HECKERLING INSTITUTE 2001
REPORT #5

As we did in January of the last four years, 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 weeks highlights of the proceedings of the 35th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 8-12, 2001 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida.

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

Steve Leimberg Esq. of Bryn Mawr, PA - leimberg@home.com
Bruce Stone Esq. of Miami, FL - Brucestone@aol.com
Eugene Zuspann Esq. of Denver, CO - ezuspann@zuspann.com
Julia Fisher Esq. of Philadelphia, PA - JuliaFisher@ewgf.com
Alan Rothschild Jr. Esq. of Columbus, GA - ar@hatcherstubbs.com
Joe Hodges Esq. of Denver, CO - jghodges@jghlaw.com

==
Again this year a complete listing of the proceedings and speakers is available on the Institute's Web site. The new URL for that site is http://www.law.miami.edu/heckerling
==
REPORT NO. 5 - Thursday, January 11, 2001

First, Reporter Steve Leimberg reports the following on Kathryn Miree's Thursday afternoon presentation entitled "he Family Foundation: An Owner's Manual":

Kathryn Miree, of Kathryn Miree & Associates in Birmingham, Alabama, co-author with Jerry McCoy of THE FAMILY FOUNDATION HANDBOOK delivered a very practical and fast paced commentary on what advisors need to know - say - and do - with respect to family foundations. Here are some of her thoughts:

Family foundations comprise about 40% of all foundations - but are rapidly becoming a larger percentage. It's estimated that there are over 18,000 Family Foundations - and this number is growing rapidly. These range from small (too small?) ($20,000- $30,000) to the Bill Gates size approaching $22,000,000.

The planner has four main roles: First, consider and fully explore the alternatives. Second, if a foundation IS appropriate, select the proper form. Third, instruct, warn, and help keep the parties within state and federal guidelines and laws. Fourth, help the parties structure and monitor the operation of the foundation including governance, structure, and grant-making.

Kathryn noted three reasons to be ultra careful about the set-up and structure of the Family Foundation: (1) The foundation is a public entity in the sense that the public will have knowledge of its deeds/misdeeds and to a great extent the public will see and think of the family as it is reflected in the foundation's actions, (2) The foundation's board has accepted significant and continuous long-term fiduciary responsibility (spelled L I A B I L I T Y), (3) the penalties for failure to meet federal and state laws in this area are severe.

It is very important that the professional impress upon family members that their responsibility encompasses much, much more than merely writing checks. (And also that the foundation - even though it is preceded by the word, "family" is not equivalent to a discretionary family checking account. So advisors must caution family members that foundation money must not be used to pay a family member's charitable pledges or other personal expenses).Planners must also focus - and have family members focus - on what the goal(s) of the foundation are - and how important each goal is. For example, "Are we here merely to encourage philanthropy?" " Is the major objective to bring the family together?" "Do we want (need) the foundation to support our children financially?"

The importance of concentrating on goals makes the creation of a mission statement critical and requires that the board of directors be very involved in the creation of that statement. So advisors should construct and give involved family members questions to answer. Those questions, regarding the mission of the foundation, should be used by all parties to move the parties to - and keep the parties in - consensus. Kathryn continually warned about the fact that different family members will have different agendas and goals and that a key role of the professional was to take the time to help the family work through the issues. Her outline reminds her readers that a family foundation can be a catalyst for family discord rather than the unifier many donors hope it will be if the planners and creators ignore generational differences, don't take time to recognize individual strengths and weaknesses, and don't select and train the board properly.

Kathryn stressed that the rules and tax laws in the foundation area are not intuitive and that it was easy for family members to "stray from the path". She discussed the Federal Volunteer Protection Act of 1997 which was enacted to provide a measure of liability protection for true volunteers (uncompensated directors, officers, trustees, or other volunteers) when acting within the scope of their duties and when the act or omission was not willful, criminal, gross negligence, reckless misconduct, or flagrant indifference) but cautioned that this protection has its limits.

It is essential, she continually reminded the audience, to develop and maintain policies and procedures, checklists and forms - particularly in the areas of (1) gift acceptance (be particularly sensitive about real estate and closely-held businesses), (2) grant making policies, (3) board training, and (4) investment policies.

