Report #1 (Monday 1/10)

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

The institute has finally begun. It was kicked off this morning by the optional pre-conference Fundamentals session (the first of three) on FLPs and LLCs from A to Z. It was presented by Louis Mezzullo. The official kickoff of the Institute occurred at 2:00 p.m. when the Institute's Director, Tina Portuondo, gave her opening remarks. This was followed by an all afternoon session on Recent Developments in Estate, Gift and Income Taxation that was ably presented by the trio of Steve Akers, Pam Schneider and Jonathan Blattmachr (with materials generously provided by Richard Covey and Dan Hastings). Before reporting in detail on these sessions (which will be in Report 2 issued Tuesday since the Reports have not been received yet), here are a few preliminary items.

News Items:

First, Courtesy of our sister List ABA-TAX, the following was reported earlier today:

Media Relations Office Washington, D.C. Media Contact: 202.622.4000 www.IRS.gov/newsroom Public Contact: 800.829.1040

Revised Schedules K-1 to Reduce Filing Complexity

IR-2005-4, Jan. 10, 2005

WASHINGTON The Internal Revenue Service today announced the availability of the revised Schedules K-1 for this year's filing season. The schedules have been simplified to reduce common errors and the burden associated with preparation and filing requirements.

Income, deductions and credits from partnerships, S corporations and trusts are reported to investors on Schedules K-1. The new partnership and S- corporation Schedules K-1 will be available for the 2004 tax year and the trust Schedule K-1 will be available for tax year 2005.

The redesigned schedules feature an improved layout similar to that of Form W-2 as well as streamlined instructions. The schedules are also scannable, eliminating the risk of transcription errors.

"We've modeled this on the well-understood Form W-2," IRS Commissioner Mark W. Everson said. "We believe this will be easier for taxpayers to follow."
The Office of Taxpayer Burden Reduction led a collaborative effort in the redesign of the Schedules K-1, featuring a team of IRS subject matter experts who took input from external stakeholders in the tax professional community. The revisions also incorporate information gathered from public comments and feedback from focus group participants.

Approximately 25 million Schedules K-1 are filed each year with the highest number filed by partnerships.

“The revisions to Schedules K-1 will reduce taxpayer or practitioner preparation time, increase quality and improve reporting accuracy,” said Larry Gray, Governmental Affairs Liaison for the National Association of Tax Professionals. “The Schedules K-1 are now laid-out similar to a Form W- 2. For example, a code for each amount to be reported in Box 13 ‘Other Deductions’ is listed on page two of Schedule K-1 (Form 1065) and is similar to the coding system used for Box 12 on Form W-2. By using the code information the taxpayer or practitioner will know specifically where to correctly report the amount on the taxpayer’s Form 1040.”

The forms are available on IRS.gov. Printed copies of the forms and instructions are also available by calling the IRS at 1-800-829-3676.

Second, the RIA Legislative Watch News Service reported the following today:

Legislative Watch--
President signs bill that extends time to claim 2004 deductions for tsunami relief donations. On Jan. 7, the President signed H.R. 241 into law. Under the measure, taxpayers can elect to claim a charitable contribution deduction in tax year 2004 for donations made through Jan. 31, 2005, for the relief of victims in areas affected by the Dec. 26, 2004 Indian Ocean tsunami provided the contribution is in cash and otherwise meets the requirements for charitable contribution deductions under Code Sec.
170. See the Newsstand e-mail for Friday 01/07/05 for bill language and planning tax planning commentary.

Third, PLI announced the following today:

The book
STOCKER & RIKOON ON DRAWING WILLS AND TRUSTS which can be relied upon for the legal, tax, technical, and interpersonal guidance needed to craft documents that fully express their client's wishes, help them gain tax and non-tax benefits, and avoid costly legal challenges, is now available at a 20% discount. According to PLI, this publication provides everything you need to more quickly and easily:
* Translate clients' objectives into clear, precise provisions.
* Draft legacies that clearly define articles and legatees.
* Ensure that tax clauses in wills conform to directions provided in trusts.
* Deal effectively with contingencies that might otherwise upset wills or trusts.
* Avoid conflicts of interest when representing multiple clients within families.
Even more, PLI says this publication enables you to help clients exploit such tax-saving and non-tax strategies as irrevocable inter vivos trusts, the unified credit, GST exemptions, split trusts, grantor trusts, and many other vehicles.

