - Part Two

6:00 7:00 p.m.

Complimentary Reception for Registrants

Tuesday, January 11

8:00 9:00 a.m.

Complimentary Continental Breakfast

9:00 10:30 a.m.

Question & Answer I

Richard B. Covey, Esq.

Dave L. Cornfeld

S. Stacy Eastland

Malcolm A. Moore

10:30 10:45 a.m.

Break

10:45 11:30 a.m.

When IRD Meets ERISA: Making Retirement Benefits

Payable to Trusts

Natalie B. Choate

11:30 a.m. 12:15 p.m.

Life Insurance Potpourri No Employer?

Try Family Split Dollar Other Recent Developments

Donald O. Jansen

12:15 2:00 p.m.

Lunch Break

2:00 2:45 p.m.

Remembering the Grandchildren Leverage,

Discount and Freeze Perpetually

Georgiana J. Slade

2:45 3:30 p.m.

Guiding (Controlling?) the Children and Grandchildren:

Planning and Drafting to Influence Behavior

Howard M. McCue III

3:30 3:45 p.m.

Break

3:45 4:30 p.m.

Taking the "Foreign" Out of Foreign Trusts Recognizing

Them and Advising U.S. Clients with Connections to Them

Maria E. Núñez

4:30 5:15 p.m.

Picking Up the Pieces When Law and Ethics Collide

Bruce S. Ross

Wednesday, January 12

8:00 9:00 a.m.

Complimentary Continental Breakfast

9:00 9:45 a.m.

To Be or Not To Be: An LLC, LP, LLP, S or a C

Louis A. Mezzullo

9:45 10:30 a.m.

Making Sure Your Transfer Tax Planning Doesn't Create

Income Tax Nightmares When You Sell the Family Business

Richard B. Robinson

10:30 10:45 a.m.

Break

10:45 11:30 a.m.

Fractionalized Equity Valuation Planning: An Egyptian

Mortician's Techniques for Preserving (Mummifying)

Post-Mortem Valuation Discounts

Susan K. Smith

11:30 a.m. 12:15 p.m.

After the Fact, But It's Still Not Too Late An Overview of Post-Mortem

Tax Planning Strategies

Steve R. Akers

12:15 2:00 p.m.

Lunch Break

2:00 5:15 p.m.

Fundamentals Program Millennium Schminium:

Is Your Tax Drafting Y2K Compliant?

(Runs concurrently with the Special Sessions)

M. Read Moore

David Powell

2:00 3:30 p.m.

Special Sessions I

I-A CASE STUDY Retirement Benefits Payable to Trusts

Natalie B. Choate

I-B Hot Transfer Tax Valuation Issues

Susan K. Smith

Judge David Laro

John W. Porter

I-C The Total Return Trust Revolution: An Introduction

Robert B. Wolf

Stephan R. Leimberg

Susan Porter

I-D GSTT: Lifetime Transfers

Georgiana J. Slade

I-E Foreign Trusts

Maria E. Núñez

3:30 3:45 p.m.

Break

3:45 5:15 p.m.

Special Sessions II

II-A CASE STUDY Total Return Trusts:

Techniques and Applications

Robert B. Wolf

Bruce A. Guiot

II-B Charitable Planning Update @ Y2K

Jerry J. McCoy

II-C When Law and Ethics Collide

Bruce S. Ross

II-D Post-Mortem Tax Planning

Steve R. Akers

II-E Choice of Entity

Louis A. Mezzullo

Thursday, January 13

8:00 9:00 a.m.

Complimentary Continental Breakfast

9:00 9:45 a.m.

Giving Well is the Best Revenge:

Planning Opportunities with Stock Options

Daniel H. Markstein, III

9:45 10:30 a.m

No More "Gravy Train": 1997 Law Revisions Dramatically

Affect the Economics of CRTs Only Those With True

Charitable Motivation Should Create Them

Byrle M. Abbin

10:30 10:45 a.m.

Break

10:45 11:30 a.m.

Non-Charitable Inter Vivos Gifts A Plan for Tax Relief

James W. Narron

11:30 a.m. 12:15 p.m.

Beyond the Basic Freeze: Further Uses of

Deferred Payment Sales and Avoiding the Meltdown

Jerome M. Hesch

12:15 2:00 p.m.

Lunch Break

2:00 3:30 p.m. and

3:45 5:15 p.m.

Fundamentals Program Numbers Matter:

(Runs concurrently with the Special Sessions)

Lawrence P. Katzenstein

2:00 3:30 p.m

Special Sessions III

III-A CASE STUDY Putting It All Together:

A Potpourri of Potential Plans

Jon J. Gallo

III-B Hot Transfer Tax Valuation Issues

(Repeat of Session I-B)

Susan K. Smith

Judge David Laro

John W. Porter

III-C Ethical Issues and Developments in Multidisciplinary Practice

Donna Barwick

Dennis I. Belcher

Samuel A. DiPiazza, Jr.

Douglas W. Duncan

Sherwin P. Simmons

III-D Planning and Drafting to Influence Behavior

Howard M. McCue III

III-E Planning Opportunities with Stock Options

Daniel H. Markstein, III

3:30 3:45 p.m.

Break

3:45 5:15 p.m.

Special Sessions IV

IV-A CASE STUDY Putting It All Together:

A Potpourri of Potential Plans (Continued)

Jon J. Gallo

IV-B CRTs and CLTs

Byrle M. Abbin

Jonathan Gopman

IV-C Non-Charitable Inter Vivos Gifts

James W. Narron

IV-D Sale of the Family Business

Richard B. Robinson

IV-E Deferred Payment Sales

Jerome M. Hesch

Friday, January 14

8:00 9:00 a.m. Complimentary Continental Breakfast

9:00 9:45 a.m.

Coming Soon to Your State: Community Property

M. Read Moore

9:45 10:30 a.m.

A Significant Challenge: Estate Planning for Individuals

Worth $3 Million or Less

Jonathan G. Blattmachr

10:30 10:45 a.m.

Break

10:45 a.m. 12:15 p.m.

Question & Answer II

Alan D. Bonapart

Louis A. Mezzullo

Susan Porter

Edward S. Schlesinger

General Information

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Heckerling Institute Report
Report #1 - Software and Vendors

The following is Report #1 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 2000 at the Fontainebleau Hilton in Miami Beach, Florida.

First, Institute Director, Tina Portuondo reports that the Institute did not suffer any Y2K glitches either, although they did schedule it a week later than usual this year just to be safe given that so many of the participants were going to be flying into Miami to attend the Institute.

This Report covers the Software and some of the other Vendors who are exhibiting at the Institute.

The software vendor list this year includes (in alpha order):

Advanced Logic Systems, Inc. [DAE for W&T and Probate]
BNA Software/Tax Management [ETP, ITP, etc.]
Brentmark Software Inc. [CFP, RIA, etc.]
CCH Inc. [ViewPlan's Vista, etc.]
Crescendo Planned Gifts Software [Pro and Lite]
Eidelman Associates [DAE for W&T]
Evaluation Services Inc.[On-line Valuations]
EVP Systems Inc. [On-line Valuations]
Financial Data Services Inc. [On-line Valuations]
InsMark Inc. [EP Systems]
The Lackner Group Inc. [6-in1 FAS]
Lawgic Publishing Company [CA and FL W&T Systems]
Lexite Development [ZCalc]
Matthew Bender/Lexis Publishing [HotDocs, etc.]
Ocaso Software
PenD'Calc Corporation [Retirement, IRA]
ProBATE Software [FAS, EP]
ProDoc, Inc. [EP, EA, W&T]
RIA Group [WTP, EP, etc.]
Schumacher Publishing [RLTs and Web Sites]
SunGard Trust Systems [W&T]
The Technology Group [Wealth Transfer Planning]
U.S. Trust Company of New York [EPlan, etc.]
West Group [IEP, DWTA, etc.]
Zane & Associates Inc. [FAS]

The initial rumors afloat along vendor row and elsewhere included the following:

Heckerling Institute Report
Report #2 - Opening Session/CLE from 1/10

The following is Report #2 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers the Recent Developments opening session and other CLE sessions that were held on Monday, January 10th.

This report was filed by on-site reporter, and Miami resident, Bruce Stone. Bruce is also a member of the Institute's Advisory Committee.

The University of Miami Heckerling Estate Planning Institute convened on Monday afternoon, January 10th, at the Fontainebleau Hotel in Miami Beach. Over 2,600 registrants enjoyed 80 degree weather with sunny skies and an emerald green ocean - a stark contrast to last year's inhospitable weather.

Continuing with last year's success, the Institute got off to a good start Monday morning with a Fundamentals basic track course on the Fundamentals of Using Life Insurance in Estate Planning. It was presented by Lawrence Brody and Donald Jansen and was very well attended, but not by this reporter.

Institute Director, Tina Portuondo of the University of Miami, officially convened the 34th Institute in the afternoon. After introductory remarks, she announced that Dick Covey has decided to retire from his current developments duties, which he has delivered each year since 1962 when the Institute was founded. Tina said that Dick had graciously agreed to participate as part of a recent events panel discussion this year to ease the transition. She presented Dick with a gift and thanked him for his many years of service.

Dick Covey then spoke, telling the audience how Phil Heckerling had talked him into being a part of the conference two years before the Institute was even founded. He said that after all these years, it was simply time to let someone else carry on the tradition. He said that this year's presentation will be his last. He made it clear that although he is retiring from the Institute, he is not retiring from the practice of law. Dick brought his standing ovation to an end with a loud and falsely gruff "sit down!" And with that, the current developments discussion began.

Dick touched on a variety of topics, including Revenue Ruling 2000-2. He stated that this ruling was no surprise, because the section 2056 regulations have long equated a withdrawal right with the right to income for marital deduction purposes.

Heckerling Institute Report
Report #3 - "When IRD Meets ERISA"

The following is Report #3 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers Natalie Choate's Tuesday morning session entitled "When IRD Meets ERISA: Making Retirement Benefits Payable to Trusts."

This report was filed by on-site reporter, Robert Wolf. Bob is also a speaker at this year's Institute and an acknowledged expert on TRU.

Natalie Choate gave a brilliantly clear and entertaining session on the most difficult issue facing estate planners dealing with retirement plan assets, and that is, when is a trust a qualifying trust so that the beneficiaries of the trust can be considered "designated beneficiaries" for purposes of the pay out rules of Section 401(a)(9). She broke the issue down into 6 rules, although the IRS only explicitly admits to 4. She had inquired of one Treasury official as to why their 4 was really 6, and he replied that "it depended upon what the meaning of 4 was for," or words to that effect. These rules must be met at the time of the RBD, or, if later, at the date the trust is named as beneficiary.

1. **Trust must be valid under state law**. No big problem here. A testamentary trust should be O.K.

2. **Beneficiaries must be "identifiable"**. This rule causes a good deal more difficulty--as of the RBD, is it possible to determine who is the oldest person who could ever be a beneficiary of the trust.(the oldest one needs to be determined, because it is the oldest one used for the life expectancy calculation). Similar to the common law Rule against Perpetuities, because even the possibility of flunking the test is enough. Hence "to spouse and then to issue" is O.K., since issue must be younger than spouse (query by reporter-adoption?), but if it is to spouse and then to issue and spouses of issue" it would flunk, because the child could marry someone older than the child's parent.

3. **Irrevocability**. The trust must be irrevocable or will, by its, terms, be irrevocable upon the death of the employee. This is the "new" rule--Prop.

Reg. Section 5(b)(2). This should mean that a revocable living trust or a testamentary trust should qualify.

4. **Documentation Requirement**.

(Death before RBD) The new rule here has been relaxed, to allow the documentation to be provided "to the plan administrator" by the end of the ninth month beginning after the death of" the participant. Either a copy of the trust or certain summary information about the trust and the beneficiaries.

(at RBD) to get to use a beneficiary's life expectancy, the participant must provide a copy of the trust to the plan administrator, and agree that if the document is amended any time in the future, to provide a copy of the trust within a reasonable time to the plan administrator.

Note re IRA's --they have no plan administrator, so the custodian is the safest bet. If litigating, the participant arguably is plan administrator, since he is responsible for compliance (not the custodian)

What about people using living trusts who are taking out over single life expectancy whose RBD arrived between 87and 97? Could they convert to a slower payout by complying now by following the rules NOW? Good question --no answer yet.

5. **All beneficiaries must be individuals**. A charity is not an individual. An estate is not an individual, according to the IRS in this context (although it seems to be for the purpose of spousal rollovers). If your trust allows payment of taxes and expenses of the estate from the trust, arguably the estate is a beneficiary--hence you flunk the test. Natalie thinks this is wrong, because of the treatment of estates as "look-through" entities for spousal rollover purposes. Why not this too! This is a real trap-so put language that prohibits such payment from these assets in your trusts. If you're in trouble on this, you may want to look for some protective statute in your state which holds IRA's and qualified plans harmless from creditors. For arguments on this see the September issue of *Trusts and Estates Magazine*.

6. **No changing beneficiaries after Participant's death**. This could cause problems for all powers of appointment, but several private letter rulings indicate that the power itself should be O.K., so long as the participants themselves would qualify. So, as long as no possible appointee would disqualify the trust, you should be O.K.

