A complete listing of the proceedings and speakers is available on **the Institute's Web site**

# Report 13

**Thursday, January 8, 2004**

2:00 - 3:30 p.m. - Special Sessions III

**Session III-A CASE STUDY - Tax-Free Corporate Divisions in Family Business Succession Planning**
Michael W. Bourland
Marcus P. Johnson

Reporter: Gene Zuspann Esq.

The panel discussed a long fact situation and the possibilities of restructuring to accomplish the family goals.

The attorney must first determine if a division is necessary. The adversity among family members may be personal rather than problems with the business. Sometimes the business as a whole is worth more than the sum of the parts, and if so, the division would reduce the value of the business.

Following the division, will the different companies do business only with each other? If they do, there may be an issue that the
division had no real business purpose and that the only reason for the division was a shareholder purpose. Remember that there must be a valid business purpose and a shareholder purpose alone is not enough to qualify for §355.

Keep a mind the problem if one of the 3 businesses (in this example the panel was using a 3 way split-up) has not been in business for five years. One of the requirements is that the business must have existed for 5 years ending on the date of the distribution. You may be able to work this out, but care is needed.

If the value of each division is not identical, there are several alternatives to consider.

- If one shareholder receives cash to equalize the division, the cash will be taxed as boot. If no cash changes hands, there is a gift. If there is boot, consideration should be given to the tax impact.

- You could use non-business assets in the distributing corporation to try and equalize the values, but there is a risk that the new corporation is not in a trade or business after the division if the amount of the non-business assets are significant. Problem assets are those that are not functional assets in the trade or business. The risk in this case is that the entire transaction could be jeopardized.

Debt in excess of basis is not a problem because §355 uses a §368 reorganization and (if I understand correctly) the debt in excess of basis rules in §357 do not apply.

**Session III-E Premium Financing Techniques**
Donald O. Jansen

Reporter: John Warnick Esq.

Reporter's Note: Due to the time constraints imposed in the regular session, Mr. Jansen was unable to fully cover his topic in the general session that was reported in Report No. 9. He picked up in the afternoon at p. 43 of his outline of approximately 80 pages. You will note that he took questions from the audience at several points during his workshop presentation. These questions have been italicized for convenience of the reader. During the workshop Mr. Jansen did not address the case study examples which were included in the Special Session materials.

The Economic Benefit Regime is analogous to the old endorsement split dollar arrangement. It will apply to split dollar arrangements entered into after 9/18/2003.

What are the economic benefits of adopting the new Economic Benefit Regime:
1. the cost of current life insurance protection is based on the term tables provided by the IRS (see Notice 2002-8 for the most recent IRS announcement)
2. the amount of the policy cash value to which the non-owner has current access
3. the value of the economic benefit to the extent not taken into account by the non-owner in a prior tax year.

If the cash value is directly or indirectly accessible to the non-owner, he has constructive receipt and he will be taxed on the equity build-up. He is deemed to have access to the cash value if he can withdraw or borrow such amount.

The cash value must be accessible to the owner/employer. We have to build into the contact full access for the employer to the cash value while the employee is alive. Mr. Jansen suggests that in a family arrangement the IRS may look past the terms of the arrangement.

The cash value must be accessible to the general creditors of the owner/employer. There are some states which protect the cash value of a life insurance policy from the claims of creditors of the owner. Perhaps in those states the split dollar arrangement should expressly allow access to the creditors of the owner.

What about a policy in which there is no equity but which pays a dividend to the employee rather than the owner/employer? Under the economic benefit regime the employee will be taxed on economic benefits such as dividends or policy loans in the year that he receives them and those amounts will be treated and taxed to the employer under Section 72 and to the non-owner according to what his relationship is with the owner - employee (compensation) trust(gift), etc.

P. 51 - 7a. he thinks this is a stretch and will be challenged in court.

P. 52 - 8 Non-owner's basis - "surprise"

p. 54 - You may ask who in his right mind would use economic benefit regime? There are quite a few people and two broad categories where Mr. Jansen sees this will be used frequently:

1. Executive compensation where there is no trust involved.

2. Switch-dollar. Why not use an economic benefit arrangement with the life insurance contact is owned by a trust but the cash value is owned entirely by the employer. Just before you reach a cross-over point, you switch over to the Loan Regime. The conversion when there is no equity should cause no income tax problem. But by delaying the switch to the loan regime we get to take advantage of the lower term costs of the Economic Benefit regime.