Featuring extensive new coverage in its chapter on trusts, PLI says the updated 12th Edition shows how:
* Trusts continue to confer tax savings despite the effects of the 2001 estate tax repeal.
* Powers of appointment are another means of affording flexibility for property held in trust.
* A states-driven movement is gaining momentum to repeal the Rule Against Perpetuities, which significantly limits donative freedom.
Plus, you'll find vital new guidance on drafting inter vivos trusts, continuing trusts, the enforceability of testamentary provisions, code provisions pertaining to the creation of QTIPS, the effects of

HIPAA, and more.

For further information, contact PLI.

Fourth, the ABA issued the 2003-2004 Lawyer Census Report today dated October 31, 2003. The highlights of the report include the following demographic information:

• Overall, membership is quite diverse in terms of age, firm size and areas of concentration.

• Men comprise 71% of ABA membership.

• Women continue to increase as a percentage of members (26% in 1995-96 vs. 29% in 2002-03), and tend to be younger than male members.

• The ethnicity of ABA members somewhat lags the lawyer population (9% of ABA members are minorities compared to 11% of U.S. lawyers).

• Most members work in private practice (71%).

• Among those in private practice, fewer solo practitioners are members of the ABA relative to the solo lawyer population (15% of ABA vs. 48% of U.S. lawyers).

• Solo practitioners tend to be older (40% over 56 years old with only 6% under 37 years).

• Most lawyer members have their ABA dues paid for them by their employers (59%).

• Over three-quarters of members (77%) are employed full-time in the practice of law.

Next, we want to cover (in alpha order) all the vendors who are here in the Exhibition Hall. They include the following (among these, the ones with an "*" following their name are technology related and will be covered in more depth in later reports):

Adams Capital, Inc.
Advanced Settlements, Inc.
Air Planning, LLC
Alaska Trust Company
American Bar Association
American Express Tax and Business Services American Guaranty & Trust Co.
American Research Bureau
American Society of Appraisers
Antiquorum Auctioneers
Appraisers and Planners Inc.
Ashton Group
Atlantic Trust
Authoritative.net & zCalc *
Bank of America
Bloomberg Wealth Manager
BNA/Tax Management, Inc. *

Bonhams & Butterfields
Brentmark Software. Inc. *
Briddge Strategies For Art, Heirs & Philanthropy Capital Management Strategies CCH Tax and Accounting * Charitable Trust Administration Company Christiana Bank & Trust Company Christie's Commonwealth Trust Company ComStock Valuation Advisors, Inc.
Connect2a.com, L.L.C. *
Coutts Bank von Ernst
Coventry First
Crawford & Company
Deutsche Bank Private Wealth Management
Doyle New York
Eidelman Associates *
Empire Valuation Consultants, LLC
Estate Valuations & Pricing Systems, Inc./EVP Systems, Inc. * EstateWorks * FASTER Systems, LLC * Fidelity Charitable Services Fiduciary Real Estate Advisors LLC Fiduciary Trust Company International Financial Data Service, Inc. * Firstat RN Care Management Services Foley & Lardner LLP FOR 1031 Foundation Source Gibraltar Bank Harris Private Bank & Harris myCFO Harvey E. Morse, P.A.
Heritage Galleries & Auctioneers
Heritance System by Datatech Software
HSBC Private Bank
Houlihan Lokey Howard & Zukin
Huron Consulting Group
Integrity Marketing Solutions
InterActive Legal Systems *
International Genealogical Search Inc.
LAWGIC LLC *
Lawyer's Weekly, Inc.
Leslie Hindman Auctioneers
LexisNexis *
Madison International Realty, LLC
Management Planning, Inc.
Maple Life Financial
Marsh - Private Client Services
MassMutual Financial Group
MassMutual Financial Group
Masterson Gurr Johns
Mercer Capital
Merrill Lynch
Millea Bros. Ltd.
Nadeau's Auction Gallery Inc.
National Philanthropic Trust
Newkirk Products, Inc.
Nixon Peabody Fiduciary Services
Northern Trust Bank
Paul L. Comstock Co
PENSCO Trust Company
Plexus Financial Technologies LP
PPC
ProDoc, Inc. *