Who are beneficiaries--note that you can disregard contingent beneficiaries, if they will not take if the preceding beneficiaries live to their life expectancies. So, if you have a charitable beneficiary if a child dies before a trust terminates at 35, that is O.K., because if the child lives to their actuarial life expectancy, the charity won't take.

Dynasty Trusts-Natalie thinks these will flunk simply because the benefits will never really all go to beneficiaries who are individuals.

For more on this, and also, on the new guidance on TIP Trust qualification see Natalie's website at http://www.ataxplan.com

That's it for Report #3.

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Heckerling Institute Report
Report #4 - The Tuesday Sessions

The following is Report #4 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers **all the Tuesday sessions**. More in depth reports on the sessions that were done by Messrs Choate, Jansen and McCue can be found in Reports 3 and 5.

This report was filed by on-site reporter, and Miami resident, Bruce Stone. Bruce is also a member of the Institute's Advisory Committee.

The **second day of the Heckerling Institute** opened with a **Question and Answer** session. The questions were fielded by **Dick Covey, Mal Moore, Stacy Eastland, and Dave Cornfeld**.

The panel opened with a discussion of the overall state of the transfer tax system. Mal Moore thinks that repeal of the estate and gift tax is unlikely, but he said that the question is how do we advise clients in the current situation? Perhaps we counsel clients not to make large taxable gifts. How should we change the drafting of our documents? Stacy added that estate freezing techniques and discounting strategies are in favor in the current environment. The panel generally thought that the revenues that will be raised by the estate tax in the coming years are so large that if the system is repealed, it will have to be replaced with something that will generate a large amount of revenue in its place.

Dick addressed a question that asked if a surviving spouse's elective share really would attract DNI if it does not receive interest or any share of post-mortem income under state law. He said that the answer is clearly yes, it will attract DNI. Elective share amounts are not described in section 663 (a)(1), and therefore they will attract DNI even under the separate share rules.

Mal answered a question that asked if a simple statement that a sale to an intentionally defective trust is not a gift because it is for adequate and full consideration will be sufficient under the gift tax disclosure regulations. Mal thought that such a statement should suffice. Furthermore, if a gift tax return is filed even though not required, it should commence the statute of limitations.

In addressing another question, Stacy stated that he is now worried much less about section 2704(b) issues in family limited partnership transactions than he was several years ago. He does utilize gifts of limited partnership interests to public charities fairly frequently in his planning. Giving the charity a Class A preferred limited partner interest (with a coupon interest rate) allows clients to pass money to charities without regard to the percentage limits on charitable donations, AMT concerns, etc.

Dave said that a spouse can hold a $5,000 Crummey withdrawal right without estate tax problems as long as the spouse doesn't make a contribution to the trust. The period to disclaim a 5 and 5 withdrawal right would commence each time that a contribution was made to the trust subject to the withdrawal right, but he does not recommend disclaiming such a right because of a risk that the disclaimer might be regarded as a release of the right. It is better simply to allow each withdrawal right to lapse, if it is not to be exercised.

Mal said that an intentionally defective trust should not have Crummey withdrawal powers. It will become a grantor trust over time with respect to the Crummey beneficiaries. If the transaction is properly planned, no gifts should be involved with transfers to the trust (other than any initial seed gift of capital).

Stacy recommends the use of disclaimers of pecuniary amounts over $X where an estate has hard to value assets, and for the will to provide for those disclaimed interests to pass to charity. He described this as a poison pill that works. The downside is that you may have to negotiate with the charity or with the state attorney general over the value of the estate assets.

Stacy recommends a weighted appraisal approach which assigns a defined percentage of emphasis on asset valuations, and the balance of the percentage emphasis on going concern factors, and then applying minority discounts, etc. This gives guidance in how much discount to allow for built-in capital gains.

Dave said that a gift to a corporation qualifies for the annual exclusion, as a gift to the shareholders, as do gifts by analogy to LLCs and limited partnerships - subject to the facts and circumstances of each situation, of course.

Mal stated that a surviving spouse's disclaimer of an asset that would not receive a basis step adjustment because of section 1014(e) will result in the basis adjustment being allowed if the asset passes to someone other than the spouse (such as to a trust in which the spouse has a beneficial interest).

Mal said that if the beneficiary of a QPRT wants to buy a more expensive house than is held in the QPRT, the beneficiary can either contribute the additional cash needed (which must be spent within 3 months), or do a joint purchase with the QPRT on a fractional interest basis.

Stacy said that the most common drafting error in family limited partnerships that he encounters is giving the general partner too much wide open discretion that overrides the fiduciary duties that the general partner otherwise would owe to the limited partners.

Dave stated that no taxable gift will be caused if the donor/custodian of an UGMA account simply resigns as custodian of the account to avoid estate tax inclusion under section 2038. However, if the custodian dies within 3 years after the resignation, inclusion will still result because of sections 2035(d)(2) and 2038.

Dick repeated his comments from yesterday about the gradual increase in the lack of professionalism of the Service in the past few years. As an example, he referred to TAM 199935003, involving the consequences of a commutation clause in a common law GRIT, as an example of egregious abuse by the Service of its authority.

Following the opening Q&A session, **Natalie Choate** then spoke on **trusts as beneficiaries of qualified plans**.

She recommended putting on your estate administration checklist to give a copy of the client's trust to the plan administrator within the 9 month deadline, if the client dies before the required beginning date (RBD). (Note: the 9 month deadline is not the same date as the 706 due date.)

If the client dies after reaching the RBD, Natalie recommends sending a copy of the trust to the administrator, along with a statement that the client will notify the administrator of any later amendments to the trust. A copy of the trust should be sent to IRA administrators, even if they don't want it.

To avoid the IRS rule that an estate does not qualify as a designated beneficiary, the trust should contain language prohibiting payments back to the estate to pay taxes, administration expenses, claims, and unfunded bequests.

Natalie brought down the house when she picked up a copy of her book to answer a point about "designated beneficiaries" - she turned to a page and began to read the words "... she moaned softly as he ...." Natalie then said "oops, that's in the new edition!" She referred the audience to her website to receive an updated copy of her outline that will analyze Revenue Ruling 2000-2. Her website is www.ataxplan.com.

Following Natalie, **Don Jansen** then spoke on current developments on the **use of life insurance in estate planning**, and generally on family or private split dollar (PSD).

Don reviewed a number of rulings dealing with exceptions to the transfer for value rules, tax-free exchanges of policies, and modified endowment contract issues. He then turned to an analysis of PSD rulings, noting that no rulings have been issued since 1998 in any split dollar arrangement (not just PSD). Before then, there were only two private letter rulings on PSD arrangements.

If the noninsured spouse is a party to a PSD arrangement, care must be taken to address what happens if the noninsured spouse dies before the insured spouse. The noninsured spouse's interest in the arrangement should not pass to the insured spouse or to any trust in which the insured spouse is a beneficiary or trustee.

If the insured is a party to a PSD arrangement, there should be no right to borrow, and there should only be a barebones collateral assignment (a security interest in the contract), without any right to surrender, borrow, assign, change beneficiaries, etc.

Overall, due to the lack of much guidance, and due to the apparent attention being given by the Service, caution should be exercised in the use of PSD arrangements, especially if the insured is a party.

Following the lunch break, **Georgianna Slade** spoke on **inter vivos planning with generation skipping trusts**.

Clients should make GST trust grantor trusts for income tax purposes wherever feasible, and should fund the trusts with cash (full basis, with no possibility for valuation disputes and arguments over GST inclusion ratios). To the extent possible, the trust should be made a party to valuation shifting opportunities, such as allowing the trust to take advantage of business opportunities, or by making loans on arms length terms to allow the trust to make investments that might not otherwise be possible (such as hedge funds).

When charitable lead trusts are used, attention must be paid to the private foundation rules if closely held stock is used. Usually the excess business holding and jeopardy investment prohibited transaction rules will be involved, because ordinarily the charitable deduction will exceed 60%.

Georgianna discussed a technique that might possibly minimize GST tax ultimately payable, by planning with the generation assignment rules. A trust can be drafted for the benefit of great grandchildren (making no provisions for children or grandchildren), with a power in the trustee to add other descendants as beneficiaries. Following the initial transfer, the transferor's generation assignment should drop to the level immediately above the great grandchildren's level. If the trustee later adds children or grandchildren as beneficiaries, distributions to the grandchildren should not be subject to GST tax. This could be coupled with a power to divide the trust, and then add children or grandchildren as beneficiaries only for a separate trust after the division.

Following Georgianna, **Howard (Scott) McCue** spoke on **planning and drafting to influence the behavior of beneficiaries**.

He cited the trend of ultra-wealthy individuals such as Bill Gates and Warren Buffet not to leave their descendants enormous sums of money, coupled with a trend to create incentive trusts for clients who do want to leave their wealth in trust for their descendants.

Clients mostly want to encourage beneficiaries to receive an education, to work hard, to enter social service fields (such as teaching, although this is nowhere nearly as common as it was years ago), to provide stewardship of the family wealth for succeeding generations, and to engage in philanthropy. These purposes are encouraged almost exclusively through the use of trusts, including incentive trusts. However, incentive trusts have significant disadvantages - they lack flexibility, they cannot adapt easily over time to changing value systems, and they present problems of enforcement. Scott cited one example of a beneficiary who was required to undergo drug testing every month, which alienated her from her family members and made her forego her interest in the trust.

Scott also analyzed how entity structures that are now commonly used in estate planning (such as limited partnerships) may strip control away from individual family members, with planned or unplanned consequences on behavior, and which may provide wanted or unwanted insulation for managers of the family wealth.

Following Scott, **Maria Nunez** gave an overview of the **foreign trust rules** since enactment of the 1996 and 1997 tax legislation.

Maria cautioned practitioners on the importance of understanding what is and what is not a foreign trust under the new rules, and warned that common sense is often deceptive and wrong in this area. Generally speaking, a trust beneficiary is any person who could possibly benefit from the trust, including persons who could benefit if the trust were amended. In most trusts this cause a virtually unlimited class of beneficiaries, both domestic and foreign. It is easy for a trust to be foreign and not know it, if you do not have a familiarity with the new rules.

The closing speaker for Tuesday was **Bruce Ross**, whoi spoke on some **trends in the rules governing professional conduct in trusts and estates practice**.

Only six states now clearly require privity as a condition precedent to brining a claim for legal malpractice in estate planning: Ohio, Maryland, Nebraska, New York, Texas, and Virginia. The issue is in a case that will be decided by the Hawaii Supreme Court.

Liability to beneficiaries for attorneys who represent fiduciaries is a hot area now. Generally, privity is required to sue an attorney representing a fiduciary for negligence. However, if more than negligence is allegedly involved, such as aiding and abetting, privity requirements are being relaxed. This is certainly true in the Restatement of Law Governing Lawyers. The Ethics 2000 project also may make significant changes in the rules governing confidentiality of communications between lawyers and fiduciary clients.

Bruce advised that ACTEC has completed a multi-year project on publishing engagement letters in estate planning and administration matters. Those letters and the third edition of the ACTEC commentaries on the rules of professional conduct can be purchased from ACTEC by anyone at a nominal cost. [**Editor's Note:** In addition, they will soon be available in full text on the public side of the ACTEC Web site at http://www.actec.org under RESOURCES]

That's it for Report #4.

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Heckerling Institute Report
Report #4a - The Tuesday Sessions

The following is Report #4A from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report has been numbered 4A because it is a **clarifying post** about some remarks that were attributed to **Mal Moore** by our on-site reporter, Bruce Stone, as having been made by Mal during the **Tuesday morning Q&A session** that Mal and Messrs Covey, Cornfeld and Eastland presented.

First, here from Report #4 [NOT Report #6] (which Report was all about the software vendors) **is the remark in question** that Mal supposedly made as the same was reported to us by Bruce:

"Mal said that an intentionally defective trust should not have Crummey withdrawal powers. It will become a grantor trust over time with respect to the Crummey beneficiaries. If the transaction is properly planned, no gifts should be involved with transfers to the trust (other than any initial seed gift of capital)."

In response to this, the following messages have been posted on the ABA-PTL list and are being republished here so all the subscribers to all of the lists to which these reports are being sent can read them and reach their own conclusions. **In addition**, should Mal wish to have us post a clarification of his remarks in this regard, if one is needed, we would be glad to do so, and perhaps one of our on-site reporters could raise this issue with him if he is still there in Miami.

<<Message One>>
Date: Wed, 12 Jan 2000 21:18:14 EST
From: "Dennis P. Williams" <TAXPLAYER@AOL.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Mal suggested that

"Do not use Crummey withdraw power for Trust that are to be "Defective" and to which the Grantor will sell assets, because over time the Powerholders will be the beneficiaries of the Trust."

Correct me if I am wrong, if the Grantor trust rule under Code Section 671-677 are "violated" the Trust is "defective" with respect to the Grantor. If concurrently, a Beneficiary is a "substantial owner" of the Trust under Code Section 678, because of the lapsed withdraw power, the Code Section
671-677 power will supersede the Code Section 678 provisions, and the Grantor, and not the Powerholders, will be treated as if he/she owned the Trust property.

