Report #8B

This report is a continuation of 8A. It was broken due to the large size.

- Gene Zuspann

As we have done in January for the last six 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 week highlights of the proceedings of the 37th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 6-10, 2003 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida.

A complete listing of the proceedings and speakers is available on the Institute's Web site.
The URL for that site is http://www.law.miami.edu/heckerling.
===
REPORT NO. 8B

DANIEL H. MARKSTEIN, III From The Far Bank Of The River Styx – An Update of Post-Mortem Planning Issues

p. 41 – Sale of a partnership interest to a grantor trust – concerns have been raised regarding the value of the note issued by the trust and the possibility that treatment of the debt as equity might result in the transaction being subject to Sections 2701 or 2702. Also, watch out if you have a GST trust and you are using a beneficiary guaranty that you don't end up with a taxable gift to the trust by the guarantors who would then become both transferors and partial grantors of the trust, thereby fragmenting the trust's grantor trust status.

Perfect the security interest which collateralizes the note. Is there any problem with this. See the discussion of Regulation U at page 50.   There is a margin requirement of 50%. Would that apply to the limited partnership interest sold? There are two Federal Reserve Board staff opinions that support the position that a security interest in a limited partnership interest would not implicate Regulation U because the partnership interest is not "margin stock". But these are only staff opinions. There is no Board opinion. The only other comfort is the fact that the cases that have been litigated under Regulation U suggest there is no private cause of action for a violation of Regulation U. But the draconian sanctions which can be imposed on Regulation U violators may still suggest caution.

What can be done to avoid Regulation U status? Perhaps a beneficiary guaranty is the answer. Or perhaps a letter of credit from an independent bank. Markstein is using that and has got a letter of credit issued for 35 basis points. How can the IRS argue it isn't a debt instrument or that the note isn't worth its face amount. Perhaps paying some gift tax to fund up the trust so that it will have adequate collateral to stand behind the note is an answer.

What do you do if at the death of a taxpayer, the estate is largely illiquid because it holds a minority interest? Consider borrowing using a Variable Rate Demand Note. The problem is that to obtain an estate tax deduction for unpaid but accruable interest the IRS has ruled that the obligation must not be subject to prepayment or to acceleration upon default. If the interest can be made deductible there is a double bonus because the amount that will have to be borrowed to pay estate tax will be reduced. There is a trade-off in that the fiduciary income tax return will not be able to deduct that interest if it has been taken on the estate tax return.

There is a corporate financing technique called a VRDN ("Variable Rate Demand Note") that involves a taxable, floating rate, credit enhanced security sold to institutional investors. The interest rate can be converted from a floating rate to a fixed rate using the issuance of an interest rate swap. To enhance the borrowing leverage the estate would get a letter of credit from a bank that would back the estate's VRDN.

Hollywood has really started to focus on estate planning. Consider the following recent releases:

For the client who really is concerned that he doesn't want his children to be spoiled by a large inheritance:

Inherit the Wind

For the client who believes we will see permanent estate tax repeal:

Die Another Day

For the client who really wants to be aggressive in his estate tax planning:

Catch Me If You Can

Dean John R. Price – Estate Planning With GRATs and Near-GRATs – Opportunities and Pitfalls of a Cloudy Crystal Ball
In designing GRATs consider establishing separate GRATs for separate classes or types of assets. Example: Contrast separate two year GRATs created January 1, 2001 with a tech stock and a gold mining stock.

Don't forget what Dick Covey terms the common law GRIT when your client has aunts, uncles, nieces, nephews or cousins whom he/she wants to benefit. These individuals are not family members for purposes of Chapter 14 and hence you escape the reach of 2702.

Walton creates an opportunity to have tremendous upside potential with little downside. It is particularly attractive in light of the uncertainty of the future of the transfer taxes.

Consider purchasing a term insurance policy as a hedge against premature death.

The private annuity trust cases directly relate to what Dean Price calls the "Variation on a GRAT" which he feels is extremely attractive. This involves the sale to an intentionally defective irrevocable (grantor) trust in exchange for a private annuity for a fixed term. The private annuity will be ignored for income tax purposes. This eliminates one of the serious disadvantages of private annuity transactions.