Professional LawCards LLC
Renaissance
RIA *
Rockefeller Philanthropy Advisors
Rona Bartelstone Associates, Inc.
Schumacher Publishing, Inc. *
Schwab Fund for Charitable Giving
Skinner
Smith Barney
Sotheby's
South Dakota Trust Company LLC
Southpac Group (McNair, Davis Inc.)
Stack's
The Capital Trust Company of Delaware
The Citigroup Private Bank
The Goldman Sachs Trust Company, N.A.
The Lackner Group, Inc. *
TheInsuranceAdvisor.com
Thomson / Fast -Tax *
Thomson West *
Trugman Valuation Associates, Inc.
Trusts and Estates
U.S. Trust
UNS - United Nursing Services
Vanguard National Trust Company
Wachovia Exchange Services, Inc.
Wachovia Trust
WealthCounsel, LLC *
Wealthwise, LLC *
Willamette Management Associates
Wilmington Trust
Wyoming Bankers Association
Yellowstone Trust Administration

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Report #2 (Monday Cont'd)

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

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This Report contains coverage of the Monday Fundamentals, Introduction and Recent Developments sessions. Supplemental reports on these subjects from other reporters are anticipated and will be published at a later time once they are received.

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Monday, 1/10/05 - Optional Pre-Conference Fundamentals Program
FLPs and LLCs from A to Z
Louis A. Mezzullo Esq.

Report by Herbert L. Braverman Esq.

On Monday morning, Lou Mezzullo presented a pre-Institute fundamentals program discussing "FLPs and LLCs from A to Z". His objective was to provide information with respect to the set-up, operation and dissolution of certain business/estate planning entities with a specific focus on (family) limited partnerships and limited liability companies. His primary theme seemed to be that these entities should be used only when clients have clearly delineated business/non-tax purposes for entering into this kind of planning. His presentation was quite effective, not only because of his thorough outline (large portions of which were not discussed in any depth because other portions of the Institute program will cover the skipped topics), but because of his attached forms which provided more than 60 pages of specimen language to which he referred frequently, helping to bring "home" the points that he was making. More presenters at the Institute should follow his example and provide helpful specimen language for the attention of our attendees. I certainly recommend Lou's outline to those who would benefit from a fundamentals program on these topics.

Lou discussed choosing an entity under specific state law and with respect to various asset types. He clearly has a preference for LLCs, but he spent time reviewing a number of different entities in light of the following "desirable nontax characteristics":
1. limited liability
2. retention of control (by our clients, of course)
3. continuity of life (even after the lives of members/partners)
4. restrictions on interest transferability
5. one business entity

6. restrictions on voting and management rights
7. asset protection from exposure to liability (avoiding mixing hazardous assets like some real estate parcels with other assets)
8. asset protection from creditors
9. simplicity and inexpensive
10. managing recalcitrant family members (we all know what Lou means here)

He also noted certain "desirable tax characteristics" that influence his decision-making with his clients, such as

1. partnership tax treatment
2. no restrictions on ownership (compare S corp. limitations, recently relaxed considerably, but still an issue)
3. no restrictions on capital structure (maximum flexibility in partnerships or LLCs)
4. tax-free formation
5. tax-free contributions
6. tax-free withdrawals
7. Adjustments to basis
8. discounts and premiums
9. self-employment income tax (minimization/avoidance)

Lou's discussion of these characteristics should the business purpose /non-tax reasons why limited partnerships and /or LLCs are the most flexible and more preferable entities, assuming state law is not problematic. Lou noted that the client could establish an entity in a state other than his/her domicile and he opined that the IRS would probably not attack the decision to go out of state.