After the Grantor death (or should the Code Section 671-677 provisions removed, then the Powerholders will "spring" into being the "Substantial Owner, under Code Section 678.

Does anyone share Mal's concerns about having Crummey Powers in a Trust that
is to be used y the Grantor for his/her Sale of a Defective Grantor Trust?

This is important to me, becuase I have a Crummey Trust that I am about to have the Grantor sell some Class B Non-voitng stock (S-corportion) Stock,
and I need it to be 100% defective, with respect to the Grantor (and not with
respct to the Powerholders).

Any comments will be appreciated.

Please feel to e-mail me at work at "dwilliams@webersterlinglaw.com"

Dennis P. Williams
Weber & Sterling, LLC
419-893-7207
Fax 419-893-7146
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<<Message Two>>
Date: Thu, 13 Jan 2000 10:06:05 -0500
From: "<Bruce D. Steiner>" <BSteiner@KKWC.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

If Mal is correct, wouldn't this produce a *good* result? During the grantor's lifetime, the grantor pays the income tax, even though the trust

is not included in the grantor's estate. After the grantor's death, the beneficiary pays the income tax, even though the trust may not be included
in the beneficiary's estate.

Bruce Steiner

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<<Message Three>>
Date: Thu, 13 Jan 2000 12:36:30 -0500
From: Doug Delaney <delaneyhhi@HARGRAY.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Also, assuming the grantor has a larger marginal income tax bracket than the
beneficiary, isn't the audit risk lower as we may have a sizable income tax refund due?

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<<Message Four>>
Date: Thu, 13 Jan 2000 07:57:19 -0800
From: Steve Oshins <steveo@WIZARD.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Bruce-

I think Mal's comment was to NOT use Crummey powers. I will not make any
comments on that. But there is at least one PLR out there on that (that David Handler brought to my attention a couple of years ago when he and I
were discussing it).

However, with respect to the trust being grantor defective during life and then beneficiary defective after death, see the 1990 PLR on this which was later changed by a 1993 PLR. According to the 1993 PLR, it doesn't work. The cites to the PLRs are in the 1998 T&E article my father and I co-authored called "Protecting & Preserving Wealth into the Next Millenium"
which I think you all know how to find on the Published Articles page at http://www.oshins.com/. Sorry, I'm too lazy this morning to look for the actual cites.

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<<Message Five>>
Date: Thu, 13 Jan 2000 11:24:19 -0500
From: Wes Yang <wyang@KLETTLIEBER.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Steve,

If one limited the withdrawal rights to a 5 & 5 standard, would this avoid the problem of beneficiaries being treated as the transferors? My understanding (perhaps erroneous) is that it is the lapse of the withdrawal power above the 5 & 5 amount that is treated as being transferred by the beneficiary. While this obviously is more limiting than a full annual exclusion Crummey withdrawal amount, it would at least provide use of some portion of the annual exclusion on gifts to the defective trust. I understand (or at least I think I do) that the exclusion is not available with respect to the GST, and therefore GST exemption must be allocated, if the trust is a GST trust. Is my understanding a misunderstanding? Thanks.

Wesley Yang, Esq., CPA
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One Oxford Center, 40th Floor
Pittsburgh, PA 15219
412-392-2022
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<<Message Six>>
Date: Wed, 12 Jan 2000 21:25:05 EST
From: "Dennis P. Williams" <TAXPLAYER@AOL.COM>
Subject: Re: [ABA-PTL] Miami Heckerling Institute 2000 - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Oh, one final question.

If a Defective Grantor Trust has a provisions that obligates the Trustee to pay to the Grantor any income tax attributable to the Trust's income so long
as it is defective, I believe there is a PLR that states there will be no Code Section 2036 or 2038 problem for the Grantor.

Would the same result apply if the Trust has such a provision that permits, but does not obligate, the Trustee to pay to the Grantor an amount equal to
the income tax attributable to the Trust's income?

I believe Wealth Transfer Planning form use "may," and not "shall" in the provisions related to paying the grantor an amount equal to the income tax
attributable to the Trust assets.

I would rather use "may!"

Thank you for you thoughts.

Dennis P. Williams, JD and CPA (inactive)

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<<Message Seven>>
Date: Wed, 12 Jan 2000 22:14:01 -0500
From: Don Cairns <doncairns1@WORLDNET.ATT.NET>
Subject: Re: [ABA-PTL] Defective trusts - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Try to avoid needing the reimbursement clause - in non-GST trust you're returning value to the settlor - in GST context you're doing that and wasting the GSTT exemption. If settlor can't handle the income tax (a good
way to reduce settlor's estate without transfer tax) consider giving the independent trustee authority to add the spouse as a beneficiary and move the income tax money out of the trust back to settlor/spouse. (Yeah, yeah,
not always a spouse . . .) Using power in trustee to add beneficiaries such as spouse and charities is an excellent way to achieve grantor trust status.

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<<Message Eight>>
Date: Wed, 12 Jan 2000 22:16:36 EST
From: "Dennis P. Williams" <TAXPLAYER@AOL.COM>

Subject: Re: [ABA-PTL] Defective trusts - Report #6 **[sic #4]**
To: ABA-PTL@HOME.EASE.LSOFT.COM

Good Comments:

I generally give a Disinterested Trustee the power to remove the defective provision (and add them back later) so prospectively the tax liability can be
shift from the grantor to the trust and back!

I have not used the "reimbursement" provisions, because I do not like to rely
on PLRs.

Dennis P. Williams, JD and CPA (inactive)

<<Message Nine>>
Date: Thu, 13 Jan 2000 12:41:44 -0600
From: "James A. Williams" <jwilliams@GDHM.COM>
Subject: [ABA-PTL] Crummey Powers in Defective Grantor Trusts
To: ABA-PTL@HOME.EASE.LSOFT.COM

One of the reports **[#4, not #6]** from the Heckerling Institute correctly attributed to Mal
Moore (while serving on a question and answer panel) the flat footed comment
that defective grantor trusts shouldn't have Crummey powers. I was in the
audience. As Dennis Williams points out in his earlier post, Mal is dead wrong
on this point. He overlooked the fact that grantor held powers under Sections
671-677 trump Sec. 678 powers. I think he was just going too fast and that what
he meant to say was that it is generally best to have such powers lapse protected. Unfortunately the other panel members (Covey and Cornfield and
Eastland) were preoccupied with their own questions and Mal's overstatement
wasn't corrected. That wasn't the only wrong answer given by the question and
answer panel during that session. It's unfortunate that the reporter passed the
comment along without editorial comment about, at least, its questionability.

James A. Williams
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<<Message Ten>>
Date: Thu, 13 Jan 2000 13:33:10 -0600
From: "Jay S. Goldenberg" <attyjsg@CHICPLAN.COM>
Subject: Re: [ABA-PTL] Crummey Powers in Defective Grantor Trusts
To: ABA-PTL@HOME.EASE.LSOFT.COM

[W] well, there is an alternative answer. While I consider the whole
Service theory on
Crummey powers making the holder the "owner", I point out that 678 was
only *one* of
the theories they've propounded. Another is that the power holder is
treated as
though they themselves had withdrawn the money and turned around and
recontributed
-- i.e., becoming the grantor! In fact, this theory was used to qualify trusts
as S
shareholders. In such case, 671 wouldn't be trumping 678, because it's
not a 678
issue.

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http://www.chicplan.com/
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<<Message Eleven>>
Date: Thu, 13 Jan 2000 14:37:05 EST
From: Nassaujim@AOL.COM
Subject: Re: [ABA-PTL] Crummey Powers in Defective Grantor Trusts
To: ABA-PTL@HOME.EASE.LSOFT.COM

Educate me: I thought that when a Crummey power (aka a General Power

of
Appointment) is allowed to lapse, the beneficiary who allowed the lapse to occur is deemed to have taken the property and recontributed it to the trust
for purposes of the grantor trust rules, thereby making that beneficiary a partial grantor. and in a typical defective trust arrangement, this dirties the diaper.

and unlike the transfer tax rules, these is no 5 or 5 safe harbor.

I have heard this conclusion from a number of sources other than Mal Moore.

if this is wrong, please enlighten me.

Jimmy

James M. Floyd, LL.M.
2030 Franklin Street
Suite 300
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nassaujim@aol.com
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<<Message Twelve>>
Date: Thu, 13 Jan 2000 15:29:50 -0600
From: "David A. Handler" <david_handler@CHICAGO.KIRKLAND.COM>
Subject: Re: [ABA-PTL] Crummey Powers in Defective Grantor Trusts
To: ABA-PTL@HOME.EASE.LSOFT.COM

Section 678(b) says that if the trust is a grantor trust as to the grantor under
671-677, then 678(a) (which makes it a grantor trust as to a beneficiary) doesn't apply. However, 678(b) says that in such circumstances 678(a) doesn't
apply with respect to a power over income, but doesn't say anything about
principal. So, one could argue that a crummey power over a grantor trust makes
the beneficiary the owner of the principal and the grantor the owner of the income. Many commentators feel this is a drafting error and thus "read" 678(b)
as if it says income and principal.

PLR 9141027 held that where the grantor was taxable on the income and

principal
under 677 and 674, the holders of withdrawal rights would not be treated
as the
owners of any part of the trust under 678. Thus, the IRS treats 678(b) as
if it
reads "income and principal." PLR 9309023 concurs. There are no rulings
in
which the IRS has held to the contrary.

David A. Handler
Kirkland & Ellis
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<<Message Thirteen>>
Date: Thu, 13 Jan 2000 16:58:35 EST
From: "Daniel R. Ross" <DanRRoss@AOL.COM>
Subject: Re: [ABA-PTL] Crummey Powers in Defective Grantor Trusts
To: ABA-PTL@HOME.EASE.LSOFT.COM

To the best of my knowledge there is no definitive authority of the income
tax consequences of the lapse of a 5&5 power. A number of years ago I
was
involved in a panel at the Hartford Tax Institute discussing this issue. A
follow-up article appeared in the Journal of Taxation.

The IRS has argued, though I am not sure there are any published rulings,
that section 678, unlike sections 2041 and 2514, contains no 5&5
exception,
and that, therefore, the lapse of a withdrawal power, even if limited to the
5&5 level, is a release for purposes of section 678. However, I and the
other panelists concluded there was more to the analysis. Both sections
2041
and 2514 contain specific language providing that the lapse of a power
shall
be treated as the release of a power; the release of a power is, of course,
a
taxable event under section 2514 and, in specified circumstances, may be
a
tax trigger under section 2041. Section 678, like sections 2041 and 2514
specifies the circumstances when a release of a power is a taxable event,
but
unlike the estate and gift tax sections, section 678 contains no language
specifically stating that a lapse of a power shall be treated as a release.
Unless there is a common law concept that a lapse should be treated as a
release, this difference in statutory language would suggest that a lapse of
a power, whether or not limited to the 5&5 level, is not a tax trigger for

purposes of section 678.

It has been many years since I have researched this issue. If anyone on the
list is aware of any authority that would contradict the above analysis, I would be most interested.

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________________________**The End**

That's it for Report #4A.
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Heckerling Institute Report
Report #4b - Rebuttal to Mal Moore Comments

The following is Special Report #4B regarding the 34th Annual Philip E. Heckerling Institute on Estate Planning that was held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report has been numbered 4B because it relates specifically to previously published Reports 4 and 4A and contains Mal Moore's rebuttal comments about some remarks that were attributed to him by our on-site reporter, Bruce Stone, as having been made by him during the **Tuesday morning Q&A session** that Mal and Messrs Covey, Cornfeld and Eastland presented.

First, here from Report #4 are the remarks in question that Mal supposedly made as the same were reported to us by Bruce:

"Mal said that an intentionally defective trust should not have Crummey withdrawal powers. It will become a grantor trust over time with respect to the Crummey beneficiaries. If the transaction is properly planned, no gifts should be involved with transfers to the trust (other than any initial seed gift of capital)."

In response to this, several messages were subsequently posted on the ABA-PTL list taking issue woith what Mal had supposedly said. Those messages were compiled and published together in Report 4A.

In response to those messages, here are Mal Moore's rebuttal comments:

This is my response to the various comments regarding my answer, at the Heckerling Institute's first question and answer session, to the question of whether the defective grantor status of a trust would be changed, or in some way make its application questionable, to the extent that the trusts granted Crummey withdrawal powers to third parties. My response from the podium was that I thought there could be a problem since the Crummey withdrawal power holder could also be a deemed a grantor of the trust for income tax purposes and hence, the first, intentional, grantor might not be treated as the sole owner of the trust for income tax purposes.

Various comments after the session pointed out that I should have mentioned Section 678(b) which states that if someone is treated as owner of the trust for income tax purposes under Section 678, and grantor trust treatment is already being applied to the trust by reason of Section 671 through Section 677, those latter taxation provisions would "trump" the taxation provisions of Section 678(a). Hence, despite what Section 678(b) says on its face relating only to powers over income, these comments state that if an intentionally defective grantor trust has been created by the use of any one of a number of techniques, then the fact that there are Crummey withdrawal power holders would be disregarded and that the "true" grantor would continue to be the entire owner of the trust for income tax purposes.