P. 55 - Section 162 Executive Bonus Plans. Employer bonuses the premium to the employee who owns the policy and all the cash value. If this is a large policy the cash value build-up may become significant in a relatively short period of time. With employers viewing these benefits as primarily a retirement supplement, they may want to impose restrictions upon the executive's access to the cash surrender value before he reaches his anticipated retirement age.

Many restricted access executive bonus plans have been developed. What are the income tax problems with these arrangements? Could the IRS argue that the executive restricted bonus plan is really a compensatory split dollar life insurance arrangement governed by the loan regime? If the restricted executive bonus plan has a vesting schedule, the issue will be whether the last two parts of the three part definition are met. This is not clear. Is the "reasonable person would expect the payment to be repaid in full" test met if repayment to the employer can occur before the executive is vested. Is the repayment "to be made from the policy's ...cash surrender value" test met although the separate agreement does not require the executive to use cash value for payment if the triggering event occurs before vesting but the policy contains an endorsement that the executive cannot access cash value without employer consent?

If the restricted access executive bonus plan not a split dollar arrangement then the premium would be taxed to the executive under general income tax principles under either Section 61 or Section 83.

Mr. Jansen suggests avoiding the outside vesting schedule if at all possible? Maybe the vesting schedule really doesn't give that much to the employer. But if the employer suggests using a vesting schedule, Mr. Jansen raised the question of whether the executive should consider making a IRC Section 83(b) election?

Does ERISA apply to the restricted access executive bonus plan? Recent DOL advisory opinions indicate that single employee plans are covered by ERISA. DOL. Adv. Op. 75-09; DOL Adv. Op. 79-75. Since 1987 most cases in this area have been impacted by the Supreme Court's decision in Fort Halifax Packing Company v. Coyne, 482 U.S 1 (1987). Some courts have found a nonqualified deferred compensation or welfare benefit granted to a single employee have found the plan to be covered by ERISA but others have reached a contrary result. To strengthen the argument that there is no ERISA plan, each restricted access executive bonus arrangement should be individually negotiated and perhaps included in the employment contract. Certainly it would be advisable not to have a general document which applies to all executives who meet certain requirements.

Even if you find that the restricted access executive bonus plan is it a welfare plan under ERISA or a Pension Benefit Plan under ERISA?

To avoid treatment as a welfare plan, the executive should always be the owner of the life insurance arrangement.
ERISA applies to a plan which provides retirement income to employees or results in deferral of income by employees for periods extending to the termination of covered employment or beyond. ERISA Section 3(2)(A).

If the restricted access executive bonus is treated as an employee pension plan, any vesting schedule should be designed to lapse well short of normal retirement age. Mr. Jansen uses the example of a ten year restriction for a 35 year old executive as one which should avoid characterization as a pension benefit plan.

If the plan is considered to be an employee pension plan, then there are numerous ERISA requirements you must contend with. If you can succeed in characterizing this restricted access executive bonus as an "unfunded top hat" arrangement applying to a select group of management or highly compensated employees, only a written plan containing items such as designation of a named fiduciary and setting forth a claims procedure is required. The requirement of filing an annual Form 5500 can be avoided if a single alternative statement is filed with the DOL as provided in ERISA Reg. Section 2520.104-23(b). The penalties for failure to file the annual report is substantial so it is highly recommended that the alternative statement be filed. Mr. Jansen suggested that it might also be desire to file a protective alternative statement within 120 days of the implementation of the plan to anticipate the possibility that the DOL might determine that the restricted access executive bonus is an unfunded top hat pension plan. Such a protective alternative statement might state that the employer doesn't think the plan is subject to ERISA but in case it should subject to ERISA, the statement is being filed.

NOTE: Mr. Jansen cautions that the "top hat" exemption is not applicable if the DOL determines the executive bonus plan is a funded rather than unfunded plan. This would be the result if DOL determines that the restricted cash value of the policy constitutes a plan asset funding a retirement plan.