He discussed the partnership anti-abuse regulations briefly, noting that the deletion of examples 5 and 6 from the regs means that they probably do not apply to FLPs and LLCs, although the IRS may still raise gifting issues on the formation of a partnership. Lou noted that the transfers of investments to an entity must avoid the undesirable treatment of IRC 351, investment company treatment. He dismissed classification issues by bringing to mind the 1997 check-the-box regulations and the flexibility they provide for us. Similarly, he pointed out that the that the IRS is no longer attacking our entities with the IRC 704(e) income tax rules and has not for several years.

Lou's outline has an extensive discussion of valuation issues, including IRC 2036 inclusion issues, where he re-emphasizes the need to have non-tax reasons for getting into planning with these entities. He also covers the special valuation rules of Chapter 14 of the Code (IRC 2701-2704) nicely, though these will be covered in other portions of the Institute program.

Lou suggested that FLPs and LLCs have several benefits over other entities, such as flexibility, management of business, reduced costs, creditor protection and use of overall investment policy. He suggested that the transfer of assets from a bypass trust into an entity would allow client to argue successfully that use of entity was not tax avoidance device, since bypass trust assets were already in tax-free status.

The rest of the session was a review of drafting issues, which cannot be easily summarized in a report such as this. Perhaps a couple of examples will suffice. In discussing the use of business purpose language, Lou suggested that a laundry list of business purposes in an agreement, backed up by testimony as in the Kimball case, was not his preference, since the client and others may not follow the list in their activities, resulting in a lack of consistency. He prefers a carefully worded cover letter and a file that has absolutely no tax-avoidance material of any kind in it. Lou also cautioned about being a slave to existing forms or to unnecessary changes suggested by the continuous flow of case law and opinions. For example, Lou noted that he did not change his drafting approach when Kimball, Turner or Strangi were decided; he did when Hackl was decided, but he was not sure about this either. Finally, he mentioned Circular 230 and the impact it will have on attorneys and CPAs giving estate planning advice after June 20 (or 30), 2005. We will hear more about this in other Institute programs.

I recommend that you obtain the CD of this presentation if you have an interest in the subject. Better yet, find a friend who attended Heckerling and get a copy of the outline--especially the drafting materials.

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Monday, 1/10/05 - Introduction and Recent Developments
Steve R. Akers Esq.
Pam H. Schneider Esq.
Jonathan G. Blattmachr Esq.
Outline Materials by Dick Covey Esq. and Dan Hastings Esq.

Report by Bruce Stone Esq.

Tina Portuondo convened the 2005 Heckerling Institute on Estate Planning. After various administrative announcements, she introduced the panel for Recent Developments in Estate, Gift and Income Taxation: Steve Akers (of Bessemer Trust Company), Jonathan Blattmachr (of Milbank Tweed), and Pam Schneider (of Gadsden Schneider & Woodward). Credit was given to Dick Covey (of Carter Ledyard & Milburn) and Dan Hastings (of Skadden Arps) for preparation of the extensive outline materials.

Steve began the discussion with the prospect of repeal of the federal estate and generation-skipping taxes. He turned to Jonathan to ask his views. Jonathan noted that President Bush has appointed a blue ribbon task force to deal with tax reform, headed by former Senator Connie Mack of Florida. Jonathan anticipates a report from the task force in late 2005, with possible legislative action in 2006. Jonathan noted, however, that the President has stated he wants to make his earlier tax cuts permanent in 2005. Jonathan suggested that dedicating estate tax revenues to funding social security reform would be a viable reason not to repeal the estate tax. He stated that carryover basis in its currently enacted form will not work, and that substantial revisions will be needed if it is to become effective.