I certainly should have mentioned Section 678(b) from the podium. However, Section 678(b) is not a complete and dispositive answer to the question put to me. First, Section 678(b) only applies to powers over income, and not to principal. While there have been a number of statements that that was a mistake and that principal as well as income was intended to be covered (I said that myself in a Miami article back in 1988), the matter has never been "officially" resolved. Another speaker at the Heckerling Institute this year (Larry Katzenstein) told me that 10 years ago he could not get a ruling on this very issue because the government was not willing to state that power holders over principal, as well as income, were covered by Section 678(b).

One of the respondents to the list serve discussions cited two Private Letter Rulings which appeared to deal with the issue. They are PLR 9141027 and PLR 9309024.

The 1991 PLR involved a situation where, because all the income could possibly be distributed to the grantor's spouse, the original grantor was treated as the owner of the trust's income under Section 677. The grantor was also the owner of all the corpus of the trust under Section 674 because of a power of appointment over corpus held by the grantor's spouse. In concluding that the grantor was taxable on all of the trustee's income, the ruling simply referred to Section 678(b) of the Code providing that Section 678(a) would not apply with respect to "a power over income", not mentioning a power over principal. Hence, the ruling does not state that Section 678(b) applies with respect to a power over corpus, although the conclusion of the ruling -- that the original grantor was the owner of all of the trust for income tax purposes -- is inconsistent with an interpretation of Section 678(b) which would apply the power strictly to income, and not principal.

The 1993 ruling involved an inter vivos QTIP marital deduction trust which required that all income be paid to the grantor's spouse, and also gave the trustee power to pay over to the spouse part or all of the trust principal as the trustee "deems necessary or desirable for any reason or cause that the trustee deems to be in the best interests of Spouse". The spouse also had a "Crummey" power to withdraw the amount of any transfer to the trust within 30 days of the transfer. The ruling, like the 1991 ruling, states that because the grantor is treated as the owner of the trust under Section 677(a), the spouse is not the owner of the trust under Section 678(a), citing Section 678(b). In both these rulings grantor ownership under Section 677(a) was based on the grantor's spouse being an income and principal beneficiary of the trust. The 1991 ruling involved Crummey withdrawal powers granted to both the spouse and children. The 1993 ruling involved only a withdrawal power granted to the spouse.

Neither of the rulings come right out and say that Section 678(b) applies to powers over principal as well as to income. Therefore, I do not conclude that these two rulings will "resolve" the question in terms of someone relying upon them to unequivocally conclude that there is no problem with a Crummey power being present in an otherwise grantor trust where grantor trust treatment is essential -- i.e., a sale to a grantor trust of S corporation stock.

Further, I believe there could be an argument (although some would say that Section 678(b) would make no sense if the following argument were viable) that a Crummey power holder is deemed to have withdrawn the property from the trust, redeposited it, and retained the income from it, thus making that Crummey power holder a grantor taxable under Section 671-677, rather than Section 678. Indeed one of the comments on the list serve stated just that.

Prior analyses of Section 678(b) vis-a-vis grantor trust treatment were made a time when the

intentional use of grantor trusts was not nearly as extensive as it is now. The problem was looked at in past years not so much from the point of view of there being a grantor trust around, but if there happened to be, what did that do to the otherwise taxable income of the power holder under Section 678. Now that a great number of defective grantor trusts are being created, with a number of sales of assets being made to those trusts, and in particular S Corporation stock, I think it is too simplistic to say that Section 678(b) solves the problem so that the
"true" grantor will continue to be treated as the sole owner for income tax purposes regardless of whether a Crummey power holder holds powers over principal, but not income. On its face Section 678(b) does not apply to a power over principal. Further, there is the other argument about the Crummey power holder being a separate grantor.

I believe I did say from the podium that I did not see why anyone would want to use Crummey withdrawal powers in an intentionally defective trust to which either large contributions or significant sales of assets were being made. Presumably the $10,000 annual exclusions could be used in some meaningful way other than with respect to transfers to a grantor trust so that there would be no chance that they would "gum up" the pristine grantor trust treatment which is necessary for these newer transactions to succeed. This is particularly true if S Corporation stock is involved.

I hope this clarifies the matter. In addition to Larry Katzenstein, I also consulted with two other very well known and regarded academics in the area, and they are in accord with I am saying here. My editing of the Q and A session transcript will reflect these clarifications [in the printed book that Matthew Bender will publish - see below].

From the Editors: Thank you, Mal, for taking the time to prepare the above reply for us.

Appended here is further commentary, from **John Price**, a respected ACTEC Fellow and author of the ACTEC Commentaries. His analysis here is an excellent addition to what Mal had to say. (the editors)

Mal Moore is, of course, correct in pointing out that the explicit language of sec. 678(b) provides that secs. 673-677 trump sec. 678(a) only "with respect to a power over income." However, as indicated in my 1999 Heckerling paper, "In effect, the IRS disregards the portion of subsection 678(b) which on its face limits that rule to cases in which the nongrantor's power is 'over income.'" The same conclusion has been reached by other commentators. Thus, Professors Peschel & Spurgeon state in their treatise that, "If the grantor of the trust is taxable on some portion of the trust because of retained benefit or control, Section 678(b) overrides Section 678(a)." Federal Taxation of Trusts, Grantors & Beneficiaries, par.

9.04[2]. In the accompanying footnote, the authors note that, "Technically, Section 678(b) provides for an override only in the case of a power over income. The prevailing view is that this provision should not be read literally. Early, 'Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status', 62 J. Tax'n 198, 200 (1985)." As I recall, Professors Ferguson, Freeland and Ascher reach the same conclusion in their treatise. Messrs. Zaritsky and Lane simply note that, "Section 678 does not address the problem of dual powers over trust principal that do not affect the payment of current income. There is no sound policy reason for this distinction and it must be viewed as a flaw in the drafting of Section 678." Federal Income Taxation of Estates and Trusts, para. 12.05.

Given the past history, the risk that the IRS would apply sec. 678(b) literally seems very, very slight. In numerous private letter rulings the IRS has concluded that the grantor trust rules of secs. 673-677 trump a beneficiary's Crummey power of withdrawal. A sample of the rulings, which deal with a variety of issues, including the application of the Sub. S. rules of sec. 1361, include, LRs 8521060, 9140047, 9141027, 9226037, 9309023, 9450014, and 9504024. The earliest of the cited rulings deals with two irrevocable trusts created by A for the benefit of his minor children C and D, each of whom held a power of withdrawal over contributions to the trust. The IRS concluded that, "C's treatment as owner of a portion of Trust-C is conditioned on (1) A not being treated as the owner of the portion under section 677 of the Code, and (2) A not being treated as the beneficiary of the portion under section 662. See section 678(b) of the Code and section 1.677(b)-1(a) and 1.677(b)-1(b) of the Income Tax Regulations." Others reach the same conclusion, not infrequently stating that, "Section 678(b) provides that section 678(a) shall not apply if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of subpart E, part I, of subchapter J, other than section 678." Having never seen, or heard of any ruling or decision that expressed a contrary view, its difficult to see that the threat is serious.

IMHO, the rulings to which Mal Moore responded, state their conclusions in clear, unequivocal terms. For example, LR 9141027 states that, "A [the grantor] is the owner of all of the income of the trust under section 677 because all the income of the Trust may possibly be distributed to A's spouse. A is the owner of all of the corpus of the trust under section 674 because of the power of appointment over the corpus held by A's spouse, B. Because A is the owner of all the income and corpus of Trust, the holders of withdrawal powers will not be treated as the owners of any part of Trust under section 678." Similarly, LR 9309023, in which the beneficiary spouse held a Crummey power, concluded that, "Under the terms of the Trust, both income and corpus are payable to Spouse during his life.

Accordingly, Transferor is treated as the owner of the Trust under section 677(a) of the Code. Because Transferor is treated as the owner of the Trust under section 677(a), Spouse is not the owner of the Trust under section 678(a)."

Mal's recent message concluded with clear, helpful advice--Counsel clients against giving Crummey powers of withdrawal to the beneficiaries of IDITs to which the grantor may make sales of appreciated assets.

Heckerling Institute Report
Report #5 - Life Insurance/Planning and Drafting

The following is Report #5 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers both Donald Jansen's Tuesday morning session entitled "Life Insurance Potpourri: No Employer? - Try Family Split Dollar and Other Recent Developments" and Howard McCue's Tuesday afternoon session entitled : Planning and Drafting to Influence Behavior (of Children and Grandchildren)."

This report was filed by on-site reporter, Stephen Leimberg. Steve is also a presenter at this year's Institute. He will be co-presenting (and reporting on) the TRU Revolution Special Session on Tuesday afternoon with Robert Wolf and Susan Porter.

Topic: Life Insurance: Recent Developments
Speaker: Donald Jansen of Fulbright and Jaworski

Details: After reviewing recent cases and rulings involving life insurance, Don Jansen covered the three typical uses of private split dollar (1) "Parent helps child", (2) "Keep control of the cash values and retain them for retirement - yet get the proceeds of out the estate", and (3) Shift wealth at minimum gift tax cost. He noted the two theories of taxation (no compensation or stock-holding involved so no income) and (the wife is making an interest-free loan to the trust) and reiterated the history and taxpayer - favorable conclusions of recent rulings.

Don was the second speaker in two days who mentioned that there was "a cloud on split-dollar". He noted that there are rumors of a major change in the income taxation". He expressed surprise since the Treasury has a major task force studying split-dollar but said that "there may be something going on in the IRS on ALL split dollar arrangements." He didn't elaborate but my impression is that the IRS will move in the direction of 7872 treatment, i.e. below market loan theory. This would cause premium payments to be treated as a series of loans with below market rates. So the paying "family member would realize interest income equal to the applicable federal rate on the amount of premium paid."

Don reminded us that even in the taxpayer-favorable PLRs 9636033 and 9745019, the only two rulings to focus specifically on private split dollar, the IRS was asked to respond only on gift and estate tax issues and didn't examine the income tax ramifications.

He cautioned that - as in every split dollar ruling issued in recent years - that the rulings state "we express no opinion regarding the application of Section 7872 to this transaction." He also cautioned that it was essential for planners to explain the trade-off (pay estate tax on the cash value when the "owning non-insured spouse dies to get the death benefit out of the estate yet still retain control of the cash value) and to provide for disposition of the non-insured spouse's interest.

Don also warned planners to be careful of equity in private split dollar situations. He expressed concern that "there is a risk that the equity build-up each year might constitute additional gifts to the trust or third party owner under an analogy to TAM 9604001." The IRS "might still argue that the equity is transferred for gift although not income tax purposes with regard to private split dollar."

My take on Don's talk is, "proceed cautiously in the area of private split dollar!" We only have a couple of PLRs and these are (only) PLRs.

Topic: Planning and Drafting to Influence Behavior
Speaker: Howard "Scott" McCue of Mayer, Brown, & Platt

Summary: The line between guiding and controlling beneficiaries is sometimes thin. Howard examined modern business structures and trust designs as vehicles for enabling planners and their clients to accomplish personal as well as tax objectives. He focused on the use of incentive trusts, FLPs, various split-interest (charitable and private) trusts in this context and strategies to involve younger family members in the planning for multi-generational transfers of wealth.

Details: Howard's witty and insightful talk gave three major reasons for the increased interest in behavior influence planning in both clients and planners: (1) the explosion of wealth, (2) the fact that the tools and techniques we've used have worked and more wealth is continually being shifted, and (3) "the tax system as we know it can not endure".

The key to understanding his talk and its major import is his statement that "If repeal becomes a reality, after the initial flurry of planning against the reintroduction of the tax (or a worse substitute), clients will go back to planning to accomplish what they really want and intend, rather than what we force them into in the name of the avoidance or minimization of enormous transfer taxes. Estate planners who have thought about the effects of planning and drafting on beneficiary behavior will be better able to attract and keep the best clients."

Howard pointed out that we need to consider whose behavior we are trying to influence and control and reminded us that we are constantly impacting behavior of people even if we don't consider that impact (e.g., a spouse in a QTIP situation) and think carefully about what types of behavior we can and should encourage - or discourage. "Almost everything we do has some impact on behavior; it's only a question of, "Is what we are doing sensible?"

He discussed a number of techniques and stressed the importance of devices that rest control and flexibility in the client(s), i.e. FLPs, LLCs, S corporations, and charitable structures such as foundations or donor advised funds that allow families to work together to develop shared values and charitable lead trusts that, if the children are involved, can teach patience, frugality, and stewardship.

He favors tools are techniques such as discretionary trusts which adjust well to changing values over time and don't unduly restrict flexibility. But he stressed the importance of providing clear guidelines and protecting the trustee through exculpation clauses. Incentive trusts, which have a place as an important tool, must be carefully thought-out so as to meet changing circumstances and the "real intent" of the donor. A provision such as "earn a dollar - get a dollar" for example, where there were two children with drastically different incomes may not have the result the client intended.