*Audience Question on Section 677(a)(3) - income is or may be applied to pay insurance premiums on the life of the grantor. Do you feel that we can rely on that to establish grantor trust status?*

There are some older cases that indicate that this doesn't result in a grantor trust if it is a "dry trust" - that is the trust holds no assets other than the insurance policy. It clearly would be a grantor trust for ordinary income but might not be for capital gain purposes. The cases don't reach that point. Therefore, Mr. Jansen strongly feels that

*Audience Follow-Up Question on Section 677(a)(3) What about putting the premiums in early and let them generate some income before paying the premiums?*

Mr. Jansen feels this might help some but questions just how helpful it would be if the amount of income generated is rather inconsequential in relationship to the premium.

Mr. Jansen then returned to his outline and a discussion of Employer/Employee Joint Ownership - what if you start out with a 60/40 ownership split and what if over time they increase the ownership percentage of the executive? This might be combined with an executive bonus plan. This plan offers some of the advantages of the restricted access executive bonus plan. It isn't quite as useful for wealth transfer purposes because of the gift tax element.

And there is a practical problem, particularly with a variable policy, of tracking what is owned by each party at each point in time.
What are the income tax consequences of this joint ownership plan? Is it a split dollar life insurance arrangement? The split dollar life insurance regulations state that each owner will be treated as the owner of a separate contract to the extent of such person's undivided interest. But there is a

disturbing comment in the regulations which states that each person must have, at all time, all the incidents of ownership with respect to an undivided interest in an contract.

You can't have an arrangement where the employee owns 40% of all incidents of ownership of one portion of the policy and a split dollar arrangement as to the remaining 60%.

As the employer transfers an interest to the employee each year, there will be income to the employee each year with a corresponding deduction to the employer.

The key issue in transferring a fractional interest in the policy each year is what is the value of that interest. The regulations state that it is the cash surrender value. Don't try to take a minority interest discount. Mr. Jansen sees some clouds on the horizon. The IRS is becoming increasing dissatisfied with using cash value as the measure of value. Mr. Jansen points out that the new split dollar life insurance regulations raise a question. The original proposed regulations use the term "cash surrender value" but in the final regulations they removed the word "surrender". Elsewhere in the final regulations (in the discussion of economic benefit) they state "policy cash value is determined disregarding surrender charges or other similar charges or reductions." Although that definition doesn't literally apply to policy cash value, is it possible the IRS will attempt to use this methodology to value the transfer of a split ownership policy. If the undivided ownership is not a split dollar life insurance arrangement, then Section 83 or Section 61 should apply and the use of cash surrender value should be permitted.

What are the gift tax consequences of the Joint Ownership life insurance arrangement? The valuation of gifts of life insurance policies is calculated differently than under Section 61 or Section 83. For gift tax purposes the value of a life insurance contract is its actual cost or replacement cost.

What is the effect of the new split dollar life insurance regulations is on private split dollar where the arrangement is between the insured and a trust? The final regulations make it clear that the loan regime and economic benefit regime apply to private split dollar. If it is a grantor trust you should avoid the income tax consequences of a loan regime but you still have to deal with the gift tax consequences. Mr. Jansen would avoid the economic benefit regime for private split dollar arrangements because of the Section 2042 problems.

---

**Friday, January 9, 2004**

9:00 - 9:45 a.m.
**State Death Tax Credit: Planning and Drafting in Light of Phase Out**
Robert C. Pomeroy

Reporter: Gene Zuspann Esq.

When congress started phasing out the estate tax, they compensated in the early years by phasing out the state death credit faster than the federal reductions. The result is that there is no loss to the federal fisc in the early years of the repeal. In fact, the collections by the federal government are now larger than they were before the phase out started.

This has caused a substantial loss to the states that has occurred very quickly. The materials include a table showing the current status of all 50 states. He noted that Oregon and Pennsylvania have since modified their laws.

He quickly discussed the differences in the laws in a number of the states that are decoupled. The different approaches vary widely,
are already in place in a number of states and other states either have or anticipate bills to change the law.

Planning for death-time transfers:

He does not think that the planning for a single person will change much - the estate is going to pay more tax. However, changes in the marital deduction planning will need to be considered. In decoupled states, the alternatives are to pay the state tax that arises for the difference between the federal and state exemptions, or to underfund the marital deduction. The client must consider the benefit of paying money to the state on the first death to avoid a higher federal tax in the second estate, as opposed to paying no tax at the first death and relying on continued changes in the law (or a complete repeal of the estate tax) that eliminates the tax on the second death.

