Report #6

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REPORT NO. 6 - Thursday, 1/10/02

We still haven't received a report yet on the Tuesday afternoon EGTRRA Drafting session, so we are going ahead and reporting on the Thursday CLE sessions at this time. The bulk of this Report #6 was prepared and submitted by reporter Bruce Stone of the Holland & Knight law firm in their Miami, Florida office, and reporter Steve Leimberg submitted the report for his afternoon Special Session.

Thursday, January 10, 2002

8:30 - 9:15 a.m
Subchapter J - Recent Developments Relating to the Income Taxation of Trusts and Estates
Prof. Mark L. Ascher

Joe Gorman of Los Angeles convened the Thursday proceedings by introducing Professor Mark Ascher of the University of Texas School of Law.

Mark began with a discussion of the separate share rules, which until 1997 applied only to trusts. He used an example of an estate with two equal beneficiaries (A and B) and with DNI of $25,000. The estate distributes $25,000 to A and nothing to B during the taxable year. Under prior law all of the estate's DNI was deemed to be distributed to A. Under the new law and regulations, DNI is allocated equally to the separate and equal shares for A and B, and thus A receives $12,500 of DNI, the estate has DNI of $12,500, and B has no DNI for that year.

If the estate contains a specific bequest of IBM shares to beneficiary C, that is a third separate share. Under state law income on specifically bequeathed assets passes with those assets. If the IBM shares yield $5,000 in dividends, the estate now has $30,000 in DNI, with three separate shares. However, expenses are not necessarily allocated to all three shares, because if deductible expenses relate solely to one of the separate shares, they will be allocable solely to that share and will not affect the DNI of any other share.

Now suppose that the decedent's spouse makes an election to take an elective share under state law, and the share is a pecuniary amount based on date of death values and does not share in the estate's income. The estate now has four separate shares, but because the spouse's share is not entitled to any income, no DNI will be attributable to it. If state law provides for payment of interest on the elective share amount, the spouse will have taxable income but the estate gets no deduction for the interest paid to the spouse (at least according to the regulations). In Mark's view this conclusion is wrong, but he notes that it is a final regulation.

Mark then used another example where an estate has two equal beneficiaries: child A and the decedent's revocable trust. A section 645 election is made. There are two separate shares of the estate, those of A and the trust. Because of the 645 election, the trust is taxable on the estate's DNI not allocated to child A. If a non pro rata distribution is made during administration, the separate share ratios must be adjusted.

Mark called attention to the regulation which states that if the estate has IRD, it must be allocated among all of the separate shares that could potentially be funded with the IRD irrespective of whether the share is entitled to receive any income under the governing instrument or under local law.

Mark then briefly discussed the proposed regulations under section 645. He pointed out Notice 2000-26, which states that until the effective date of the final regulations, taxpayers can choose to follow either the original guidelines in Rev. Proc. 98-13 or the proposed regulations. He also pointed out that under the proposed regulations, not all former grantor trusts will be qualified revocable trusts upon the death of the grantor, and that not even all trusts which were revocable by the grantor will be qualified revocable trusts. Mark said that one of the most intriguing parts of the regulations provides that at the end of the election period, the combined estate and trust are deemed to distribute to a new entity.

Mark then moved to the proposed section 643 regulations, which in theory cannot be relied upon. Mark agreed with Jeff Pennell's observation from Monday that the proposed regulations do not make major changes to existing law, but they do make some changes. Overall they are an improvement over current law. The IRS is trying to mesh section 643 with developments stemming from the **Uniform Prudent Investor Act** and the **Uniform Principal and Income Act**. Because those acts are not a source for tax abuse, the IRS has recognized that it does not have a "dog in the fight." There are two principal areas of change: the definition in fiduciary accounting income (FAI), and when capital gains will be included in DNI.