His bottom line was, "Talk to your clients about how they want to influence behavior, and be sure they consider the implications of the steps toward that goal that they take. As Warren Buffett said, "I want to give my children enough so they can afford to do anything they want to do - and not enough so they can afford to do nothing".

That's it for Report #5.

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Heckerling Institute Report
Report #6 - More News on Software Vendors

The following is Report #6 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers **more news about the software vendors** that are exhibiting at this year's Institute.

This report was filed by on-site reporter, Alan F.Rothschild, Jr. Alan is the current Chairman of the K-2 Technology and Economics Committee of the Probate Division of the ABA Real Property, Probate and Trust Law Section.

Alan reports that the Miami Institute always boasts a large number of vendors displaying their latest wares, but that perhaps the biggest news this week is not a vendor's new product, but the lack of one.

RIA, which for the last couple of years spend much of its energy at Miami on the **Wealth Transfer Planning** system, turned the system back over to its originator, **The Technology Group**, in December. RIA will instead focus its efforts on its Internet research product, **Checkpoint**.

CCH's primary focus is also on its **Internet research services**. As CCH and RIA have each built comprehensive web-based research services, many practitioners might find the pricing for these services so great that they must choose a single vendor, rather than continuing to enjoy the luxury of multiple tax
research services, and many solos and small firms (who make up over 50% of the membership of the ABA and the Real Property, Probate and Trust Law Section) are simply no longer able to afford to pay for and use many of these tax services.

[**Editor's Note:** Apparently these tax research service publishers have not yet embraced the rather novel but welcome reverse pricing structure that companies like **VersusLaw** (http://www.versuslaw.com/) have been so successful with recently, whereby they charge a mere $6.95 per month per lawyer to gain access to their entire Internet Web site database of federal and state case law. Now that's what we call "affordable" legal research via the Internet.]

Another interesting trend is that many users are electing to go straight from hard copies of research services to their web products, or are "upgrading" from CD to the web --- not because the web is necessarily better, but because it allows the practitioner to go around their own IT departments, which apparently do not timely load or install the latest versions of research services.

The Technology Group's display focuses on its **Wealth Transfer Planning** system **and** its upcoming **LawOnTheWeb** on-line research and document preparation system. TTG acknowledges the problems WTP has experienced in its recent history, but claims now that the program is back in the hands of its founders, the problems have/will be fixed and the program will soon (2/00?) be accessible over the web. WTP still offers great promise, but I suspect there are many disappointed former subscribers who will not be back soon. [**Editor's Note:** We STILL do not know what the URL is for their new Web site that was suppose to be unveiled on 1/10/00 during the Institute - anyone out there know what it is?]

Unlike prior years, there were a few other exhibitors of **"expert systems"** which include both the document assembly engine, but also prepackaged forms.

These include **Lawgic Publishing**, which released its automated **Florida Wills and Trusts Forms** system in November of 1999. These are the Holland & Knight forms that Ed Koren and Bruce Stone and two other partners of theirs assisted in co-authoring. Diane Balmer-Martin, the Marketing Communications Director for Lawgic Publishing, reports to us that Lawgic announced by Press Release issued on 1/12/00 that it had a record year in 1999. In fact, she says Lawgic doubled its total number of products, grew sales by 78%, and increased customer renewals for its subscription software over 150%. Lawgic claims that it's success in 1999 was due in large part to it's patented software technology - which is only available from Lawgic - which powers all of its products, called ***Intelligent LegalTechnology***. This technology provides the platform for what they claim is the only suite of software products that combines a simple Q&A process with legal research, in-depth analysis and dynamic text generation. They claim that these features "expertly guide legal professionals through the creation of comprehensive, customized legal documents." In the Family Law and Estate Planning fields, Lawgic introduced two new Florida-specific products in the 3rd and 4th quarters of 1999, building on their earlier 1998 successes with their **California Wills and Trusts** system and their **Delaware Incorporations** system.. These **new Florida programs** assist Family Law attorneys in the preparation of Marital Settlement Agreements and Estate Planning practitioners with the creation of state-specific Wills & Trusts documents. More information is available on their Web site at http://www.lawgic.com/.

Automated Legal Systems Inc. out of Universal City, Texas, is here demoing its **ProDoc** expert automation program and announced that its automated document authoring program will be available soon. This would allow practitioners to utilize ProDoc to automate any type of repetitive document. ProDoc has developed various **law practice area systems for** states like **Texas** and **Florida**, including Wills and Trusts, **and** a complete **probate practice system** for the State of **Colorado** that is based on and completely automates the use of former Probate Judge Jim Wade's *Colorado Probate Practice Manual*. More information is available on their Web site at http://www.prodoc.com/.

One new vendor of estate and probate practice systems, primarily for 9 mid-western states, including **Iowa** and **Illinois**, that is missing from this year's Institute is **Advanced Logic Systems**, the makers of the **Document Production System**. Unfortunately, they do not have a Web site either (at least that we are aware of), but you can contact them by telephone toll-free at (800) 454-7703.

One additional vendor that has been around almost since the beginning, but is also missing from this year's Institute, is **Interactive Professional Software** from Atlanta, Georgia, the makers of the popular and affordable **FastDraft** document assembly engine. We mention this vendor here not only because they have Wills and Trusts drafting systems available for **Georgia** and [through SunBank] **Florida**, but also because **Bank One** has just recently chosen the FastDraft engine to power their new Wills and Trusts drafting system called **The One(r) Source for Wills and Trusts (sm)**. They have state-specific forms libraries available on CD-ROM for 13 states (AZ, IN, OH, UT, CO, KY, OK, WV, FL, MI, TX, WI and IL), and you buy the product one state at a time. The System and one state costs $399 single user, and each additional state costs $99 each single user. Separate hard copy Manuals are available for AZ, TX, WI (all CP states) and all the Common Law states. For further information, call (414) 765-2689, as they do not have a Web site at this time, at least for this software, as far as we have been able to determine.

Two exhibits which are attracting a lot of attention this year are **WealthTec** and **estateplanning.com**.

WealthTec is a new player in the forecasting and graphing area, and they are demoing **AdvancedPro Series**, a very sophisticated program with 20 different planning modules divided into 4 general categories for estate planning, charitable planning, qualified plans and executive compensation. The program's creator was formerly with the national tax department of Ernst & Young and seems to have a strong understanding of the practitioner's wish list of features. More info is available at their website at www.wealthtec.com.

The other busy booth is **Schumacher Publishing's estateplanning.com** website "building and hosting" service. Most well known for its living trust marketing services, Schumacher's estateplanning.com service seems to offer practitioners a rather easy means for establishing a web site presence in the Internet, including selective access to SP's resources on-line, all for a cost of around $90 per month. More information about this service can be obtained from, and a demo can be viewed at, their Web site at http://www.estateplanning.com/.

That's it for Report #6.

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Heckerling Institute Report
Report #7 - Ethics and MDP / Entities

The following is Report #7 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers **Bruce Ross**' **"Ethics and MDP"** presentation and **Lou Mezzullo**'s **"Entities"** presentation, both of which were given on Tuesday, January 11th.

This report was filed by on-site reporter, Alan F.Rothschild, Jr. Alan is the current Chairman of the K-2 Technology and Economics Committee of the Probate Division of the ABA Real Property, Probate and Trust Law Section.

Law & Ethics -- Bruce Ross

Bruce, a Los Angeles practitioner and well-known expert on the rules of professional conduct in the area of trust and estates, provided a national update on legal malpractice in estate planning and administration since his 1994 Heckerling (28th Institute) presentation.

Bruce began by noting the inherit conflicts and confidentiality concerns regularly faced by practitioners. He noted that the rules of professional conduct are not well designed for this area of practice, nonetheless, the rules are being used increasingly in civil litigation to impose liability on attorneys.

In most jurisdictions, Ross pointed out that the elements of a malpractice claim are: Attorney is under an obligation to use the skill, prudence and diligence as other members of the profession; the attorney has breached this duty; there is proximate cause between the attorney's negligence and an injury; and there is damage to the "client". Other theories of recovery include breach of fiduciary duty, negligent misrepresentation and fraud.

Bruce spent a significant amount of his program discussing recent cases on the issue of standing or privity. He noted that in the estate planning area, a majority of the jurisdictions hold that the beneficiaries of a defectively drafted instrument should be considered as "indirect" clients for purposes of establishing standing. In the estate administration area, however, most states still apply the privity rule to bar malpractice actions by a disgruntled trust or estate beneficiary against the attorney for the fiduciary.

Choice of Family Business Entity for Estate Planning Purposes -- Lou Mezzullo

Lou provided a fast-paced update on selecting the best family business vehicle based on a number of income tax, estate tax and family planning factors. The backbone of his paper can also be found in BNA's Family Limited Partnerships and Limited Liability Companies portfolio (#812) and RPPT's An Estate Planner's Guide to Family Business Entities, both of which Lou authored.

Selection of Entity arises in three situations -- 1. establishment of a new venture, 2. Outside developments (changes in law or nature of business), and 3. Changes in owner's personal circumstances. Tax issues which can impact entity selection include treatment of earnings and losses, the value of an interest in the entity for transfer tax purposes, and the entity's ability to combine with other entities or to break up without taxable gain.

Mezzullo also emphasized the importance of state law in selecting the appropriate entity. He noted there were lots of choices available to the practitioner today -- good news because of the choices available, but bad news for the challenges to the planner who tries to stay current on each one.

The factors Lou reviewed included: (Nontax) Limited Liability, Retention of Control, Continuity of Life, Restrictions on Transferability, One Business Entity, Restrictions on Voting and Management Rights, Protecting Assets from Liability Exposure, Protecting Assets from Creditors, Simple and Inexpensive Formation, Dealing with Recalcitrant Family Members, and (Tax) Partnership Tax Treatment, No Restrictions on Ownership, No Restrictions on Capital Structure, Tax-Free Formation, Tax-Free Contributions, Tax-Free Withdrawals, Adjustment to Basis, Discounts and Premiums and Self-Employment Income Tax.

After analyzing these tax and non-tax factors, Lou clearly indicated his preference for LLC's as the easiest, most flexible family business vehicle in most circumstances. A FLP with a limited liability general partner was a close second.

That's it for Report #7.

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Heckerling Institute Report
Report #8 - Total Return Trusts

The following is Report #8 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

First, an eratta re Report #7. **Lou Mezzullo**'s presentation on **"Entities"** took place first thing Wednesday morning, not on Tuesday as was mistakenly reported in Report #7. We apologize in advance for any confusion this may have caused anyone, and especially Lou.

This Report covers Wednesday afternoon's **Special Session I-C** entitled **"The Total Return Trust [TRU] Revolution: An Introduction"** that was co-presented Wednesday afternoon by **Robert Wolf, Stephan Leimberg** and **Susan Porter**, and **Special Session II-A** entitled **"CASE STUDY - Total Return Trusts: Techniques and Applications"** that was presented by **Robert Wolf** and **Bruce Guiot**.

The portion of this report on Special Session I-C was filed by none other than on-site reporter, Stephen Leimberg, who was one of the co-presenters of that Special Session. The portion of this report on Sepcial Session II-A was filed by none other than on-site reporter, Robert Wolf, who was one of the co-presenters of that Special Session. Nothing like getting it straight from the horses mouth we always say, especially when it comes to a multi-facited topic such as this one. This is a long post too, but well worth reading.

Summary - Special Session I-C: Wolf and Leimberg began this Special Session by explaining the modern portfolio theory, defining total return investing, and comparing the TRU (Total Return Unitrust) with the traditional "income payout" , "discretionary", and indexed annuity trust design. They explained that, although the TRU was an exceptionally important planning tool that should be considered in any trust situation, it was not a "trust for all seasons" but rather one of many tools to be applied where and to the extent appropriate. They emphasized that one of the most important elements of planning in the decades to follow was the importance of drafting to meet client-monetary as well as tax savings goals - and appraising the client of realistic expectations after considering computer modeling which takes into consideration trust expenses, turnover, inflation, and taxes.

Details - Special Session I-C: Wolf and Leimberg made the following points during their presentation:

TRUs can solve problems that can't be solved by the traditional trust model.

• Future planning and drafting will be based more on our client's needs and desires.

• Total return planning will reinforce our client's financial and investment planning.

• Total return planning and computer modeling will highlight insufficiency in capital to accomplish stated objectives.

• Total return planning will be driven by human needs--not taxes - yet it will help us plan better for taxes too.

• The usual approach to drafting trusts - telling the trustee to "Hold the principal - and pay the income" in what we call the "income rule trust" -- is not just the wrong thing to do: From a long-term financial viewpoint, drafting the traditional income rule trust may be as harmful - or even more harmful - than making a drafting error that causes trust principal to be included in a beneficiary's estate.

• Articles in Standard and Poor's Outlook, Bloomberg Personal Finance, and FORBES MAGAZINE have made the public aware - not only that there is a choice - but that the choice can make a lot of difference!