He discussed 3 choices to consider and the decision will affect the formula clause for the marital deduction planning:

- Minimum total tax

- Minimum federal tax taking state death tax credit into account only to extent it does not increase state taxes. You must be careful with this kind of formula where there is property in multiple states and the laws in the states vary. He gave several examples. The result seems to be that you need to crunch the numbers to obtain an answer and advise the client that the results will change as assets and values in the various states change.

The basic issue/decision is how you fund your marital deduction amount.

- Minimum federal tax

Consideration of the effect of using the applicable exclusion amount during life to reduce the total tax. There are several alternatives that can accomplish this result, if the client will consent.

- Do an inter vivos stand-by credit shelter trust, funding such a trust shortly before the client's death. The trust would be funded with the client's applicable exclusion amount. This strategy is attractive in estates with pre-EGTRRA state death tax credit if the state does not have gift tax or tax gifts in contemplation of death.

This planning could be accomplished with a durable power of attorney (to a disinterested person) to make very sizable gifts to the objects of the client's bounty or a trust for their benefit. For example, a $10,000,000 gift (in 2007) made the week before the client's death might save $880,000 in taxes. If the assets are low basis assets, the agent could borrow on the assets and sell them after the death of the donor, repaying the loan.

- If the client does not believe repeal is really going to occur, or will not survive until 2010, gifts which incur federal gift tax continue to be attractive. The client will have to survive three years to keep the gift tax out of the estate.

- A client could consider a change of domicile if the state death taxes are very high. The materials contain an extensive appendix listing recommended actions for changing domicile to a new state.

If the assets are not portable, the assets in the former state may be put in an LLC or other entity form. The intangible should be taxable in the state of the domicile. He points out that this strategy may not be effective in all states. He does suggest filing something with the former state showing the change in domicile so that a large penalty and interest does not attach later in the event the former state determines that this approach does not work.

At the moment, the states are acting independently in dealing with the change in the state death tax credit. Because of these actions by the states, and the lack of a possibility that a unified approach can be adopted in the near term, the estate planner will have to take the different laws of the states into account in the planning.

---

9:45 - 10:30 a.m.
**Old Age with Fears and Ills: Planning for the Very Old Client**
Lawrence A. Frolik

Reporter: Gene Zuspann Esq.

He classifies old as 85. He also points out that most of these people are women. One-half of women alive at age 65 live to age 85. In men age 65, the anticipated expectancy of being alive at 85 is 30%.

In counseling, the attorney must realize that time is of the essence. Both the client and the attorney should put the estate plan on a fast track. The client may not only die, but has the potential for dementia. One problem with many clients is the fear of making a mistake and of making changes. The attorney has to work through this problem to complete the engagement.

The client also may have physical infirmities. There are many things that the attorney needs to keep in mind in working with the older client.

- Use a series of short meetings. It is often a strain on the client just to get to the office.

- Many clients are less sharp in the late afternoon (sundowning). Schedule meetings in the morning and early afternoon.

- Consider going to their home.

- Many have hearing problems. Do not have any background noise.

- Sit next to them at a small table - do not have the conference across your desk. Have firm chairs.

- Loss of vision often causes problems. Do not bother with demonstrations on your computer screen. It is often difficult for them to see and older clients are not comfortable with this method. Do it the old way (pencil and paper).

- Because of short-term memory problems, prepare a written outline or simple explanations of what was presented at prior meetings and what is to be addressed at the next meeting.

- Problems with financial realities. Example: Client suggests a generous gift of $5,000 when client is worth $5,000,000. You need to suggest this may not be seen as generous and point out the cost of things now - a basic car costs $20,000.

- Some clients will not be able to understand the concepts of a complex plan. Most clients to not understand the detail of such a plan, but they do understand the concepts. Be careful of a claim of undue influence.

Psychological barriers.

- Be alert to depression or dementia. The most common symptom of dementia is diminished short-term memory.

- Talk with other family members (who are almost always involved with a very old client) about depression.

- You may want to use a mini-competency test. Some attorneys use these much of the time with the statement "Let's clear this up so we have no problems." Who is the current president of the U.S.; count backwards from 100 by 7, etc.

- Realize that an physically disabled spouse may not have the same goals as the well spouse.

- What are the client's attitudes toward death - some are fatalistic and not protective enough about their own financial well-being.