The annuity can be structured, much like a GRAT, to generate little or no gift tax results. To do so, the annuity agreement must provide that payments be made to the annuitant or to his or her estate for the entire term. If desired, the annuity payments could be graduated and increase by 20% a year.

The initial funding of the IDIT would have GSTT consequences so the grantor's exemption would have to be used to give the trust a "0" inclusion ratio. Also, another advantage is that unlike the GRAT the GST allocation occurs upon funding of the trust and we don't have the ETIP complications of the conventional GRAT.

The biggest advantage this variation offers over a GRAT would be the strength of the argument that only the discounted value of the remaining payments under the annuity for a term is includible in the annuitant's estate under Section 2033. Under the *Fabric, Stern and LaFargue* cases the taxpayer has a much stronger argument to avoid full inclusion of the trust assets.

If the grantor is married, consider using a GRAT that would qualify for the marital deduction if the grantor dies before the annuity term expires. The simplest, but least effective for estate tax minimization purposes, approach is to have the GRAT terminate upon the grantor's death and distribute its assets to the grantor's estate from which it will pass to or in a trust for the benefit of the surviving spouse. Another alternative provides that the annuity payment is the greater of a percentage or actual income of the trust. This may permit qualification for the marital deduction. Question: can this be set up so that only in the event of the grantor's death will the greater of the annuity payment or actual trust income be distributed.   See Mulligan, <u>The Reinvigorated GRAT: Is a Sale to a Defective Trust Still Superior?</u> 29 Est. Plan. 379 (Aug. 2002).

RICHARD B. ROBINSON – Unwinding the Discount Entity: What to do When the Family Wants to Take the Money and Run?

We should be paying as much attention to the path for unwinding a FLP or FLLC as we do to the formation of the entity. Failure to do so can result in disastrous estate or income tax consequences. The family will want to liquidate the partnership immediately upon the death of the parent. However, that can have a disastrous impact on the estate's ability to take a marketability discount for estate tax purposes. Likewise, if the liquidation will take place within seven years of formation or contribution of appreciated assets to the partnership there may be deemed sale income tax consequences.

Note: There is no explicit "step in the transferor's shoes" rules for the excess distribution rules under Section 737(a) as there is for the built-in gain rules under Reg. § 1.704-4(d)(2). There is a disagreement among the commentators on whether there should be a step in the shoes rule for the excess distribution rules. See the argument Robinson offers at p. 12-4 that if the distribution consists of **<u>all</u> the step in the shoes property.** Robinson's conclusion is that you should postpone making the distribution until you are outside the seven year period that commences upon the contribution of the appreciated property to the partnership.

Think about when you want and don't want the valuation discount. It has a dramatic impact on basis step-up at death. It is generally desirable to get as much basis step-up as possible.

How Do We Allocate Basis Between a Controlling and Non-Controlling Interest in a Family Entity:

See Rev. Rul 84-53. The rules for basis are different than the rules for holding period. We could theoretically have a single basis for a partnership interest but have multiple holding periods for portions of that interest depending on when it was acquired.

What happens when the partnership interest is transferred, either by death or by gift. Reg. § 1.61-6 (a) provides that the single basis is allocated to the portion transferred and the portion retained based on the relative values of each interest. See the example at p. 12-22.

These rules prove that if you can keep your head when all around are losing theirs, then it is clear you really don't understand the situation.

RUSSELL ALLEN – JP Morgan Private Bank "What Do You Mean Subpoena? I'm a Lawyer! "

The three most common areas of controversy of concern to trust and estate lawyers should be: what constitutes legal advice; when is there a legitimate expectation of confidentiality; and when has the privilege been waived?

It is likely the IRS' efforts to discover or characterize a transaction as a sham or as a step transaction or arguments over the business purpose of a transaction will result in an increasing number of discovery requests of counsel concerning their efforts on behalf of and communications with clients.

The new tax practitioners' privilege is shrouded in ambiguity. This makes communication between a client and accountant the source for almost as much concern as it traditionally has been. Furthermore, anytime an accountant is involved in a communication the attorney-client privilege is at risk.

It is unlikely that an appraisal – whether obtained by the client or by the client's lawyer – can qualify for the privilege. See U.S. v. McKay, 372 F. 2d 174 (5th Cir. 1967).