Jonathan believes that there is a very good chance that a value added tax could be enacted, which in any event he regards as far more likely than enactment of a national sales tax. He observed that a national sales tax would be far more regressive than a value added tax.

Steve commented briefly on the Senate Finance Committee report which would make significant changes to oversight of charities and charitable gifts, and which would grant the federal government standing parallel to that of state attorney generals to enforce charitable gifts and to police charitiesâ€™ organizational practices.

Pam reviewed the IRS 2004-2005 Guidance Plan on regulations and other action projects. She noted that the last quarterly revision to that plan made in December had not revised any areas of particular interest to trust and estate practitioners. She focused her discussion mostly on the project to provide guidance under section 2036 (retained life estates) with the observation that this might be driven by Strangi and other cases, under section 2704 (regarding liquidation of interests in entities), and under section 664 (concerning commutation of charitable remainder trusts). She noted that the income tax consequences of commutation of interests in CRTs is the most interesting area, and talked about how to avoid the imposition of a tax under section 1001(e) on the full value of the beneficiaryâ€™s income interest being commuted (without any basis offset).

Jonathan discussed several provisions of the American Jobs Creation Act. He began by noting the deduction that is now allowed for income tax purposes of either state income taxes or state sales taxes, and noted that the IRS will issue tables for reliance by taxpayers. He noted that the benefit of these deductions is still subject to the alternative minimum tax, and reminded the audience that President Bush has stated that he wants to eliminate all deductions for state taxes, so this could be a very short-lived deduction.

Jonathan then noted that the provisions for tax shelter disclosures and penalties under section 6011 had been significantly beefed up.

Steve commented on the provisions of the Act related to subchapter S corporations, including the increase from 75 to 100 permissible shareholders, and the rule that allows any descendant within a family to elect to treat related shareholders as one person for purposes of the 100 shareholder rule. Steve also pointed out the very significant changes that apply to nonqualified deferred compensation plans, called attention to Notice 2005-1 (which applies to stock appreciation rights), and observed that most nonqualified compensation plans will have to be revised as a result of the legislation.

Pam spoke on the regulations under Treasury Circular 230 that were issued on December 17, 2004. She said this had been the single most important development of 2004, and both Steve and Jonathan agreed. The new rules have an effective date of June 20, 2005, and will apply to every single one of us. The new provisions contain a number of "best practices" which are aspirational in nature, not mandatory, but Pam observed that the failure to adhere to a suggested best practice could be used against a practitioner in a lawsuit or disciplinary proceeding. On the other hand, there are a number of mandatory requirements for "covered opinions." She noted that these requirements apply to everything in writing, which will include emails. She observed that we will have to become very cautious and probably change how we communicate to clients in writing. She discussed the new requirement to have compliance officers in firms or organizations to adhere to the new rules, and mentioned the possibility of creation of advisory boards with the IRS to allow it to keep track of current developments in areas of interest.

Pam summarized the list of best practices, such as clear communications with clients, establishment of relevant facts by the adviser, and informing clients of the full import of conclusions reached by the adviser. These are all intimately tied up with the section 6662 accuracy related penalties. Pam noted however that while the section 6662 tax shelter provisions refer to avoidance of income taxes, Circular 230 refers to "any" tax.

Pam repeated that written advice includes email. She discussed "reliance opinions," and how to differentiate between reliance opinions and covered opinions. Pam said that we will want to avoid use of phrases such as "more likely than not" in our written communications and avoid giving percentage assessments of success when advising clients about particular strategies. Tax opinions do require "more likely than not" opinions, however, and for those we will have to follow the "covered opinion" rules unless we specifically tell our clients that our opinions cannot be relied upon for section 6662 purposes.

Pam observed that the covered opinion rules require the adviser to ascertain and establish all relevant facts. Unreasonable assumptions cannot be used, nor can unreasonable factual representations made by the client or others be relied upon by the adviser, such as the existence of a valid business purpose unless the representation specifically describes the business purpose. The opinion cannot take into account the chances of audit, or the likelihood of success or settlement if an audit occurs.