The key function of a family foundation is, of course, grant making - and Kathryn pointed out that this is also the area where the board is most likely to get into trouble. Her three guidelines here to professionals were: (1) continually remind the board that its distributions must be for CHARITABLE purposes, (2) it must strike a balance between the minimum distributions required by law (to discourage accumulations of funds) and exhausting the funds of the foundation, and (3) since the IRS will not take your word forwhat you - or the recipient of the grant has done with the foundation's money, the board must keep meticulous records and provide timely tax information to both the federal and state government.

Professionals should help keep clients out of trouble by giving them examples of "safe" and "risky" distributions. In other words provide each board member with a list of "on road" and off-road examples so they know when red flags should be raised and bells should ring -BEFORE they make a distribution.

Setting realistic objectives and getting the board to agree to rules at the outset will avoid divisiveness and makes problems easier to solve at the outset.

One of the policies that should be decided upon early on in the foundation's life is the grant-awarding process and the procedure for handling - or denying - unsolicited grant applications. Kathryn recommended the creation of a checklist to help board members know what to look for - and a format for politely saying, "NO."

She discussed the prohibited transaction (essentially "anti-self interest" "anti-abuse") rules and the potential for violation of these strict prohibitions. The many traps of self-dealing (transactions between the foundation and a "disqualified person" (such as certain substantial contributors, foundation manager, certain family members, or certain others with power or control over the foundation) include the payment of salaries for family members. The compensation problem can arise with staff, trustees, or board members paid for professional services. The key to safety seems to be the reasonableness of the payment (consider complexity, time, training) with respect to the work done, the skill required, and the need of the foundation for the specific services rendered. .

Kathryn discussed the general prohibitions against real estate sales or leases between the foundation and "disqualified persons" and the exception that allows a disqualified person to lease real estate to the foundation at no cost. She also alerted the audience to the problems where the foundation owned a business - and that foundations should generally not be overly involved in the ownership of businesses.

Kathryn concluded her comprehensive and informative discussion by stating that the attorney's central role is to assure that the private foundation vehicle is "right" for the client and the client's family, that a proper structure is in place to facilitate the creation of a mission statement and the accomplishment of that mission, create forms and checklists to make life easier and safer for board members, and help avoid crisis management.

++++++++++++++++++++++++++++++++++

Next, Reporter Steve Leimberg reports the following on Thursday afternoon's Special Session III-B entitled "What’s New in Life Insurance?" and staring three well known presenters, Leslie C. Giordani, Lawrence Brody and Charles L. Ratner.

First, Leslie Giordani's presentation:

Leslie Giordani, a partner in Giordani, Schurig, Beckett and Tackett, LLP in Austin, Texas discussed offshore and domestic private placement life insurance. These are concepts that are new to many - although as she explained - the key benefits of such techniques (incredible flexibility, highly efficient cost structure, and very favorable tax results) have been available for many years and there has been a recent surge in the number of products available to facilitate this planning for the ultra wealthy (best used with clients who have a $20 million plus net worth). The facilitating vehicle is U.S. tax compliant VUL (Variable Universal Life Insurance) issued by an insurer situated outside the U.S. (For example in Bermuda or the Cayman Islands).

Her talk was divided into three segments: (1) advantages, (2) tax rules, and (3) implementation. Advantages include: TAX (earnings grow tax deferred within the "shell" of the policy, the cash values can be accessed tax free if the policy is not a MEC (Modified Endowment Contract, no U.S. state premium or federal DAC tax is imposed), and the death benefit is tax free), FLEXIBILITY (The client can select - and retain the ability to replace - one or more investment managers and thus has considerable (albeit indirect) influence over the assets which will be purchased with the money the client puts into the contract. There are no SEC or state insurance or "Blue Sky or other securities laws" to contend with. So a broad range of investment products and designs is possible. In some situations it may even be possible to pay premiums "in kind" rather than in cash), FEE STRUCTURE (The fees and annual charges are exceptionally low relative to typical domestic based products), and ASSET PROTECTION (There is typically higher protection against creditors than is afforded to most U.S. based products).

DESIGN: Leslie pointed out that these VUL products are almost always an investment rather than tax-driven tool so, in design, considering that mortality charges are a drag on investment, these policies usually are arranged with minimum death benefit relative to cash values. Usually, the attempt is to save income rather than estate tax with these contracts and so the normal estate planning tactic of placing the policy into an irrevocable trust is not used. (Such use would also have the double disadvantage of high gift tax cost and block access to policy cash values). Quite often, the overall plan encompasses the use of cash already given away. So clients who have already established and funded dynasty trusts would be good candidates.

