Report 5

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Tuesday, January 6 (Continued)

Reporter: Carol Warnick Esq.

2:45 - 3:30 p.m.
Taming the Tiger: Designing, Implementing and Operating the FLP to avoid a Successful Section 2036 Attack.
T. Randall Grove

We should select with care the clients with whom we use entity planning. Many problems arise when entity planning is used where it does not really fit very well.

We should all ask these types of questions:

Is my client the right kind of client for entity planning?

What is the best strategy for this situation?

What is the right design for the overall entity plan?

What is the right guidance and assistance for the client with respect to the operation and creation of the entity? Look at full spectrum in order to counter the substance oriented arguments.

He believes that the Service is bringing up a sham argument couched as a 2036 argument.

Reminder: There is NOT a lot of certainty in this area...still a facts and circumstances issue.

2036 (a)(1) refers to a retained interest argument.
2036 (a)(2) refers to a transfer and then control over who receives the benefits.

Retention of Benefit by Donor.

First stage of cases looked at commingling, disproportional distributions, continuation of pre-entity benefit, etc. (*Schauerhamer, Reichart, Harper*.)

Second stage of cases focus on the entity having the characteristics of a testamentary device. (*Harper, Thompson, Kimbell, Strangi II*.) Courts discuss the purpose of 2036 to include transfers that are testamentary in nature. There is no practical effect of the entity until transferor's death. (Factors include a transfer of a majority of decedent's assets to the entity, minimal change in economic benefit of the assets from prior to the creation of the entity, donor advanced in age and has serious health conditions.).

Third stage cases such as *Stone*. Need non tax reasons for setting up the arrangement to be able to overcome the implied agreement issues.

Again, ask the question. Is my client the right client for entity planning. Should include both analyzing the client and listening to the client.

Will my client be able to make a successful transition from the sole proprietor mind set to an entity mind set?

This is also important to the client with regard to the long term satisfaction of the client. (will they be moaning in the future about the complicated nature of the plan?) What kind of articles will the client be sending you from the Wall Street Journal ten years from now?

What is the client's willingness to treat the entity as an on-going business with an unrelated third party (not family members). If they can do that, they will probably make the right decisions with the entity as they go along.

What about client's other relationships, i.e. with the CPA, etc. Will they help the client deal with the complexities? What is the relationship with at least one of the children who may have an easier time understanding the sophistication required?

Asset transfers are a huge issue. Will client pay to make sure that the attorney sweats the details on implementation? Have in writing what is attorney's role and what is the client's role.

Ethics rule 1.4 Communication with client. We must reasonably consult with the client to permit the client to make informed decisions. We need to communicate the material risks and the reasonable alternatives, as well as the risks of reasonable alternatives.

When discuss risks and disadvantages, discuss the fact that to do entity planning you are giving up other types of planning.

Be sure you have a good engagement letter.

Explain the opportunities and risks to the client in writing. Do not be viewed as the guarantor of the client's expectations without shaping those expectations.

What is the simplest way to accomplish the client's objectives. Will divided ownership in the property accomplish the same thing?

Balance low to high complexity versus high to low tax benefit.

Identify alternatives for client.

DESIGN ISSUES key issues

Look at the situation and build your design around it. *Stone* is a good example. The economics in *Stone* are a lot like the economics in *Strangi*, but there were other good facts in *Stone* that could be emphasized, i.e. negotiations among the parties, the kid's being involved in the terms of the partnership agreement, etc.

Then look to shore up any weaknesses.

Avoiding the implied agreement. There were 3 issues in *Strangi II* that sunk their ship.
1. Did not pay rent currently. Whenever personal use assets go into an entity, must have a high level of documentation and compliance with agreements. (In *Strangi*, no rent for use of personal residence was paid concurrently.)

2. Not retaining sufficient assets for use of donor. Only transfer assets that fit with the purpose of the entity. Have non tax reasons for that asset going in.

3. Not sufficient changes from after the entity was set up. If taxpayer is retaining a major part of the benefit, show significant changes in investments, how assets are invested, control, benefit, etc. Consider establishing an irrevocable trust like *Byrum* (helps for both 2036(a)(1) and 2036(a)(2) matters).