So emails to our clients about GRAT strategies or family limited partnerships (FLPs) may constitute covered opinions. If so, the covered opinion must address and analyze all significant tax issues.

Jonathan discussed the favorable ruling in FSA 200140080 (dealing with trust charitable deductions under section 642(c) for a charitable contribution made by a partnership in which the trust was a partner). He then proceeded into an extensive discussion of the section 643 regulations, and how to cause inclusion of capital gains in fiduciary accounting income and how to cause inclusion of capital gains in DNI (there are different sets of rules for each). Jonathan suggested that a conversion from an income only trust to a unitrust should not be made without obtaining a private letter ruling unless you have an authorizing state statute, or unless both the situs and the governing law of the trust are changed to a state which does have an authorizing statute. He also said that if you wish to convert to a unitrust which provides for a payment of less than 3% or more than 5%, you should also obtain a private letter ruling. He noted that PLR 200417014 approved a flexible unitrust in which the trustee could choose a unitrust rate between 3% and 5%.

Jonathan stated his belief that you should not convert standard discretionary trusts which allow principal invasions to a unitrust, because the trustee of the discretionary trust will have greater flexibility than with a unitrust. For example, not converting allows the trustee to allocate capital gains to be part of income, or only with respect to income from specific assets (for example, Microsoft stock) or from specific asset categories. There are no consistency rules if you do not convert. Jonathan also noted that the section 643 regulations do not tell us that if corpus is converted to income, how that enters into DNI.

Jonathan referred the audience to www.ilsdocs.com for samples of language that can be used in trust documents.

Jonathan discussed Rev. Rul. 2004-64 (dealing with tax reimbursement provisions in defective grantor trusts). The good news is that paying income tax on trust assets does not constitute an additional gift. But if reimbursement is mandatory, there will be 100% inclusion in the gross estate. If the trust document merely authorizes reimbursement, or if state law authorizes reimbursement, there will be inclusion in the gross estate if in essence a deal has been made between the grantor and the trustee, or if creditors of the grantor can reach the trust assets under state law because of the potential for tax reimbursement. In those cases, Jonathan commended the use of states such as Delaware and Alaska which have enacted asset protection legislation. Jonathan concluded that the best course of action in most cases is to include language in the trust instrument prohibiting reimbursement for taxes.

Jonathan discussed a request for a private letter ruling which had been pending for two years involving use of a 675(4)(c) provision (the right to reacquire trust assets) as a means to obtain grantor status for income tax purposes. The IRS had been unwilling to issue the ruling unless it also held that use of the provision would cause estate tax inclusion of the trust assets in the grantor's gross estate at death. The taxpayer finally withdrew the ruling request. Jonathan discussed the Jordahl case which is routinely cited as authority for the lack of gross estate inclusion when the right of substitution is used, but he noted that the power in Jordahl was held in a fiduciary capacity. Steve commented that there was dictum in the Jordahl opinion which indicated that even if the power had been held in a nonfiduciary capacity, there still would have been no estate tax inclusion.

Steve discussed the Estate of Mildred Green and the Estate of Thompson cases on valuation discounts. He also discussed cases involving the effect of post-transfer events on valuations (the Okerlund, Polack, and Helen Noble [2005-2 T.C. Memorandum] cases) which have generally been adverse to taxpayers.

Steve also discussed the regulations under section 2032, and PLR 200452030 which granted relief for an alternate valuation date election.

Steve then moved to a discussion of FLP cases, and said that the biggest 3 cases in 2004 were Kimball, Thompson, and Strangi. The Kimball case identified 13 specific factors which led the court to conclude that the FLP was a bona fide arrangement with business purposes. Thompson went even further in analyzing the necessity and nature of business purposes. Where the two cases differed was in the analysis whether the exchanges made were for adequate and full consideration. Steve reported that oral argument in Strangi has just been set for the week of March 7.

