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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