DOWNSIDE: All the normal consumer protection expected by purchasers of domestic U.S. life insurance does not exist - since the offshore policy lives in an essentially unregulated environment. (But of course, because of their size, the insureds are usually sophisticated investors and should have sophisticated counsel capable of the proper due diligence).

NEEDLES TO THREAD: Leslie pointed out that the following Code Sections must be carefully studied and complied with: 7702, 7702A, 817(h), 4371, and 953(d). Leslie stressed that it is exceptionally important that the insurance carrier selected have the software and systems to assure the client of continued compliance with these code sections. Although this is typically not a problem for the offshore subsidiaries of U.S. insurers or large offshore carriers, it may be a problem for smaller offshore companies.

OFFSHORE IMPLEMENTATION: Doing this right requires that almost all the steps be accomplished outside the U.S. So, once the client has a general idea of the benefits, costs, tax, and other legal issues and has reviewed sample policy illustrations, the following must be completed by the insured offshore: Discussion of specific transaction details with broker, review of specific illustrations and comparison of specific carriers, specific discussion of carrier to use, the policy application, medical and financial underwriting, ownership (trustee of a foreign trust or foreign company must own the policy), premium payment (the foreign owner must make payments directly to the offshore insurer.)

Once these things are accomplished - all offshore - the carrier will typically place all or essentially all of the risk with reinsurers. At that time, the trust will be finalized and the trustee of the trust will sign the application. Upon receipt of a final offer from the carrier, the premium will be placed into the policy's segregated account.

Leslie concluded her exceptionally well constructed and lively talk by emphasizing the importance of carefully selecting an insurance broker. Among the duties of a broker are to obtain the best possible medical and underwriting outcome, assist in policy design, assure and constantly monitor due diligence, tax compliance, advocate with reinsurers, negotiate fees, monitor jurisdictional issues, and provide follow through service.

Second, Larry Brody's presentation:

Lawrence Brody is a partner in the St. Louis based international law firm of Bryan Cave, LLP. Larry had the unenviable and Herculean task of explaining the unexplainable, the just released IRS notice 2001-10 on split dollar. As expected, he performed a masterful job.

Here are snippets of his major comments: (Because of the importance of this topic, I'm going to go beyond a quick review and cover as much of Larry's enlightened thinking as possible - as accurately as possible - without interjecting any of my own opinions).

(1) The notice was not totally unexpected. The IRS, when it stopped issuing rulings on split dollar in mid-1999, signaled warning that the taxation was "under study". The IRS, since the 1996 TAM, has been silent on the income taxation of equity split dollar.

(2) The IRS has been "concerned" about the use of "alternative" (substitute) term rates for quite some time.

(3) This Notice is an attempt by several departments of the IRS to put their best thinking on both these issues.

(4) The Notice covers alternative term rates, P.S. 58, and the current IRS thinking on equity split dollar.

(5) The "transfer" of policy values under Section 83 discussed in the â€˜96 TAM was difficult to see since the TAM really didn't explain its rationale. This Notice attempts to make that explanation and follows the TAM.

(6) This Notice asks for comments on the issues it raises and suggests that they will impact on the outcome.

(7) The Notice has many, many segments that are difficult to understand. It starts by stating that the IRS is reviewing the federal income tax of split dollar and providing "interim guidance pending publication of further guidance." Larry asks, not so tongue in cheek, "Is this guidance - or are we waiting for guidance? (It's not really clear WHAT this Notice attempts - or does - accomplish). How reliable is it - and when does it become effective?

(8) Although it primarily addresses split dollar between employers and employees, the Notice goes on to state that it also applies to other situations - including "arrangements including gifts." Larry assumes that means private (personal) family split dollar involving gift tax implications (there are no compensation issues here but the gift and GST implications may be significant). The full implication of this statement is (like much of the Notice) "not totally clear".

(9) The Notice makes an excellent summary of the current state of the law on split dollar based on the published rulings. It does NOT mention the TAM!

(10) The third section (III) begins by stating that none of the published rulings has directly addressed equity split dollar. It then states that equity - if it involves a transfer of property - is taxable under Section 83.