Issue of transfer: Whether any gratuitous transfer is needed or if you get into (a)(1) simply by funding the entity?

At this point, look at a "full and adequate consideration" design. He thinks that is the safest right now.

He provides in the outline eight design guidelines which will keep you on the right path both with implied agreement issues and full and adequate consideration issues.

1. Clarify the specific business (nontax) purpose.

2. Negotiate the decisions regarding design, implementation, and operation of entity between the donor and other parties.

3. Develop a business plan and pool the property and services from each of the partners.

4. Transfer to the entity only those asset6s that are appropriate to achieve the economic objectives and to satisfy other nontax goals. The donor should keep sufficient assets to comfortably provide for his/her personal needs and desires, including gifting.

5. Implement and operate the entity in a business-like manner as a joint enterprise for profit.

6. Utilize an active investment approach to accomplish the economic objectives of the entity.

7. Make significant changes in the benefit to be received from assets and in the management of assets (in order to avoid "implied agreement").

8. Continue to operate the entity after the death of the donor and invest assets according to economic objectives (rather than primarily using assets to pay estate taxes or liquidating the entity.)

There are two major design pitfalls dealing with 2036(a)(2). They are (1) joint action and (2) constraints on right to designate

1. Joint action - occurs only in situation where taxpayer does not already have the authority to make those kinds of decisions. In *Byrum*, joint action did not come up. There was an independent trustee utilized. Mr. Byrum could flood the trust with dividends because he supposedly could control the

directors, but did not have control to get the dividends all the way to the beneficiaries.

Mr. Gulig in *Strangi* had two fiduciary roles, manager of the entity and attorney in fact for Mr. Strangi under the power of attorney. The attorney in fact role helped create the joint action problem. Court did not believe he would exercise fiduciary duties to other shareholders if it conflicted with his fiduciary duties as attorney in fact for Mr. Strangi.

2. Constraints on right to designate, not just fiduciary constraints. But *Byrum* is a bit more involved than that. Mr. Byrum had tremendous management control. He could replace independent trustee, etc. But also had to deal with certain "realities of corporate life"(words used by opinion).

He thinks that utilizing an irrevocable trust with an independent trustee, as in *Byrum*, is very important.

Have an organization meeting that involves the key advisors. The appendix includes a checklist of various issues to address at that meeting.

Do not gift too much. (Look at gifting checklist, also in appendix.)

Key issues for annual review. (Exhibits 12 and 13 in appendix go through summary of operation of entity.)

3:45 - 4:30 p.m.
Defined Value Clauses: How Much Do I Love Thee? This Much No More, No Less.
A. Christopher Sega

Mr. Sega discussed that much of our clients' property is not subject to easy valuation, therefore lawyers have come up with two types of formula clauses, which he discusses at length.

1. Price adjustment clause I'm giving you Black acre, but if I'm wrong on value, you give part back to me or else pay me more. The price adjustment formula adjusts the amount transferred based upon the occurrence of a subsequent event (a "condition subsequent.") The subsequent event is typically a valuation redetermination. These formulas undo a portion of the gift and either return this portion to the donor, or increase the compensation paid to the transferor for this portion. These clauses do not work because of the *Procter* case.

In *Procter*, the Fourth Circuit ruled on four articulated public policy grounds.

1. If respected, the clause would inhibit efficient collection of tax by discouraging audits. (A successful challenge would not increase the amount of tax collected but would restore the property to the donor.)

2. The effect of the condition would be to requir4e the court to pass on a moot case. If the condition was valid and the gift held taxable, the only result would be to defeat the gift so that it would not be subject to tax. Thus the proceeding would become one of seeking the court's "declaratory judgment" that no gift occurred.

3. The provision should not be permitted to defeat a judgment of the court..

4. Because the trust beneficiaries were not party to the tax litigation between the donor and the Service, the beneficiaries might later seek to enforce the gift after the tax litigation concluded, even though the gift of the excess value was determined to have never been made.