• Although our clients come to us to create trusts set to last for many years or many generations, those well-intentioned trusts - by definition and design cause conflict between those generations

• This potential for family conflict is inherent in the design itself. It's because trusts create separate categories of beneficiaries, current and future - and the interests of the two are instantly and inevitably in competition. This also places the trustee in a very unenviable position: If the investment portfolio is invested for income, the remainder beneficiaries are unhappy. If the portfolio is tilted toward growth, the income beneficiary is upset. Quite often, a grantor's spouse ends up on opposite sides from the grantor's children or grandchildren, the exact opposite result from the family harmony the grantor intended, hoped for, and assumed.

• In an attempt to be fair and impartial, the trustee will typically purchase a near equal proportion of income (typically bonds) and growth (typically equities) . This produces neither a satisfactory level of income (since so much is invested in equities with very low dividend yields) nor growth (since so much is invested in bonds with no growth potential). Too often, neither party's satisfaction will be achieved and the portfolio will - as a whole - under-perform. This makes both sets of parties unhappy with the trustee's performance - and the ultimate goal of the grantor - financial security for both parties - is thwarted.

• What's not readily apparent without computer modeling is the incredible degree to which the classic trust model dramatically reduces a trust's potential investment returns.

• Assuming the S&P 500 dividend yield remains at about 1.2% , on a million dollars of stocks, a trust invested totally in equities yields (gross) $12,000 a year! After trustee's fees are charged to income, and taxes are paid , that $12,000 shrinks to around $8,000 a year.

• Investing in fixed income solves the income problem - but creates another since Treasury Notes are yielding slightly more than 5.5%. So each "unit" of $1,000,000 generates only $55,000 a year - before trustee's fees and taxes. And that's investing every nickel - the entire trust corpus - in fixed income investments - resulting in zero growth.

• So the trustee has a Hobson's choice -- invest for growth, and there's almost no income or invest for income and there will be no growth.

• Traditional trust documents don't even talk about this choice. Our trusts don't tell the trustee what the client wants - because we attorneys have never asked! Our trusts just say, "pay all the income".

• Trustees are required to be impartial as between the life beneficiary and the remainder beneficiary - which is why most trustees don't want to invest less than half of a portfolio in equity securities.

• If the trustee makes a 50-50 mix, half S&P 500 - at about 1.2% yield - and half 5 Year Treasuries - at about 5.5% return - averages out - after trustee's fees - to approximately 3.3% current return - and minimal growth.

• After taxes, expenses, and inflation, over the long Ibbotson period from 1926 to the present, the only category of investment that had any return at all is stocks; bonds have no net real return--and that has enormous implications upon what we can pay out and how we need to be drafting our trusts!

• Yet, because of the low yield of stocks, there would not be sufficient income for the income beneficiary. So a portfolio solely based on stocks will not accomplish our dual objectives.

• One answer to this problem is total return investing, the achievement of the highest overall rate of return, including both income and appreciation - consistent with the risk tolerance of the investor.

• The TRU (Total Return Unitrust), like its charitable counterpart, is an expanding (or contracting) pie. The current beneficiary is given a fixed percentage of the pie as revalued year to year. So if the pie grows bigger (or smaller), so does the slice. For instance, if we assigned a 4% annual interest in the pie to the current beneficiary and the pie was $1,000,000, she'd get 4% of $1,000,000, $40,000.

• The purpose of TRU is to allow a trustee to invest for total return, eliminate the conflicts of interest between the life beneficiary and the remainder beneficiary, a trust which will work fairly and according to understandable and dependable rules all the parties are aware of - no matter whether the market goes up, down, or how fast. Finally, a TRU allows us to make the distributions to our current beneficiary "smooth" (non-volatile) without unduly risking the trust's principal.

• Section 104 of the Revised Income and Principal Act was designed to alleviate problems experienced by traditional trusts. It gives trustees power to adjust returns between principal and income. And it grants that power without any specific limitations - other than the duty of impartiality -- the duty of fairness. This broad ability to make adjustments between the interests of the current and future beneficiaries gives the trustee a way to increase or decrease what the income beneficiary gets. Although many trustees will be glad for the power to make such adjustments, many others may not want that responsibility (curse?). Nor will some beneficiaries want such a power in someone else's hands. Instead, they (and the trust's trustee and investment advisors) may want - a concrete rule.

• Modern Trustees must have the ability to invest for total return regardless of what is defined as income and what is principal. But in many situations, trustees may need and want - a distribution method, a rule-- not just a power. For many reasons, and in many situations all the parties want and need to know what the rule - or rules are - in advance.

• There are, of course, alternatives. One of our best alternatives to the TRU is to draft more fully discretionary trusts. Give the independent corporate or other trustee the right to distribute or reinvest income or principal with complete freedom, or provide discretion subject to ascertainable standards. Where the family situation permits it, particularly where the family gets along well and is relatively affluent, a fully discretionary trust can work very well. Sometimes, the discretionary trust will be the very best choice!

• But absolute discretion placed in the hands of a trustee will not work everywhere. For instance, if the grantor's spouse doesn't want to have to ask the trustee for money, a fully discretionary trust just will not meet the client's objectives - even with a built-in right to change trustees. And when things get tough (such as when there is animosity between the income and the remainder beneficiary), the trustee's job can get very difficult. The very discretion that is such an asset in some situations can be a curse in others! Because a fully discretionary trust by definition provides no real guidelines, each year a trustee must still decide(and neither income nor remainder beneficiaries can be sure how that decision will be made or what it will be): " How much should I, or How much can I - distribute?" The grantor must be willing to give to the trustee the full control, even over the overall division of the economic pie. This loss of control may not please the very people who the trust was created to protect and unify.

• A second alternative to the TRU is to use an index pay out trust. The way this works is to provide in the instrument for the initial pay-out. The trust provides that the pay-out will be adjusted each year for inflation. In some situations (e.g. a relatively short term trust) this can be a very appropriate choice. But a payout linked to inflation can also be risky because the trust can be quickly exhausted and high payouts occur by definition and design at the worst possible time.

• In the TRU the payout to the current beneficiary each year is based not on accounting income but on a percentage of the average trust values in the 3 previous years. This back averaging ("smoothing") avoids the potential for volatile swings in income. For example, the payout, the distribution rate - say 4% - is multiplied by an average of the year end values for the last three years. By using this simple three year smoothing rule, it is possible to decrease distribution volatility by almost 50%.

• The TRU provides an identity of interest among the three key parties to the trust, the current beneficiary, the remaindermen, and the trustee. When one profits, all profit just as when one suffers, all suffer together, because the distribution, the trustee's fees and the principal value all depend on the total return from the trust--they are all true partners in the trust venture.

• Because there is a formula -stated in advance - a rule that everyone can understand - and easily compute - the expectations of the parties are both realistic and likely to be met. Everyone - the trustee - the current - and the future beneficiaries - all know how the distribution will be measured. For example, a 4% distribution on a $1,000,000 trust will be - $40,000. There's nothing to argue about. There's no guessing, no mystery, nothing to be disappointed about, and no decision-maker to be angry with.

• A TRU can qualify for the marital deduction if the document specifically requires that all trust income be distributed annually or more frequently. This is unlikely to be a problem - since the actual unitrust pay-out amount will almost always be in excess of the accounting income of the trust.

• An "ordering provision" requires the trust to pay out income. Then to the extent the income isn't sufficient, the trustee is to allocate short term capital gain to income. To the extent that's not enough, long term capital gain is forced out. To make up any remaining shortfall, the trustee is to pay out the trust principal. So essentially, the TRU works like a CRUT (without - of course - the onerous 5, 10, and 50% tests charitable remainder trusts must meet.) We don't know at this point if the IRS will respect this ordering provision. It should because it clearly and honestly reflects the payments being made to the current beneficiary. But if the IRS does not follow this order (as it does in CRTs), a slight (say 1/4 of a percent) reduction in payout to the current beneficiary may be necessary. (The ABA's Fiduciary Income Tax Committee has submitted this issue to the IRS for determination).

• TRUs should typically include the usual discretionary distribution language (based on ascertainable standards unless the trustee is independent) because, even with the power and advantages of the TRU, flexibility is appropriate. However, it is not possible to give the trustee discretion not to pay the distribution amount. The TRU's strength is predictability. If the beneficiary may not need the income, or the grantor feels it is important to be able to withhold income from the current beneficiary for any reason, a fully discretionary trust or the power to adjust may be more appropriate.

• The TRU is much more than a CRUT - without the charity - or without messy charitable rules and restrictions. It allows us to think about investing and tax planning - in a whole new way! For example, there is a very simple but very special technique which can significantly increase the current beneficiary's after-tax return. It's called "stock pruning" or "cherry picking" : It's a way to trim some of the growth while letting the portfolio continue to grow. Stock pruning is the methodical sale of a small amount of appreciated stock - say 1 to 3% of the portfolio each year - to help make up the difference between the targeted distribution pay-out and the actual income produced by trust assets. So if trust income is insufficient to pay the promised percentage of the last 3 years' average trust value, the shortfall is made up by selling appreciated stock. But this pruning is more than a necessity--it's an important tax planning opportunity!

• Although, from a total return investing perspective, "a dollar is a dollar is a dollar (neither the current nor the remainder beneficiaries care whether it came from income or principal), from a tax perspective - a dollar of principal will typically be worth far more than a dollar of income - after taxes. Picture, for example, a dollar generated from bonds and compare it to a dollar generated from pruning long term capital gain stocks. The dollar from bonds is subject to income tax at the highest federal and state rates. The dollar from stocks is partially capital gain and partially a return of capital. The bottom line is that pruning results in the current beneficiary netting more - after taxes and much more market value in the trust for remainder beneficiaries. Using a richer equity mix coupled with judicious stock pruning, both the current beneficiary and the remaindermen win. So the trust has both a better overall investment mix and a much better tax result! Maximizing total return (only possible in a total return type trust) works far better than the compromise between income and growth that is inevitable with the traditional trusts we have been drafting!

• Because Code Section1014 eliminates income tax on any appreciation in the trust, total return investing is useful not only in the family trust where we know we are going for growth but also in a marital trust where we have traditionally invested heavily in bonds to try to fill the income needs of the surviving spouse.

• The "ideal payout rate" for a TRU will depend on the client's goals. The remaindermen will be best served by the lowest pay out to the life beneficiary. From the current beneficiary's perspective, the payout rate should be based on the beneficiary's needs and the likely duration of the trust. Our computer modeling indicates that 3.7 to 4.1 percent work well over long periods in many cases. The lower the payout rate, the more likely the TRU will accomplish both income and remainder beneficiary's objectives.

• Why not use a "5or 5" power rather than a TRU? Although it remains a highly useful tool (even inside a TRU), it remains only a power and has the following shortcomings: First, it forces the current beneficiary to make a year by year decision (and the power and extent it is exercised is beyond the control - and to the detriment of the remainder beneficiary - thus increasing rather than eliminating the diametric opposition between the two classes of beneficiaries). Second, it is awkward to administer smoothly since it was not designed to be used continually but was rather intended to be an escape valve. Third, if the income beneficiary takes too much too often and at the wrong times (and in addition to trust income), the long term integrity of the trust is threatened. Fourth, as its name implies, the 5 or 5 provision is a power and not a system: neither the beneficiaries nor the trustee can plan since there is no rule governing what will be paid out.

• The most revolutionary and important thing about total return planning and the TRU is that this new paradigm forces us to ask and with computer modeling - for the first time we can - realistically analyze: How much income does my client's family want/and/or need?, and "Are my clients' assets - realistically adequate (after taxes, trustees' fees, turnover costs, and inflation) - or do they need to be supplemented (through life insurance or other means) to accomplish my client's objectives?" Drafting a legally perfect trust is no longer sufficient - if it is not designed to accomplish this specific client's objectives. Old style trusts are flawed - by design. They are producing woefully inadequate investment results - despite a booming stock market. So understanding both what's wrong with current trust design and how to design them better is essential to every financial services professional.

• Selecting a form of trust should start by considering what trust design will best match the family's goals. That will often entail mixing or matching of different types of trusts. We should start thinking about changing our habits of the past - and use Total Return type trusts (such as the TRU) first, next, the fully discretionary trust, less often the Indexed pay out trustand lastly choose slowly and least frequently--the traditional income rule trust! The proper choice will often not be either the TRU or a discretionary trust but rather a custom designed mix.

Susan Porter of U.S. Trust Company then presented her portion of Special Sesssion I-C:

Susan made four major points:

First, she made it clear she's not in agreement with certain of the provisions in the recent New York State Legislative Advisory Committee recommendations. These recommendations would (a) give trustees of existing trusts Section 104 (of the Revised Principal and Income Act) type power to make adjustments between principal and income and (b) treat new trusts - by default - as 4% unitrusts unless the governing instrument proves otherwise. She described the latter proposal as "more of an override than a default rule" and expressed further concern that the N.Y. proposal, if enacted, would apply to estates as well as trusts.

Second, she stated that "I have a bias for a fully discretionary trust", noting that "the trustee can never be criticized unless the trustee was arbitrary or capricious." She feels strongly that a fully discretionary trust should almost always be the trust of choice. She cited the strong protection afforded by discretionary trusts against governmental reach and expressed concern that total return unitrusts might force more payout of income than income beneficiaries might need.