Section 643 itself defers completely to the governing instrument and governing local law. But the IRS has long said that governing instrument provisions will not be recognized if they depart fundamentally from general principles of law. The new proposed regulations add the word "generally" to the phrase "will not be recognized." But then the proposed regulation goes on to add 5 additional sentences, and Mark says to think of them as examples. He said that because a majority of states have now adopted the uniform acts, there will be no fundamental departure from general principles of law when governing instruments define income in unitrust amounts or allow discretionary allocations or include capital gains in income.

One objective of the proposed regulations was to make it easier to include capital gains in DNI. Under current law, capital gains are not included in DNI, but there are three exceptions (although there have been some liberal interpretations of those three exceptions).

The first exception (if capital gains are allocated to income by the governing instrument or by local law or by the fiduciary on its books) is modified by the proposed regulations to impose a new requirement of reasonableness and consistency if gains are allocated to income by the fiduciary. (Indeed, the requirement that a fiduciary's exercise of discretion be reasonable and consistent applies to all three exceptions, not just the first exception.) The second exception (if capital gains are allocated to corpus and actually distributed during the taxable year) is changed in a major way: the requirement of actual distribution is eliminated. The focus instead is on whether the fiduciary treats the gain as part of a distribution to a beneficiary on the fiduciary's books, records, and tax returns. The third exception (if gains are utilized under the terms of the governing instrument or by the practice of the fiduciary in determining the amount which is to be distributed) by dropping the requirement of a "practice" by the fiduciary. In the past the IRS has taken the position that there cannot be a "practice" in the first year of an entity's existence. The omission of a "practice" requirement may mean something.

When appreciated property is used to discharge fixed-dollar obligations to beneficiaries, the **Kenan** gain that results will likely not be deemed to have "been paid" to the beneficiaries under the second exception in the proposed regulations. The question then is whether those gains nonetheless might enter into DNI under the first exception (where capital gains are allocated to income by the governing instrument or by local law or by the fiduciary on its books). Under unitrust statutes it would seem reasonable to expect that any gains would be included in DNI, but (as stated in Mark's outline materials) the analogy to **Rev. Rul. 68-392** is so close that the failure of those gains to enter into DNI would cause a cautious analyst to pause.

9:15 10:00 a.m.
The State Income Taxation of Multi-Jurisdictional Trusts
Max Gutierrez Jr.

Max Gutierrez, who hails from San Francisco, California, began his presentation with a general overview of some general rules and constitutional considerations. The constitutional ability of a state to tax trust income is limited by the due process and interstate commerce clauses.

The 1987 **Swift** case from Missouri (727 S.W.2d) was seminal in a line of cases which establish six points of contact that support the nexus to tax a trust's income: (1) domicile of the settlor, (2) the state where the trust was created, (3) the location of the trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of administration of the trust.

The Swift line of cases was challenged in the 1997 **D.C. v. Chase** case from the District of

Columbian (689 A.2d 539). The court found that residency of the grantor was alone sufficient contact for a jurisdiction constitutionally to exercise its taxing authority. This was reasoning was further extended in 1999 in five Connecticut cases under the heading of **Chase v. Gavin** (733 A.2d 782), where the only connection to Connecticut consisted of three of the five trusts having one or more beneficiaries resident in Connecticut, plus the fact that two of the trusts were required to submit regular accountings.

The 1990 **Blue** case from Michigan (Court of Appeals, No. 116666) held that Michigan could not tax a trust that had been created in Michigan by an individual who died while a resident of Michigan. The trustee and beneficiaries were all Florida residents. The only connection to Michigan was one parcel of real estate there, which did not produce income.

Residency of the trustee alone generally is a sufficient nexus to tax a trust. Nine states tax on this basis. But California taxes on the basis of "fiduciary" residence which raises questions such as whether a trust protector or someone who holds veto powers of trust administration matters is a fiduciary for tax purposes.

Situs of trust administration alone is sufficient nexus to tax. Generally this should require more important functions than merely keeping books and records, although in some states that alone is held to be enough connection to impose tax on all trust income.