In his analysis, *Procter* ignores the fact that the clause would return a portion of the transferred property to the settlor's estate, where it would be subject to estate tax. Furthermore, the Tax Court now has the authority to make a declaratory judgment as to the value of the gift. *Procter* also suffered from being an unsympathetic plaintiff.

Rev. Ruling 86-41 confirms that price adjustment clauses do not work.

2. Defined value clauses I'm giving you $5 worth of Black acre. It defines the amount transferred from the outset. Some consider this formula as involving a "condition precedent" or "condition concurrent." You cannot ignore the defined value formula, because you need the formula to determine the property transferred. Ignore the formula, and no property changes hands. What the Service may later do is irrelevant.

A Tale of Two Technical Advices. TAM 86-11-004 (November 15, 1985) the Service upheld a defined value formula gift and made no mention of Procter.

Fast forward to TAM 2002-45-053 (July 31, 2002). Service declined to give the defined value formula effect.

But Service does sanction the use of formulas in certain "Congressionally sanctioned" situations, i.e. marital deduction formulas, QTIP formulas, GRATSs, CRTs, formula disclaimers, etc.

We as practitioners use many non-congressionally sanctioned formulas such as savings clauses.

Less aggressive taxpayers may wish to limit their formula transfers to those types of gifts that Congress has "sanctioned". How can we creatively use these safe harbors in our planning? If the principal abuse perceived by the Service is the excess value (either in kind or additional consideration) going back to the donor, one might seek to avoid this result by transferring the excess value to a third party (the "gift over"). This third party might be a tax-advantaged donee, such as a charity, a marital deduction trust, a zeroed-out GRAT, or an incomplete gift trust, so that there is little or no transfer tax consequences to a revaluation.

He goes on to discuss at length the *McCord* case. This case involved a formula with the excess (the "gift over") going to a congressionally sanctioned beneficiary. A majority of the Tax Court would have respected the defined value clause it if had provided that the amounts allocated to each donee were to be determined using "fair market value of the gifted interest *as finally determined for Federal gift tax purposes*." This language was absent and the Tax Court found nothing in the formula or assignment that the gifted interests allocated among the donees would not be ascertained until the "final" determination was made. It is significant that the majority opinion did not mention *Procter* even though both parties briefed it extensively.

Consider having "gift over" go to an incomplete gift trust over which the donor retains a special power of appointment. (Any amt that may be subject to tax goes to a 2nd tier donee, an incomplete trust.

Example: If $1M gift intended, but upon valuation is valued at $2M, the first million still goes to the 1st tier trust and second million goes to the incomplete gift trust. Also discussed other potential "gift-over" donees such as a marital deduction trust or a zeroed out GRAT, (more leverage with the GRAT).

He also discussed that one common issue with the donor's deciding to gift is the lack of a step-up in basis with gifting. Caryln McCaffrey has previously discussed using a formula to return a gift to the donor's estate in the event the donee's income tax cost on a subsequent sale exceeds the donor's estate tax savings. (He calls his a Hedge Formula.) This might occur when low basis property is gifted, but fails to appreciate or declines in value. In that event, the donor may have saved estate taxes by having the property included in her estate at the lower value, with a basis adjustment at death. The donee could then dispose of the gift without incurring a capital gain. He indicated that such a formula should have no 2036 issues. What about 2038? No, because appreciation (or lack thereof) causes it to return to donor's estate. The donor cannot control the appreciation.

Steps he suggests to take if using a defined value clause. (More are discussed in the outline.)

1. Get a good appraisal up front. Do not do a quick and dirty appraisal up front and then call in the big guns if you get audited.

2. Know what the appraisal says before you make the gift.

3. Do not transfer all the donor's partnership interest

4. If using a hedge formula, make sure you have an independent trustee...

5. If it has a trigger provision, make sure that you pull it. Adjust the books based on the formula.

6. Report it as a dollar amount gift on the tax return, not a percentage of partnership interests.

7. Engage in similar transactions with nonfamily members

8. Include in your agreement that anytime within the gift tax statute of limitations, either party can request a third party appraisal to revalue the gift.