Third, she expressed the opinion that the D. N. I. of a unitrust doesn't carry out capital gains.

Fourth, she noted that the N.Y. proposal, defining income as a 4% unitrust interest (with a three year smoothing rule) presents an issue as to marital deduction qualification. While she personally felt it qualified, she noted that it is an open issue which is being discussed with Treasury officials.

She concluded that planners should use unitrusts for predictability and discretionary trusts for flexibility.

Special Session II-A: Case Study Session on Total Return Trusts, presented by Bob Wolf and Bruce Guiot:

The **general thrust** of the session was to display the variety of ways in which Total Return Trusts can be used to satisfy human needs and investment goals, while helping us leverage our tax planning and estate planning. By definition, a total return trust is any trust which allows the trustee to invest for total return and which does not base what the beneficiary receives on principal and income distinctions. It is not limited to total return unitrusts, but includes fully discretionary trusts, indexed annuity trusts, total return unitrusts and other hybrid trusts Real life estate planning situations and solutions were used to illustrate real families, real problems and real solutions (if a Total Return Unitrust was used, a TRU Solution).

The **initial case study** tracked a real trust where the trustee was forced to hold the principal and pay the income (only) over a 10 year period. Because of a high income need, the trustee adopted a 50/50 asset allocation, periodically rebalancing to preserve the allocation and attempt to prop up the income. During the 10 year period chronicled, while the market value of the trust almost doubled, the actual income distributed to the beneficiary declined by about 10% because of the decline in interest rates, which
outweighed the dividend increases during the period. The question was then raised: what should be done with this type of trust which is already irrevocable. The answer was-1) look for discretionary powers in the instrument; 2) use Section 104 of the UPAIA if it is in your state, and if

not, consider ;3) reforming the trust by court action into a Total Return Unitrust (TRU).

Key tip in the reformation area is the issue of GST grandfathering. The question is -- if you reform, might you lose the grandfathered status. The answer is that you may well, but there is new regulatory guidance under Section 2601 addressing modification. Such modifications will not cause a loss of grandfathering if:

1. You don't extend the vesting of a GST interest (by another generation, for example).

2. You don't shift a benefit to a lower generation. This raises a strange and intriguing question, because life estates (such as an income interest) are valued as if the total return were accounting income and distributed to the beneficiary. That is--the income beneficiary is assumed to receive a 7.4% rate of return! Hence, even though a conversion into a 4% unitrust may double the rate the income beneficiary actually receives, it may be considered to have been decreased-hence violating the rule. ANSWER: The suggestion on the reformation issue is to make the reformation into an income or 4% unitrust distribution, whichever is the greater. This should satisfy the rule.

The **second case study** shows how TRU's can help not only satisfy the NEEDS of the beneficiary, but also leverage the Applicable Credit Amount. By using a high rate unitrust (or income, whichever is greater) for the marital and a fully discretionary trust for the credit shelter trust, the amount remaining after tax for the next generation is increased over a long period (1960-1998) by 800% over the traditional income model.

<u>One of the most important points of the case studies is</u> that because most Total Return Trusts try to set a payout, or a payout rate, we are finally dealing with the one thing the beneficiary REALLY cares about-what they will get. This needs based planning changes the dynamic of the estate planning process, putting the planner on the same side with both spouses and children.

The **third case study** pointed out that in setting a rate for a TRU, the asset allocation is critical to how much one can pay and still have a rational basis to believe that the real value of the trust will be preserved. A 2% payout TRU with a 50/50 stock and bond mix and a 4% payout all equity TRU for most of the period 1960-1998 would have traced very closely in market value, despite twice as high a payout for the all equity TRU. <u>Moral</u>: during many periods, you can pay out twice as much with twice the equity exposure (even though the accounting income may be only half as much)!

The **fourth case study** involved a second marriage situation where the second spouse demanded both a high payout from the trust assets and that it be indexed for inflation. Various approaches were taken to try to match these goals with limited success, at least when tested by the most difficult investment period for these goals--that is, starting in 1973. Various new types of trust designs were suggested and tested with computer modeling, including the "no-drop" unitrust, one in which the distribution never goes
down, an indexed payout trust (what was desired, but which didn't work in the worst case scenarios) and a new hybrid, the TRUCAP Index Trust. This is a trust which is an indexed payout, but with a cap so that if it pays out more than a set percentage (suggestion was 10%) it becomes a TRU, so as to avoid depletion of the trust, which would occur with a strict indexed payout. This hybrid seems the best solution for the difficult situation in which the payout is intended to be indexed for inflation, and illustrates that the process of inventing new types of trusts to respond to human (not just tax) needs, is just beginning.

The **fifth and last case study** illustrated one of the ways in which you can create a "virtual unitrust" to solve a problem. In that case, the problem was an overconcentration in international oil stocks with a relatively high yield). By using an existing withdrawal power, the family could essentially have the benefits of a unitrust, which could provide the tax advantaged cash-flow (much of the principal pruned to make the payout is a return of cost basis, and the rest is capital gain), without necessarily having to simply buy more bonds.

One more point: if people wonder what would be a good second career for trust lawyers if they really DID repeal the estate tax, how about drafting trusts to meet human needs!

Several questions were posed as to when the total return unitrust is contraindicated, and the answers were:

1. Whenever the beneficiary may not need any income from the trust.

2. When the assets of the trust are composed of other than typical financial assets. Real estate, closely held entities, FLP's, LLC's LLP's etc. don't fit in since illiquid assets, or ones where you have control over how much the income is, are better held by fully discretionary trusts.

3. Credit shelter trusts and GST Exempt trusts, to the extent that the grantor doesn't care about how much is going to be distributed to the beneficiary or to the extent that the beneficiary doesn't need anything from the trust, work better with fully discretionary trusts.

As an aside, one of the most useful combinations is to use a TRU in tandem with the fully discretionary trust. By having a concrete payout from the TRU, often this gives the beneficiary more confidence to accept a fully discretionary trust for the tax advantaged trust, because the TRU has satisfied their need for income.

That's it for Report #8.

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Heckerling Institute Report
Report #9 - Thursday Morning Sessions

The following is Report #9 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers all the **Thursday morning sessions**, which included **Daniel Markstein** on **Stock Options**, **Byrle Abbin** on **Economics of CRTs**, **James Narron** on **Inter Vivos Noncharitable Gifts**, and **Jerome Hesch** on **Beyond the Freeze**.

This report was filed by on-site reporter, and Miami resident, Bruce Stone. Bruce is also a member of the Institute's Advisory Committee.

Daniel Markstein: Daniel Markstein of Birmingham, Alabama, opened the Thursday session with a presentation on planning opportunities with stock options.

He gave a general review of the income tax rules governing stock options under section 83. Options which have a readily ascertainable value cannot be the subject of an election under section 83(b) election to accelerate income into the year of receipt, but the only options which have a readily ascertainable value are options which are publicly traded. The receipt of options which do not have a readily ascertainable value do not result in the realization of income (unless a section 83(b) election is made), and income will not be realized until the options are exercised, even if in the interim the options acquire a readily ascertainable value.

Making a gift of an option does not result in taxable income. When the donee exercises the option, the donor realizes income, and the donee acquires a basis adjustment for the amount of income realized by the donor. But if the donor dies before the option is exercised, who realizes income upon exercise? Two PLRs indicate that the donor's estate realizes income (199927002 and 9616035), but Dan doesn't think this conclusion is supported by section 83, because under that section the transfer of an option is not a realization event if there is no readily ascertainable value. As a planning pointer, if options are exercised before during lifetime, the uncertainty of who pays the tax is eliminated, and the income tax will reduce the size of the estate (or will be a section 2053 deduction if death occurs before the income tax is paid by the donor). Dan mused whether a provision in the option agreement stating that an option will be deemed exercised if death of the optionholder is imminent would work to achieve this result.

To prevent untimely and undesired realization of income by a donee's exercise of an option, the option should be given to a trust. Whether the trust is a grantor trust or not isn't critical with respect to the option itself, because the donor will be taxed upon the exercise of the option in any event under section 83. The advantages of using a grantor trust would be with respect to other income, including income earned after exercise of the option.

Dan discussed Rev. Rul. 98-21, in which the Service ruled a completed gift does not occur when an employee transfers options which are conditioned on the performance of future services. PLR 199952012 goes further and suggests that if an option is not exercisable because price targets have not been met yet, a gift of the option is not a completed gift. Dan believes that RR 98-21 is wrong, and that the PLR is even less defensible. The AICPA and ACTEC also have gone on record agreeing that RR 98-21 is wrong. Dan observed that you can plan around the ruling, however.

Finally, Dan discussed Rev. Proc. 98-34, which gives factors for valuing options for transfer tax purposes. But it applies on to the valuation of nonpublicly traded options for stock that itself is traded on an established securities market, and thus it doesn't give guidance on valuing options to acquire stock that is not publicly traded. Furthermore, it does not allow for any discounts in value based on marketability.

Byrle Abbin: Byrle Abbin of Washington, D.C. then discussed the economics of charitable remainder trusts.

He believes that the "Chutzpah trust" regulations will be hard for the Service to sustain against challenges in court without statutory authority. He summarized the 1997 law changes to CRTs, referring the audience to his outline for a detailed discussion.

He stated that it is his belief that it is malpractice for a drafter not to include a provision in a CRT allocating post-contribution gain to trust accounting income.

James Narron: James Narron of Smithfield, North Carolina discussed the concepts and mathematics of making noncharitable inter vivos gifts.

He observed that many planners labor under the illusion that gifts remove appreciation from the transfer tax system. But if the tax rates remain constant, it does not matter when a gift is made. However, if delaying a gift will cause future appreciation to be taxed in a higher marginal rate bracket, there may be an advantage to making the gift earlier. However, if the value of a gifted asset drops in the future, there is a tax disadvantage to having made the gift, because the gifted value will be included in the base of adjusted taxable transfers at its higher value.

He explored an example in his materials (filled with many excellent examples) which assumed a deceased spouse with a $10 million estate, a surviving spouse who survives more than 10 years with a $1 million separate estate, and where assets double in value before the surviving spouse's estate. Of the three possibilities (optimum marital deduction on the first death, equalizing the two estates on the first death, and the surviving spouse making a taxable gift of a marital bequest), the lowest taxes were incurred by the surviving spouse receiving a marital bequest and making a taxable gift.

He spoke on the increasing need for and importance of appraisals under the gift tax disclosure regulations, and wondered how this is going to affect smaller estates where the expenses of obtaining appraisals often aren't warranted. He felt that the estate planning lawyer will have responsibility to deal with this situation, because if appraisals aren't obtained and adverse results follow, the planner will be blamed.

He characterized planning lesson number one as making gifts to obtain discounts that apply only during life. Lesson number two is to use QTIP trusts to capture minority interest discounts that otherwise might not be available (citing the Bonner and Mellinger cases). Other directives were never to let your client die owning the fee interest in real estate, and to work very closely with appraisers when conducting estate planning transactions.

He admonished the use of caution in certain types of gifts, such as items of IRD, or making gifts that treat children unequally if the client attempts to "equalize" among the children upon death. Often drafting lawyers do not take into account all of the factors that must be considered when a client wishes to make unequal gifts at death in order to equalize for lifetime gifts (factors such as benefits of the unified credit during lifetime, tax apportionment, etc.). He referred to PLR 199926019, which approved the split of a QTIP into two trusts, so that the spouse could make a nonqualified disclaimer from one of the trusts, and thus trigger gift tax under section 2519 only over the disclaimed trust. He urged drafters to include authority to make gifts in powers of attorney. Finally, he summarized the law governing completion of gifts made by checks that do not fully clear before death, and in that regard, he suggested that those gifts be made by bank checks, not by ordinary personal checks, to eliminate the Service's argument that the gift is not complete because of the donor's power to stop payment of the check.

Jerome Hesch: Jerry Hesch of Miami, Florida spoke on uses of deferred payment or installment sales in estate planning.

The problems of direct sales (recognition of gain, lack of basis adjustment for IRD items at death) can be avoided by sales to grantor trusts.

Jerry characterized as a "myth" the now-common folklore that there must be a 10% funding requirement for a grantor trust to purchase assets on an installment sale. He stated that nowhere in any published ruling, case, or other administrative pronouncement of the Service is there such a 10% rule. It has taken on an aura of authority because it is easy to understand, but he stated emphatically that it is only a myth, and not a requirement of the law. He stated that there must or should be some funding by the grantor under the Swanson case (not cited in his outline) to be a grantor trust, but the funding does not have to be 10% of the purchase price.

Permissible capital sources for an asset purchase are independent funds held in the trust (including funds gifted by the donor), cash flow from the asset purchased (100% bootstrap sales financed wholly from the asset purchased are legitimate and are effective both for income and transfer tax purposes), loans from third parties, and guarantees of beneficiaries. Jerry said that if you are concerned about the gift tax consequences of a guarantee by the beneficiary, the trust should pay a guaranty fee to the beneficiary. He stated in his outline that a guaranty fee of approximately 1.5% would seem appropriate if the assets purchased consist of marketable securities, and perhaps as much as 4.5% if the assets purchased consist of real estate or closely held business interests.