The mere presence of beneficiaries in a state is generally not enough connection to tax the income of a trust, which has no other nexus with that state, but eight states do impose an income tax where the only contact with the state is that one or more beneficiaries reside in the state.

No state imposes income tax solely on the basis that the law of that state is the governing law of the trust.

In planning, great care must be given to the selection of trustees. Clauses should be used that limit the selection of trustees to jurisdictions that will not impose an income tax, or at least which require state income taxes to be considered in the selection of trustees. Provisions allowing trust situs to be moved should be included. Beneficiaries should be required to notify the trustee of change of residence, and the trustee should be exonerated from losses for failing to pay taxes resulting from a change of residence without notice to the trustee.

10:00 10:45 a.m.
Implementing Total Return Trust Statutes
Richard W. Nenno

Dick Nenno of Wilmington, Delaware noted that most states have now adopted the **Uniform Prudent Investor Act**. He also noted that 90% of long-term investment returns are attributable to asset allocation, and that only modest returns are attributable to security selection, sector selection, and market timing.

Dick used an example of an income beneficiary of a classic income only trust who demands a higher rate of income than would be produced by a 50-50 allocation between equity and debt investments in today's markets. He said that under the old prudent man rule, you could usually safely invest 100% in bonds, because this did "preserve" principal for remainder beneficiaries, but this is clearly not permissible under the prudent investor rule. Of course, if the document allows principal invasions or allows what would normally be principal to be allocated to income, the income beneficiary's needs can perhaps be met using those techniques. Alternatively, the trust could perhaps be converted to a unitrust.

Dick reviewed the **power to adjust** under sections 103 and 104 of the **Uniform Principal and Income Act**. He noted that some states have gone beyond the uniform act by allowing income to be defined as **a unitrust amount**, and he briefly reviewed the law of those states: Delaware, Missouri, and New York (and he also reviewed the provisions of the proposed legislation in Pennsylvania).

Dick identified five situations where it is generally inadvisable to convert to a unitrust: when a higher payout can be reached by creditors; when the trust assets consist of illiquid interests which then would have to be liquidated to pay out the unitrust amount and which would require appraisals; when conversion in a generation-skipping trust would unnecessarily increase the amounts to be paid out to nonskip persons; where the trust is not likely to last for a long time (because the advantages of a total return trust typically increase with the length of the trust term); and where the current beneficiary has a low tolerance for fluctuations in trust distributions.

Dick then turned to a discussion of the **federal income tax treatment of total return trusts**. The proposed regulations under section 643 give three examples of unitrusts, but none, which deal with the power to adjust under sections 103 and 104 of the uniform act. He discussed unitrust statutes (Delaware and the proposed Pennsylvania statute) which contain ordering provisions which would enable the trustee to distribute capital gains to the current beneficiary, and he contrasted those statutes to the New York and Missouri statutes which do not contain any ordering rules. It is generally thought that statutes with ordering provisions will be more likely to be recognized as allowing capital gains to be distributed to the current beneficiary than statutes without those provisions. There is also some doubt whether the exercise of the power to adjust under sections 103 and 104 of the uniform act will allow the trustee to distribute capital gains to current beneficiaries for income tax purposes.

Dick reviewed the GST consequences of total return trusts. He broke those trusts down into three categories: grandfathered trusts, exempt trusts, and nonexempt trusts. He cited **two PLRs (200148034 and 200150016)**, which have given favorable treatment to grandfathered trusts even in the absence of state statutory authority.

Dick cautioned practitioners not to ignore the possible **gift tax consequences of converting income trusts to total return unitrusts**, under the possible broad scope of the **Dickman** case. He also reminded the audience of the **Cottage Savings** case and its potential reach to recharacterize reorganizations of trusts as recognition events for federal income tax purposes. He pointed out that the private letter rulings which have addressed trust reorganizations have not ruled upon income tax consequences. Dick suggested making disclosure for federal income tax purposes under section 6501 to commence a three-year statute of limitations. In some cases, conversion to a unitrust might be made contingent upon obtaining a favorable private letter ruling, although this will often be unsatisfactory because of the delay or because of the possibility that a favorable ruling simply might not be issued.