(11) The Notice makes the comment that, if the insured is the beneficial owner of the policy from inception, there is no transfer of property. (Which is exactly the argument foes of the TAM have been making - that without a transfer - without anything "moving" - how can Section 83 apply?) It looks much more like an interest free loan under Code Section 7872, either a demand or term loan. (Larry points out that the temporary regs under 7872 state, if "new things are added" those provisions would be applied prospectively only).

(12) P.S. 58 rates or - if lower - one year term rates: The Notice points out the rates are very out of date (1946). So it doesn't make sense to continue using the rates. IRS is worried about "reverse split dollar" where the employer pays the higher of P.S. 58 or one year term - and states, there is no published guidance that authorizes the use of the P.S. 58 rates. Larry agrees - but points out there is no published authority that prevents the use of the P.S. 58 rates for this purpose. Larry thinks the Service is saying, you can't "do" reverse split dollar - but notes that they don't actually say that. They just say there's no authority. So the effect of this commentary in the Notice is uncertain.

(13) The next few paragraphs relate to term rates. The IRS wants one standard set of rates.

(14) The Notice importantly states, Pending consideration of public comments and pending publication of further guidance, the taxation of split dollar will be determined ... (Larry questions whether this Notice is guidance or a prelude to guidance). But states, "Here's where they are going - IF they are not there yet: You can characterize split dollar arrangement any way you chose - as long as three requirements are met: (1) Your characterization is not inconsistent with the substance of the transaction, (2) the characterization has been consistently followed, and (3) YOU ACCOUNT FOR ALL ECONOMIC BENEFITS PROVIDED TO THE EMPLOYEE!

This means you can treat split dollar as a loan (Section 7872 governs). So ONLY 7872 applies. You must therefore account for the interest. (You do not have to add to that any life insurance protection or anything else! There is no equity issue).

If the employer doesn't get repaid, the advances (premiums) are income (e.g. The Young Case).

Alternatively (to interest free loan treatment), if you don't treat the transaction as a loan, it's a "non-loan" (which means Code Section 83 applies). This is accomplished through a fiction under which the employer (and not the employee) acquires the policy and through one or more deemed transfers shifts the policy cash values to the employee. (Even though in actuality, the employee owned the policy from inception.) In this event, the insured is taxed on the economic benefits under Code Section 83, AND the net amount at risk under Code Section 61 AND on any other benefits under Code Section 61. The Section 83 equity is taxable - presumably - as it accrues (i.e. currently) IF THE EMPLOYEE IS "SUBSTANTIALLY VESTED". Section 4 of the Notice MAY provide grandfathering - or it may NOT. It's meaning and import are uncertain.

Item 6: Where the employer doesn't get repaid: Appears to be a bonus arrangement. Similar to the Young case. Not real clear.

Item B: Grandfathers P.S. 58 rates. Confusing because - if this Notice isn't in effect yet - why is grandfathering necessary? New Table: 2001. Says nothing about survivorship. No comment on U.S. 38.

Larry's bottom line: The Notice raises as many questions as there are answers!

And third, Charles Ratner's presentations:

Charles Ratner, National Director of Personal Insurance Counseling and Managing Director of The Ernst and Young Center for Family Wealth Planning discussed the "the Good, the Bad, and the Ugly, opportunities and risks associated with replacing life insurance, both internally within the same insurer and outside with a different insurer.

Charlie began with a strong caveat that THE PRESUMPTION IS THAT AN EXISTING POLICY SHOULD BE PRESERVED. He emphasized that the burden of proof of appropriateness of replacement is on the party who claims such an action is in the client's best interest and will meet the client's needs, objectives, and circumstance more effectively than the existing contract. He also made it clear in his materials that A POLICY TO BE REPLACED SHOULD NEVER BE CANCELLED UNTIL IT IS CONFIRMED THAT THE REPLACEMENT IS IN FORCE!

The first line of inquiry should always be: "Does the present carrier allow an internal exchange?" (Often, an internal exchange, one through the insurer that issued the existing contract, can be made on a very cost effective basis, often without evidence of insurability, with a waiver of any or most surrender charges, an absence of premium tax, and without payment of an agent's commission on the new policy).