How to minimize the risk of waiver of the privilege by having the lawyer hire "experts". See U.S. v. Kovel, 296 F.2d 918 (2d Cir. 1961) and U.S. v. Schwimmer, 892 F.2d 237 (2d Cir. 1989).

Inadvertent disclosure cases. Bank Brussells Lambert v. Credit Lyonnais (Suisse) S.A. 160 F.R.D. 437.

If the client uses the content of confidential communications to defend against a penalty assessment or fraud allegation, the client waives the privilege as to that and all related communications. The IRS will take the position that seeking an estate tax deduction for legal fees or other expert costs is a waiver of the privilege. See *O'Neal v. U.S.*, 258 F.3d 1265 (11th Cir. 2001).

Allen suggests that if a lawyer is engaged to prepare estate tax returns that the client may want to consider engaging separate counsel (whose fees he suggests will likely be non-deductible) to provide advice about matters that are likely to be controversial. He also suggests that consideration be given to retaining separate counsel if "hard questions" arise in the audit arena. Allen's approach is to have two experts – one to testify and one to deal with the "hard questions".

For planning purposes, trust and estate lawyers should assume that their communications with clients that involve advice concerning the law and application of the law to particular facts *may* enjoy protection under the attorney/client privilege **if** care is taken to make sure confidentiality is not waived. For instance, communications with any other professional advisor (accountant, appraiser, CLU, financial consultant, etc.) will probably not be privileged. Careful attention should be paid to how and from whom the lawyer requests, receives, analyzes and memorializes information. Particular attention needs to be paid to electronic communications. You may want to adopt a rule that you assume every electronic mail will be read by an audience much broader than initially intended. Waiving the privilege by disclosure to non-clients should be a constant concern. Likewise, disclosure of information to estate or trust beneficiaries can also raise the possibility of waiving the privilege.

SUSAN PORTER – US Trust Company

"One Percent, Two Percent, Three Percent, Four – No Matter What You Pay, the Bene Wants More"

Susan believes not enough attention has been given in literature and symposiums to the issue of designing trusts to be as flexible as possible in regard to discretion over trust distributions of income or principal. She also feels it is critical that we educate our clients on the breadth and depth of the discretionary powers they want to give the trustee and to help them focus on the final objectives for their trust.

She noted the limitations which trusts run into when ascertainable standards are used rather than giving independent trustees much broader powers. She reviewed some cases in which the court have not respected the "absolute" or "sole" discretion granted a trustee.

Thursday afternoon Workshop on Hot Topics

Martin E. Basson – IRS

The IRS know has a national coordinator for FLPs/FLLCs. They have five regional coordinators. They have a person in Washington, D.C. who makes the decision on whether to litigate. They have a monthly conference call for the agents on FLP/FLLC issues.

Mary Lou Edelstein – IRS - She is the national coordinator for the appeals officers for FLPs/FLLCs. They have different rules for different types of entities and circumstances. For instance, their range of settlement (not clear if this is their offer or where what they view as a cap on settlements). death bed and 2036 0% to 15%. Actual operating companies and active real estate – 35% to 40%. Marketable securities partnerships – 25% to 30%.

John W. Porter – Baker & Botts, Houston John's standard rule in answering audit requests. But they don't produce documents that are subject to the attorney-client privilege. This analysis is made on a case by case basis. Correspondence and bills are not provided. The new burden of proof rules require that we have cooperated with reasonable requests from the IRS to have the burden of proof shift to the government. Last ten years of bank statements. Porter will case the IRS agent and see if there is some other way to accomplish what the agent is after without it being so burdensome. He likes to document the agreement with the IRS on what is being produced and what is privileged and not privileged.

Martin Basson – About 18 months ago a Texas collection agent reported that there was an amazing number of cases in which there was a default. In Florida there was a tremendous number of defaults. What is happening now the government is being forced to protect its lien position. The letter will say file a bond or give us some property to file a lien against. The letters will be coming out of the Cincinnati service center in the very near future.

Transfer tax returns have been centralized in Cincinnati. There is a toll-free number for the estate and gift tax group. 866-699-4083. It is an automated service but they will call back. There is a small business/self employed tab under the IRS web site. Under that tab you will find the estate and gift tax group and its contact information.