Finally, Dick drew the attention of the audience to the very detailed provisions in his written outline that provide guidelines for the conversion of an income trust to a unitrust which his employer (Wilmington Trust Company) uses.

11:00 -11:45 a.m.
Generation-Skipping Transfer Tax Planning
Lloyd Leva Plaine

Lloyd Leva Plaine, who hails from Washington, D.C., began her discussion with a summary of the **GST provisions in the 2001 tax legislation**. She said that the legislation was meant to be helpful, but that in many cases taxpayers will want to elect out of the new automatic allocation rules. She reviewed the new terms introduced in the 2001 legislation indirect skips and GST trusts and noted that the legislation applies to transfers made in 2001. She cautioned the audience to be aware of this in the preparation of 709s for 2001.

Lloyd began an extended discussion of **what GST trusts are under the new definition**. In general, the statute defines GST trusts (to which the automatic allocation rules apply) too broadly. Some common trusts which are included in the definition of a GST trust should be elected out of the automatic allocation rules. She gave an example of a spray trust, which provides for a parent and that parent's children until the parent's death, which then holds the trust property in trust until children reach a specified age. Another example is an insurance trust which provides for distribution of the trust assets on the later of the insured's death or when the insured's child reaches a specified age (even if that age is under the age of 46, which is the age used in the statute).

Lloyd pointed out that trusts which use **hanging powers** where the amount that can be withdrawn in a particular year exceeds the annual exclusion amount will <u>not</u> be excluded from the definition of a GST trust, and thus GST exemption must be allocated to these trusts if desired. On the other hand, if the amount that can be withdrawn under the hanging power for a particular year is not greater than the annual exclusion amount, the trust will be a GST trust and the automatic allocation rules will apply.

Lloyd noted other reasons that you might not want the **automatic allocation rules** to apply: such as where trust assets values are expected to decline, or where a large distribution will be made to nonskip persons. She noted that the automatic allocation rules apply to trusts created before 2001 if the ETIP period for such a trust ends after 2000.

You must **elect out of the automatic allocation rules** on a timely filed form 709. Is an election to treat a trust as a GST trust irrevocable? No one knows for certain. The new automatic allocation rules have made it less likely that a failure to make a timely allocation of GST exemption will cause more GST tax to be paid. But they have created another problem, namely that in many cases it will be inappropriate to have GST exemption allocated to a particular trust or to have it allocated on a timely basis. The failure to elect out of the automatic allocation rules in those cases will cause GST exemption to be wasted.

Lloyd suggested **an approach to dealing with an ETIP trust**, or with a trust where it is expected that children will survive to an age specified as a condition precedent for distribution to them, but where a child in fact dies before then. The trust can provide for the assets to remain in a spray trust for the benefit of the deceased child's spouse or siblings (nonskip persons) in addition to the deceased child's descendants for a fixed period of time such as six months. During that period, GST exemption can be allocated to the trust, which can then be divided in a qualified severance, so that the portion for the deceased child's descendants will have a zero inclusion ratio and the other portions will have an inclusion ratio of one.

Lloyd also discussed the **relief from late GST exemption allocations**, which is now available under **section 9100**. She described that and the automatic allocation rules as being the two most important parts of the legislation from the perspective of GST tax planning. She noted that the IRS has indicated in **PLR 9718020** that the 6-month extension period for a form 706 may be available to extend the time in which to allocate GST exemption. It is **critical** that the return or other filing includes the statement "filed pursuant to section 301.9100-2" written across the top. The existing section 9100 regulations contain many definitions and set forth detailed rules when relief will and will not be appropriate. She discussed the critical need for affidavits, and how sometimes those affidavits might work at cross purposes from the point of view of the practitioner who might be accused of professional negligence.