Charlie stated that - although there is no such thing as "the right" or "the best" policy - he emphasized that usually - one type of policy is more appropriate than another in a given situation for a given client at a given time with given objectives - and that policy design - i.e., differences in the allocation of mortality, interest, and "loading" (expense) charges and the increased ability to "dial in" and custom design a desired ratio of death benefit to cash values may be meaningful in accomplishing the client's intended objectives at that time. Often (although not always) a newer product may be "better" than an existing contract because of changes in design features, pricing, or other benefits unavailable through the presently existing contract.

On the subject of appropriateness, Charlie explained that advisors must re-examine their definition of "risk". He stated that what was once considered the least risk, whole life, is now considered by some, because of its relative lack of premium payment flexibility and specified endowment date (and consequent tax consequences), much more risky.

Conversely, he noted, what was considered the highest risk, a policy (e.g. Variable or Variable Universal Life) in which the values were dependent on the success of the specific contract's underlying assets, is considered by some to be a lower risk because of its highly flexible payment (premium) structure and potential for internal growth beyond what is possible in a whole life contract.

He also pointed out that currently, the purchase of ultra large policies is essentially "a buyer's market", i.e., that it is often possible to negotiate both the offer from the insurer and the fee payable to the agent to write and service the case.

Charlie emphasized the care and deliberation which should be taken by all parties before a policy was replaced and concluded with a quip that "Replacement was not a task that should be attempted at home."

+++++++++++++++++++++++++++

Lastly, on the technical side of things, and apropos of Special Sessions II-B and IV-B entitled "2001: A Tech Odyssey" that were presented by Joseph G. Hodges, Jr. of Denver, Colorado and Julia B. Fisher of Philadelphia, Pennsylvania, in Wednesday and Thursday afternoons, which presentations involved in large part an overview of the results of their special Heckerling Survey that was done in an attempt to find out what sort of software and other computer technology all of us are currently using and like, the following "Live Summary Report" was received by them late Thursday evening re the 2001 Technolawyer @Awards:

1) Favorite Accounting Software goes to: Quickbooks

2) Favorite Case Management software goes to TimeMatters!

3) Favorite Document Assembly/Automation Solution goes to -- HOTDOCS/HOTDOCS PRO

4) Favorite Document Management Solution goes to -- WORLDOX

5) Favorite Handheld Computer goes to -- PALM SERIES

6) Favorite Handheld Application goes to -- AVANTGO

7) Favorite Knowledge Management Solution goes to -- CASEMAP/TIMEMAP

8) Favorite Legal Research Tool goes to -- WESTLAW

9) Favorite Legal Web Site goes to -- FINDLAW

10) Favorite New Legal Software Product for 2000 goes to -- TIMEMAP

11) Favorite Online CLE Provider goes to -- LAW.COM

12) Favorite Print Legal Technology Publication goes to -- LAW OFFICE COMPUTING

13) Favorite Time-Billing Software goes to TIMESLIPS!

14) Favorite Word Processing Software goes to - MICROSOFT WORD [that's a first]

15) Favorite TechnoReleases goes to -- CASESOFT

16) Favorite TechnoLawyer Contributor goes to -- ROSS KODNER

17a) MasterPost of the Year Part 1 goes to -- MARK FELLMAN -- for the MasterPost entitled "ASPs Deserve Better than FUD"!

17b) MasterPost of the Year Part 2 goes to -- JEFF BEARD -- for the MasterPost entitled "Palm or Visor?"!

18) Syndicated Contributor of the Year goes to -- DENNIS KENNEDY

19) Techno-Firm of the Year goes to -- KIRKPATRICK & LOCKHART LLP -- whose main office is in Pittsburgh

20) Legal Technology Consultant of the Year goes to -- THOMAS ROWE

21) TechnoLawyer of the Year goes to -- DENNIS KENNEDY

++

That is it for Report No. 5. The full text of all the Reports will be posted on the ABA RPPT Web site at http://www.americanbar.org/groups/real_property_trust_estate.html beginning early next week.

======================================
MIAMI INSTITUTE GENERAL INFORMATION:

Inquiries/Registration:
Philip E. Heckerling Institute on Estate Planning
University of Miami School of Law
Center for Continuing Legal Education
P.O. Box 248087
Coral Gables, FL 33124-0201
Telephone: 305-284-4762 / FAX: 305-284-6752

==
Headquarters Hotel - Fontainebleau Hilton, Miami Beach, FL
Telephone (305) 538-2000, FAX (305) 674-4607
==