- Some are too fearful of the details that they fail to make the large decisions, i.e. too concerned with dividing the personal effects.
Try to narrow the range of choices to 2 or 3 alternatives, execute the plan, and put off such detail decisions.

- Put the desires in a perspective that the client can understand - "You want to provide enough money for your 3 grandchildren to go to any college they want," rather than "you should set aside $337,000."

Older clients often use gentler terms to express their feelings. The older client says "I am frustrated with my son." A younger client might say "I am mad as hell at my son." You need to clarify the client's attitude.

The "hide the asset" game.

- Some clients hide or hoard cash, i.e. cash in books in the library.

- Some older clients have multiple bank accounts and multiple brokers. There is no intent to hide the asset, but finding all of the assets can be difficult when the client does not remember all of the assets. Get the income tax returns and if a spouse has died, get a copy of assets in the deceased spouse's estate.

- Are there assets with an emotional significance.

- Titling of assets can be a problem. Avoid devising a plan that is dependent upon the client taking steps to rearrange assets unless you are sure these actions can be completed.

Tangled Families.

- As the client grows older, their family may not resemble a tree, but rather a tangled bush.

- The very old client will have old children. The children are probably already between 50 and 65 and the grandchildren are often in their 30's. Is a plan, "all to my children" fair or equitable when you have "hard" data about the children.

- Be cognizant of the lifestyles of the lower generations - the faults and problems of the children and grandchildren. Often this information is not well known to the client, especially when the issue is the grandchildren. If there are controversial facts, should the client be told?

This presentation was enjoyable with a lot of dry humor - a good program at the end of a long week of information overload.

---

10:45 a.m. - 12:00 p.m.
**CASE STUDY - Grand Finale - Implementing Bright Ideas**
Ellen K. Harrison
Jerome M. Hesch
S. Stacy Eastland

Reporter: Jason Havens Esq.

Ellen gave some overview comments on the current estate planning environment, including potential repeal of the estate and GST taxes, techniques in a low interest rate environment, financing life insurance, the use of FLPs, Circular 230, and more.

Ellen highlighted the considerations involved in approaching estate planning (page 3 9 factors).

Stacy's problems:

Stacy emphasized the 15% tax as a "window of opportunity" for closely-held businesses. He suggested the use of a disproportionate redemption. The cash distributed would be taxed at 15%.

Sam and Sally Selfmade

Illustration A: Disproportionate redemption: Use a loan, distribute the cash after a recapitalization of the entity, redeem Sam's and Sally's non-voting shares, and then contribute the cash to an FLP.

Calculations (page 4): Roughly a $500M savings due to estate tax savings even though 15% income tax paid, and Sam and Sally are still in control. Risk: Defined-value clauses transferring non-voting shares and then gifting over any remaining amounts to GRATs (not "zeroed-out" in this situation). Tax risk: Could be mitigated with lesser discount (30% instead of 40%) still get major advantage with "freeze" (where real savings is).

Jerry's problems: Example 8 (page 10):

Family C corporation with marketable securities

Solution: Merge private C corporation into public corporation in a tax-free merger (A reorg.) (carry-over basis to public shares). Ross Perot did this with his company and was issued a special class of preferred stock (with a dividend) by General Motors. Could then engage in loans and reinvest in other investments.

Ellen's problems: Leveraged redemption with CLAT (page 14):

Susan owns limited partnership interest. Partnership borrows $2.7M and redeems 90% of Susan's interest for cash allocated to her so that basis used (by Susan's guarantee of loan). Then Susan has no gain. She can invest in other investments. Susan can then pursue further discount planning: a new FLP and a CLAT. (Corrections to Ellen's materials: Left with a 13% interest in the original partnership because 6% of a smaller partnership post-redemption; changes numbers through rest of example.)

Stacy's problems: Example 2: Simulated CRT:

Illustration B: Using a single-member LLC and giving 99% to public charity (or FL). Then exchange ownership interest for joint-and-survivor annuity. 514 requires 10% or more gift element or else "acquisition indebtedness." Also Rev. Rul. 98-15, where IRS imposes aggregate theory of partnerships; charitable deduction allowed if charities not in control of partnership.

Stacy and Jerry: Premium financing:

Create an FLP and a preferred interest to parents. Take some and give away. Take rest and sell for note. Partnership then buys insurance policy and uses cash to purchase that policy.

---