Lloyd discussed the new rules in the 2001 legislation, which allow **retroactive allocation of GST exemption** when a descendant dies before the transferor. This is a beneficial change in the law, but it isn't clear how it ties in with the ETIP rules.

In conclusion, Lloyd advised that estate planning advisers **take a careful look at all existing trust arrangements** and determine how the new automatic allocation rules should apply. Because of the applicability to transfers made in 2001, and to ETIP periods terminating after 2000, that review has **some degree of urgency**. Finally, as always, wills and trust agreements should be drafted clearly having in mind an understanding of the new GST rules.

11:45 a.m. 12:30 p.m.
Special Needs Trusts
Sterling L. Ross Jr.

Terry Ross of Mill Valley, California began his presentation with a discussion of some of the basic rules that apply to planning with persons with special needs, such as what SSI (supplemental security income) is. He emphasized **the need of traditional estate planning lawyers** (as opposed to that branch of the practice traditionally referred to as "elder law") to have an understanding of these rules. As an example, he postulated a client who is well to do financially and who asks his or her estate planning lawyer to prepare an estate plan which will preserve resources for the client's child with special needs. The typical estate planning lawyer might be tempted to respond, "that's something that 'elder law' attorneys do." But a sophisticated client will care about preserving his or her estate and to make sure that the needy child receives as many public benefits as possible.

For example, an estate planning lawyer should be prepared to question a client who says that his or her child is receiving SSI and to ask instead whether that child is receiving SSI or SSDI (as there are no resource limits on entitlements to SSDI). He also discussed the **basic differences** between first party special needs trusts (settled by the recipient of public benefits) and third party special needs trusts (settled by a parent or someone other than the recipient of the person receiving benefits). The object of a special needs trust is to make funds available for a beneficiary without disqualifying that beneficiary from governmental benefit. The laws differ from program to program and from jurisdiction to jurisdiction.

Terry discussed whether a **"wide open" trust** (one with the broadest possible discretionary powers) would work as a special needs trust. The basic answer, if the trust is a third party special needs trust, is yes but the trust will not give guidance to the trustee. Furthermore, no matter what the niceties of trust law provide, administrators and other persons who work with public benefits programs have come to have a de facto (and almost intuitive) understanding of what a traditional "special needs trust" (a term which Terry coined back in the 1970's) is. In fact, if a caseworker sees a trust with the phrase "special needs trust" in its title, that's as far as the caseworker will usually go.

Terry stated that in 27 years of his practice, there have been no fundamental changes in the rules that govern third party special needs trusts. On the other hand, there have been a myriad of changes governing first party special needs trusts.

If a judge questions the **public policy justifications** for creation of a third party special needs trust, Terry observed that the parent of a disabled child over the age of 18 (if the disabled child is 18 or older, parents' assets are not counted as available resources of the child) functions as a special needs resource. Why should the death of that parent change the ability to preserve that parent's assets for the child's special needs? In reality, good planning merely substitutes a trust in the parent's place after the parent's death.

Terry stated that if there was **one essential point** for estate planning lawyers to remember from his presentation, it is that the common terminology **now equates a special needs trust with a (d)(4)© trust**. A (d)(4)© trust (under OBRA 1993) must have a "payback" provision which requires the trust to pay to the state the amount of medical assistance on behalf of the beneficiary under that state's Medicaid program. Third party special needs trusts do not have to include such a provision, and many such trusts are being erroneously drafted with payback provisions included because of the inaccurate equation of all special needs trusts with (d)(4)© trusts.

2:00 5:15 p.m.
Special Sessions III and IV

A variety of workshops were presented on Thursday afternoon **(see listing below)**.