Mary Lou Edelstein – Don't bury your best issue at the bottom or in the body of your appeal. Start off with your strongest argument. Make them very clear and very thorough. Attach as many exhibits as appear relevant. The exhibits aid clarity and add credibility. Keep in mind that ex parte rules in Appeals. The Appeals Officer is not allowed to discuss your case with a Compliance employee without your permission or presence. See Rev. Proc. 2000-43. Appeals Officers are encouraged to attempt a resolution with just one conference. Most officers will want to try to get as much resolved in the initial conference as possible with a hope that will be the only conference. You can also request fast-track mediation while the case is still in Compliance. If you have additional information which wasn't previously provided to the compliance officer, please get it to the Appeals Officer before your conference. Before you meet with the Appeals Officer, have a realistic assessment of your case and if possible a range of settlement percentages.
There is a post-appeals mediation process for large cases. Don't be afraid to extend the statute of limitations. Appeals is trying to address all cases as quickly as possible.

Norman Benford – Greenberg Traurig, Miami – Adequate disclosure

Follow the rules meticulously.

John Porter – Valuation Developments

Jameson was reversed by the Fifth Circuit (267 F.3d 366, 5th Cir. 2001). The Fifth Circuit rejected the Tax Court's strategic buyer analysis.

Estate of Dunn v. Commr. No. 00-6-614 (5th Cir. August 1, 2002) applied a dollar for dollar discount for unrealized capital gains when determining the value of a 64% interest in a closely held Texas corporation.

You may not get a dollar for dollar discount for pass-through entities because of the availability of the Section 754 election.

Martin Basson – The IRS will look at the capital gain exposure as part of the marketability discount. They don't feel it is appropriate to treat it as a separate discount.

John Porter TAM 200247001 – How do you value an IRA for estate tax purposes? The IRS felt that the 691 deduction takes into account the tax effects. There are a number of cases in audit where this issue is being argued.

S Corporation stock valuation cases – Gross (272 F.3d 333 – 6th Cir. 2001) and Adams (83 T.C.M. 1421 (2002). The Tax Court has refused to tax adjust the income stream from a S corporation under either of these cases.

There is another case, Heck (sp?) where the argument is being made that the marketability discount for a S corporation stock should be enhanced because of the statutory eligible shareholder limitations.

Basson and Edelsteing 2036 issues are going to be raised more frequently if the transferor doesn't keep some assets outside of the LP. They are going to look at whether there has been any co-mingling of funds and whether the partnership agreement has been strictly followed. They also will look at whether the distributions appear to be related to what the income realized by the transferor prior to formation. They are also going to look at the issue of whether there are disproportionate distributions. The liquidation during the pendency of the audit or appeal will generally result in a much lower settlement offer.

John Porter - Strangi is back in the Tax Court on remand. It was formed just two months before his death. Briefs have been filed now. We may see an opinion during the next 6 to 12 months.

John Porter - Kerr held that 2704(b) would not apply to the restrictions on liquidation and dissolution. Many planners have recommended having a charity as a limited partner to make 2704 (b) not applicable. That was the situation in Kerr because the University of Texas was a limited partner.

John Porter – McCord – this is a case pending in the U.S. Tax Court that involves a valuation definition clause.

John Porter – importance of the appraisal. Because the appraisal filed with the transfer tax return constitutes an admission of value by the taxpayers, it is important for the taxpayer to obtain well-reasoned appraisals from a qualified appraiser when the return is filed.

John Porter – in the area of undivided interests look at the Sels case and Baird case. Sels resulted in a 60% discount. It involved an undivided interest in 79,755 of acres of timber. Baird involved Louisana undivided timber. *Estate of Baird v. Commr.*, 82 T.C.M. 666 (2001). In that state you have to own an undivided interest of 80% or more to compel the harvest of the timber. Another important note about the Baird case was the fact the estate used an expert who was involved in the buying and selling of undivided interest in timber. His testimony was very persuasive.

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 33124-8087
Telephone: 305-284-4762 / FAX: 305-284-6752
Web site: www.law.miami.edu/heckerling
E-mail: heckerling@law.miami.edu
==
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607

==

//--

Eugene P. Zuspann II

Denver, Colorado Mail: ezuspann@zuspann.com
Goodland, Kansas WWW: www.zuspann.com

To search the ABA-PTL archives online or manage your subscription, go to
http://mail.abanet.org/archives/aba-ptl.html