9. If you do a "gift-over" transaction, have part of the property go so that some tax will be paid, but do not make it just a "sliver." That takes away the public policy issue in Procter.

10. If doing a redemption by second tier donee, make sure second tier donee does an appraisal to determine what they got. Should be a separate appraisal.

4:30 - 5:15 p.m.
Funding Formulas Fail on Flexibility: Variations on Traditional Marital/Credit Shelter Funding Techniques.
Barbara A. Sloan

Ms. Sloan described 2 types of clients

1. The client who, absent tax planning, would leave entire estate to surviving spouse, outright. (sweetheart client). This client seeks to build in flexibility with a disclaimer.

2. Type of client who, absent tax planning, would leave entire estate to surviving spouse in trust. (all-in-trust client). This client seeks to build in flexibility with a partial QTIP election

In reality, most moderate to high net worth clients will use formula credit shelter bequests rather than the above. But then along comes EGTRRA and we do not know what to do. But even with EGTRRA, the likelihood of repeal seems so low and so far away, many practitioners have adopted a "wait and see" approach.

However, we want to provide as much flexibility as possible, and want to defer as many decisions to the death of first spouse to die since we do not have all the answers now due to the uncertainties of the tax code. Now is the time to consider taking the new tax law more seriously. We not only have the potential repeal of the estate tax, we have the possible advent of carry-over basis issues, etc.

She presented several ideas to consider.

1. Consider capping the exemption at some predetermined amount. The problem is that it does not increase flexibility, but it does increase certainty. This is especially helpful in jurisdictions where the state estate tax exemption amount now does not track the federal estate tax exemption amount. In doing this, be sure to consider where expenses should be paid from.

2. Use disclaimers. They are trickier than they appear to be, or else we would not continue to have cases on them. Especially tricky is the acceptance of benefits issue. Be sure to give a cash bequest to spouse so spouse will not be as apt to accept benefits of what is supposed to be disclaimed. Also look at successive disclaimers.

Remember, money in trust is not the same as money in hand.

3. Partial QTIPs. Provide a lot of flexibility...

4. Clayton (contingent income) trust - less well-known technique.
Named for the case which established its viability.

Starts as a trust for which a QTIP election could be make, but nonQTIP-elected portion flows to a completely different trust and does not even have to meet the requirements of the QTIP trust. The 6th and 8th Circuits and the Tax Court have all gone along, and now we even have a regulation. Reg. 20.2056(b)-7(d)(3). .

She calls it a powerhouse technique. A Clayton trust can include other family members as beneficiaries. She defines it as follows:

"A Clayton trust is a trust which starts life as a qualified trust for which a QTIP election could be made, but to the extent that the executor does not make the QTIP election, the non-elected portion flows to a separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust."

In essence, it is a trust that can mutate from being a QTIPable trust (one than can be QTIPed) into a completely different trust that doesn't have to contain the requirements necessary to qualify as a QTIP.

She discussed making the Clayton election, which is really the absence of an affirmative QTIP election. It is not the same as making a disclaimer from a QTIP. In a QTIP, the spousal interest is a vested interest. In a Clayton trust, the spouses' portion remains contingent until election is made.

This is not easy drafting. We are really drafting for a non-event, i.e. the failure or refusal of the executor to make a QTIP election within the applicable time frame. She discussed several ways to draft such a clause.

One disadvantage of the nonmarital portion of Clayton trust is that you can not take advantage of the previously taxed property deduction as you can with a partial QTIP.

Another major unanswered question looming is whether the surviving spouse, who is the sole executor of the estate, will have adverse gift tax consequences in making the election. She suggests that you should not allow the surviving spouse to be the sole executor (have co-executors with the other executor designated to make the Clayton decisions) or use an independent executor to make those decisions and the QTIP election.

She spent a lot of time dealing with the Clayton trust, and her outline contains a good discussion of the main concept as well as its variations.

GENERAL INFORMATION ABOUT INSTITUTE:
Inquiries/Registration:
University of Miami School of Law
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
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