Your reporter participated with Lauren Detzel (of Orlando, Florida) and Bob Goldman (of Naples, Florida) in a workshop discussing **recent developments in Florida trust and estate law**. The workshop was very well attended, with perhaps as many as 400 people present. Approximately 50 minutes was devoted to discussion of the planning and administration aspects of Florida's **new elective share law** (which became effective on October 1, 2001). Approximately 20 minutes was devoted to discussion of the complete overhaul of the **Florida Probate Code**. The chief point made there was that many provisions that formerly were found in the statutes are being moved to the **probate rules** promulgated by the Florida Supreme Court, and that practitioners not versed in day to day practice in Florida should not be misled into believing that the statutes set forth all of the essential rules governing administration of estates. Approximately 20 minutes was devoted to a review of **recent appellate cases of significance**. The chief case involved the assessment of punitive damages against a corporate trustee for conflicts of interest and damages which resulted to a trust when the lending side of the corporate trustee made loans to the trust to engage in commercial ventures which ultimately failed. The appellate court ruled that the attorney-client privilege did not protect communications between the corporate trustee and its attorneys in structuring and administering the transaction.

III-A CASE STUDY **Implementing Total Return Trusts**
Richard W. Nenno
Ralph C. Wileczek

III-B **Advanced LP, LLP and LLC Valuations**
D. John Thornton

Curtis R. Kimball

III-C **When Charitable Trusts Go Off The Track**
Jerry J. McCoy

III-D **Florida Law Update**
Lauren Y. Detzel
Robert W.Goldman
Bruce Stone

See summary above.

III-E **Future of the Profession**
T. Randolph Harris
Zoe M.Hicks
Howard M. McCue III
Beth Clark Rodriguez

IV-A CASE STUDY **Special Needs Trusts**
Sterling L. Ross Jr.

IV-B **Advanced LP, LLP and LLC Valuations**
(repeat of Session III-B)
D. John Thornton
Curtis R. Kimball

IV-C **What To Do With Life Insurance After the Hearse Leaves With Your Client In It**
Edward S. Schlesinger

IV-D **How to Succeed in (the) Business (of Practicing) Without Really Trying**
Stephan R. Leimberg

Steve reports on his own session as follows:

My talk was fully entitled, GETTING THE FISH TO CHASE THE HOOK: How to Succeed in (the) Business (of Practicing) Without Really Trying!

The thrust of the talk was the importance of a systematic approach to letting others know who you (and your firm) are - and how good you are! IQ, hard work, caring for the client, knowledge of tax and other laws, and even mastering tools and techniques will not alone suffice in the harsh economic climate of this decade; practitioners must pro-actively and ethodically determine who they want as clients, how to reach them, how to attract them, and how to keep them. Six steps are necessary to accomplish these objectives:

(1) Identify your target market,
(2) Expand your knowledge ("product") base,
(3) Develop a value-added strategy,
(4) Perpetually project positive imagery,
(5) Develop efficient planning systems, and
(6) Create a "quality control" culture.

The talk stressed the importance of identifying, differentiating, interacting, and customizing client contacts, of understanding the importance of making it a practice to help others see and solve their problems, of "sweating the small stuff", of understanding that marketing is a "contact" sport and that the more often we communicate with and are seen or heard by potential and present clients, the more opportunities we have to help them. We need to make it easy to contact and do business with us and impossible to forget how to refer business to us.

Getting the fish to chase the hook also requires that people see and think of you as a human being and puts a premium on the ability to project yourself as an individual and of giving the unexpected.

Because it is impossible for prospective clients (and even most fellow professionals) to judge our real ability or experience, the selection of a professional is more often based on perceptions - and feelings and personalities - or exposure - than on true value.

We must - more often - and more tangibly - show we care about our clients and those who provide us with clients - and learn what they want - and thank and reward them more frequently and more effectively. We must also create a focused, organized, written marketing plan in which specific people in the firm are given specific tasks. This requires a relationship oriented, effectively targeted, and professional nurtured plan.

Finally, we need to realize that until or unless we differentiate ourselves positively and constantly in the minds of our targeted audience, no matter how bright, dedicated, or experienced we are, we will remain an easily replaced - or overlooked - or undervalued - commodity.

IV-E **Income Taxation of Trusts and Estates**
Mark L. Ascher
Linda B. Hirschson

That is it for Report No. 6. 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.

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