Jerry noted that the tax extenders legislation passed last year in Congress included a provision that prohibits accrual basis taxpayers from obtaining installment sale treatment under section 453. Jerry noted that the $5 million maximum limitation in section 453A (which requires interest payments on deferred capital gains tax) is applied to each taxpayer, and for this purpose, spouses are separate taxpayers, and the rule is applied on a calendar year basis. Thus by structuring sales with two spouses, and having separate transactions in different calendar years (such as in December and in January), the limit becomes $20 million.

Jerry stated that there are no cases dealing with the consequences of loss of grantor trust status before an installment obligation has been satisfied in full. It is his belief that because there is no deemed transfer of property to the grantor trust during life, the deemed transfer for income tax purposes can occur only at death. Because there is no rule that treats death as an event of realization, no gain can be realized on the loss of grantor status and deemed transfer that occurs at death. The installment obligation is included in the gross estate, is not IRD, and gets a basis adjustment equal to the outstanding and unpaid amount of the obligation remaining due at death. If no principal reductions have occurred during lifetime, the basis of the purchased asset will be for the full principal amount of the note. Jerry stated that the talk abounding in estate planning circles about realization of income on death comes from theories under section 752, which have no application here.

Jerry observed that it may be advantageous to do a private annuity sale for a healthy individual in some circumstances. The private annuity is not governed by the installment sale rules, and thus can be used to avoid the rules of section 453(e) which cause gain from an installment sale to be accelerated if the related party purchaser subsequently sells the asset within two years of the first installment sale. None of the other rules of section 453 will apply, and neither will the OID rules. The technique can work well on sales of large amounts for older clients.

That's it for Report #9.

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Heckerling Institute Report
Report #10 - Friday Morning Sessions

The following is Report #10 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers all of the **Friday morning sessions**, which included **Read Moore** on **Community Property Alaska Style**, **Jonathan Blattmachr** on **EP for Individuals Worth $3 Million or Less** (yes, <u>less</u>, not more), and the final **Q&A Session**, which was run by **Messrs. Alan Bonapart, Louis Mezzullo, Susan Porter and Edward Schlesinger**.

This report was filed by on-site reporter, and Miami resident, Bruce Stone. Bruce is also a member of the Institute's Advisory Committee.

Read Moore: Read Moore of Chicago, Illinois led off the presentations on Friday, the last day of the Heckerling Institute. He spoke on community property, why lawyers in common law states must concern themselves with it, and how to plan with it.

Read noted that the Clinton Administration had proposed last year to eliminate the 100% basis adjustment for community property, but he felt that this proposal probably would never be enacted.

Read gave a basis overview of community property and its principles, noting that most common law planners need to understand and remember that when dealing with community property, title is generally irrelevant. In community property states, if title is held in the name of both spouses it is presumed to be community property, but that can result in probate of 100% of the property (including the surviving spouse's interest) - Washington is a state where this is true. Various planning techniques can avoid such a probate, such as a community property trust to hold what otherwise would be jointly titled assets.

Community property can be held as a joint tenancy to avoid probate, but there is a risk of losing the 100% basis adjustment. An alternative is to use a marital or community property agreement, which provides for transfer on death of the deceased spouse's interest without probate.

It is important for lawyers in common law states in representing clients who have moved from community property states to identify what community property the clients own, and to make sure that it is segregated. Community property reinvested in a common law state (such as in real property located in a common law state) should not be held in joint tenancy if at all possible. If it gets commingled with separate or joint tenancy property, it may lose its community property status. One way to accomplish this is to have the clients create a joint trust similar to what would be done in a community property state, with the trust governed by the law of the community property state, and to fund that joint trust only with their community property. Another alternative is to create a separate custody account for the community property, and perhaps to maintain the account in the community property state (although that isn't necessary). Whichever alternative is employed, do not allow the clients to transfer other non-community property assets into the arrangement.

Read spent the last one-third of his presentation discussing the Alaska Community Property Act, which allows both Alaska residents and residents of other states to opt into a community property regime. Alaska has adopted what is basically the Uniform Marital Property Act, but on an elective basis. It is now standard estate planning in Alaska for clients to enter into marital property agreements as part of their planning. There are various factors which can be met for nonresidents to establish sufficient nexus with Alaska to avail themselves of the community property statute. This ability for common law state residents to elect into community property was one of the reasons for the Administration's proposal last year to repeal the 100% basis adjustment for community property.

Read discussed a number of factors in his outline examining whether residents of common law states really can create community property that will be respected as such under federal law. In the end, this is a choice of law question, which turns on two matters. First, is there some nexus to Alaska? Second, where there is nexus, does the application of community property law violate some strong public policy of the state of residence? (For Uniform Probate Code states, mere violation of "a" public policy of the common law state, as opposed to a "strong" public policy," may be enough to prevent election into Alaskan law.) Read believes that conflict of law considerations should result in common law state residents being able to choose Alaska community property law for federal tax purposes, but he cautions that the 1944 U.S. Supreme Court case of Commissioner v. Harman (323 U.S. 44) could be read to reach the opposite conclusion.

Jonathan Blattmachr: Jonathan Blattmachr spoke on estate planning for clients with estates of less than $3 million.

He said that the first thing to do is focus on assets that the clients will not need. Life insurance is typically the first asset in this category. Jonathan discussed outright gifts of life insurance, and noted the possible problems with loss of control of the benefits and possible annual exclusion problems for premium payments if there are joint owners of the policy. He asked the audience whether it makes sense to allocate GST exemption to life insurance trusts. The answer: it depends. Most life insurance policies lapse before the insured's death, and even if they don't, the typical rate of return on them from inception through collection of death benefits is about 6%.

A second category of assets to give away in smaller estates is tangible property. Jonathan discussed what clients call the "2 day rule" - if you remove the items from the safe deposit box within 2 days of death, then surely they can't be included in the gross estate.

A third category is recreational real estate. An outright fractional interest could be gifted, coupled with a joint use agreement, in which the owners would allocate usage and agree to share expenses. An alternative is to create an LLC and to use it as the joint use agreement. The LLC arrangement is preferable to outright ownership of fractional shares, because of the protection from creditors, and it may provide greater valuation discounts.

QPRTs generally are better for middle class taxpayers than for very wealthy clients. But there is no GST leveraging during the ETIP term, and the client must survive the term of the retained interest for it to work. A better alternative may be to purchase the remainder interest of the QPRT, or to create a trust to hold the remainder interest, and sell a life estate to the spouse, and have the spouse purchase the remainder interest (see the February 1999 issue of Trusts and Estates magazine).

Clients of modest wealth can make inter vivos gifts to irrevocable trusts and retain indirect access to use of the gifted assets by including the spouse as a beneficiary. The grantor can name his or her spouse as a beneficiary of the trust, and even define the spouse as the person to whom the grantor is married from time to time. Of course, if the grantor's spouse dies first, the grantor may lose access to the trust funds. Both spouses can create similar trusts, but care should be used in avoiding the reciprocal trust doctrine.

Jonathan also said that spouses can create self-settled trusts in which they retain a discretionary interest and yet remove the trust assets from their gross estates. He reported that four states have now adopted enabling legislation to allow this: Alaska, Delaware, Nevada, and Rhode Island.

He also said that it should be standard estate planning practice to ask clients if they want to avail themselves of community property by opting in to statutes like the Alaska community property act. And it may be possible for clients in states that impose income taxes to establish a nexus with states that do not charge income taxes.

Jonathan said that the most important techniques of estate planning are compounding, and tax-free compounding. That is not accomplished in an IRA or qualified plan because the assets are ultimately taxed, and it is not accomplished in a charitable remainder trust, which is only a deferral device. It is accomplished with life insurance policies which are not modified endowment contracts. Clients should not hold municipal bond portfolios, but should hold higher yielding assets sheltered inside an insurance contract, where they can have full access to the asset values.

Another planning alternative is to establish an inter vivos QTIP trust, with a retained life estate if the donor spouse survives the donee spouse. The donor spouse can allocate GST exemption to the QTIP trust, because the ETIP rules do not apply to this type of trust.

Finally, Jonathan characterized charitable remainder trusts as being devices where the client "rents" the charity's tax exemption. He said that these trusts should never be drawn as anything other than income only trusts, and that there are no particular advantages with flip unitrusts.

Q&A Session: The final question and answer session was covered by Ed Schlesinger, Lou Mezzullo, Susan Porter, and Alan Bonapart.

Ed does not think the government has a winning argument in attempting to find that grantors of defective trusts make gifts when they pay their own income tax liability. In continuing the grantor status of a QPRT after expiration of the retained interest, he favors giving someone such as the grantor's spouse the power to add beneficiaries to the trust (such as spouses of descendants, or charities). He uses an escape hatch so that grantor trust status can be turned off by renouncing or releasing the feature that causes grantor status, but this shouldn't be held by a trustee, because the Service may argue that a trustee cannot renounce or release powers in a way to bind successor trustees.

Lou stated that if the surviving spouse is the beneficiary of multiple IRAs, the required minimum distribution can be taken from any one or more of the IRAs. Furthermore, you can roll over benefits from a qualified plan to an IRA at any time. However, the nonparticipant spouse must consent to the transfer, and the advice of independent counsel may be needed to advise the spouse before consenting, because of the loss of spousal rights. Ed pointed out that a waiver of spousal rights in qualified plans should not be made in a prenuptial agreement, at least not without additional documentation after the marriage, because only a "spouse" can waive rights to retirement plans.

Susan responded to a question concerning estate tax interest and penalties, and stated that generally you can never get the Service to waive interest.

Alan answered a question concerning a trust for a 19 year old, which will terminate when the beneficiary reaches age 21. The proper investment horizon isn't two years, but is whatever is appropriate under the circumstances, given the purpose of the trust and the situation and circumstances of the beneficiary. He also said that checks which aren't cashed before death will not be removed from the donor's gross estate because of the donor's right to stop payment.

Ed cautioned to always determine that there is an insurable interest when creating trusts to hold insurance policies. If there is no insurable interest, the benefits probably will not qualify as insurance under tax law and thus will be taxable as ordinary income. In some states, such as New York, the insured's estate has a right to recover the death benefits if there is no insurable interest, which will cause the value of the death benefits to be subject to estate tax even if the estate does not collect them.

Ed also said that if the trustee of a life insurance trust doesn't have enough funds to cover the premium payments, the trustee should first approach the grantor, then next borrow against policy cash values, and finally, ask the beneficiaries for help, or distribute the policy out to them. Before opting to convert a policy with investment value to an extended term policy, care must be taken to see what will happen to any policy riders. Ed noted that if there are outstanding policy loans, they will reduce the length of the extended term.

Lou noted that a single member LLC can own stock in a S corporation, but a two member LLC cannot.

Susan stated that if a grandparent created an UGMA account for a grandchild, and dies while serving as custodian, although there are estate tax consequences, there are no GST tax consequences, as long as the gifts to the account always fit within the annual exclusion limits. The gifts into the account had a zero inclusion ratio.

Alan noted that community property can be divided in any manner agreed by the spouses and transmuted into separate property. Just as with the waiver of spousal rights to qualified plan benefits when rolled over to an IRA, the situation may call for the spouses to obtain the advice of independent counsel.

Closing Remarks: Tina Portuondo then closed out the conference by stating that 2,519 persons attended this year, and there were over 2,600 paid registrants. Next year's conference will be held at the Fontainbleau Hotel in Miami Beach on January 8 through 12, 2001.

We are still trying to get some belated reports on the following Wednesday morning sessions, iven of they have to some from the presenters, so stand by for more Reports this coming weekend.

Richard Robinson - Selling the Family Business
Susan Smith - The Egyptian Mortician's for Mummfying Post-Mortem Discounts
Steve Akers - Post-Mortem Planning Strategies
Jerry McCoy - Special Session II-B Charitable Planning Update Y2K Style

That's it for Report #10.

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Heckerling Institute Report
Report #11 - Final Report

The following is Report #11 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers the sessions for which no Reports were ever submitted. Those sessions were:
Richard Robinson - Selling the Family Business
Susan Smith - The Egyptian Mortician's for Mummfying Post-Mortem Discounts
Steve Akers - Post-Mortem Planning Strategies
Jerry McCoy - Special Session II-B Charitable Planning Update Y2K Style

We asked each of these speakers if they cared to give us some comments about the highlights of their particular presentations, but none of them ever responded, so we are finalizing all of our Reports at this time so they can be put up in full text on the ABA RPPT Section's newly redesigned Web page at http://www.abanet.org/rppt. Compiled versions of the same that can be downloaded in Word, WordPerfect, ASCII Text, RTF, PDF and HTML formats will also be made available there.

At this time, we would like to say a big thank you to the following people who took time out of their otherwise busy schedules during this year's Institute to submit Reports on all the sessions they covered. These Reports would not have been possible without their help. We are particularly indebted to Bruce Stone this year, as he wins the award for the most Reports submitted.

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In closing, a reminder: Next year's conference will be held at the Fontainbleau Hotel in Miami Beach on January 8 through 12,2001.

That's it for our final Report, Report #11.