Steve made some suggestions for advisers recommending and implementing use of FLPs. First, don't let the client be the sole general partner, or the client could have the sole right to force dissolution of the partnership. Second, structure the agreement so that if a general partner interest is transferred, the transferee will be a general partner also. This will help avoid issues under section 2704. Third, it is better to have a co-general partner with the client, so that if the client ceases to be a general partner, the other general partner can continue the partnership. Fourth, if an entity serves as the general partner, do not allow the client to own a large enough interest in the entity to force a dissolution of the partnership. Fifth, if Judge Cohen's rationale in her Strangi opinion is of concern, do not allow the client to hold any general partner interest in the FLP. Sixth, Steve really likes Carlyn McCaffrey's suggestion that an irrevocable trust serve as the general partner, with a third party trustee, and have the client retain the power to remove and replace trustees within the safe harbors of Rev. Rul. 95-58 so that the trust will not be included in the client's gross estate under section 2036.

Jonathan discussed some miscellaneous developments: PLR 200432016 (how to measure the 3 year period for purposes of section 2035); PLR 200432015 (where a gift of life insurance was made to a partnership, with a transfer of a partnership interest to the spouse, with 100% inclusion of the life insurance proceeds at death and no marital deduction allowed); the Turner case (in which funding of a charitable bequest was delayed, and interest on the bequest was allowed as an administrative expense deduction; Jonathan noted that there is no income tax deduction under the separate share rules of section 663); and PLR 200444021 (dealing with income taxes on post-death IRA distributions, in which the IRS held that income taxes paid by an estate on IRA distributions were deductible under section 2053 to the extent they exceeded the 691(c) deduction). He mentioned the John David Smith case in the Fifth Circuit (04-20194), which no estate tax discount was allowed for the inherent income tax liability on a retirement plan balance at death.

Jonathan discussed PLR 200407018, which deals with the duty of consistency, requiring the surviving spouse who had served as a co-personal representative in claiming the marital deduction to include those assets in her own gross estate at death. He noted the Rose Posner case (87 TCM 1288, 2004) where later litigation determined that a power of appointment was not a general power of appointment and thus inclusion was not required, despite the earlier allowance of the marital deduction.

Jonathan discussed the Whiting case which permitted accumulation of income in a QTIP trust, but noted that the holding was dependent upon state law, and suggested that practitioners not rely on this case as a matter of practice.

Pam then discussed the proposed GST regulations at great length. She noted the rules on deemed allocations, but also noted that most practitioners need to spend time understanding the tax return itself and the instructions to the return. If allocation elections are made, they should be made the first year, because an election can be terminated. She discussed simplified procedures for section 9100 relief, under Rev. Proc. 2004-46 and 2004-47. These procedures are of value and helpful to taxpayers, but they only apply in limited situations. For example, the relief granted in Rev. Proc. 2004-47 for making a reverse QTIP election does not extend the time to make the election, and if that is needed, a private letter ruling must be obtained.

Pam discussed the proposed regulations on qualified severances. They create more questions than they answer. Pam referred extensively to a letter dated November 22, 2004 from Bob Rosepink (ACTEC President) to the IRS commenting on the proposed regulations in her discussion. That letter was distributed as part of the program materials. (Reporter's note: perhaps that letter could be made available on the ABA-PTL listserv as a separate resource.) Pam spent time analyzing downstream splits (a trust already in existence being split into separate trusts with different inclusion ratios). The IRS must be notified of severance if it is to be effective for GST purposes.

Pam also discussed the proposed regulations on the predeceased ancestor exception (and noted that the statute had been enacted in 1997). The new rules are less favorable in some aspects than the old ones, as noted in the November 22 ACTEC letter.

Jonathan discussed the Schott and Cook cases on a revocable spousal interest in GRATs, and he mentioned the Walton case. He asked if the remainder interest in a GRAT can be reduced to zero, and noted that there is nothing definitive that says this is possible. He usually creates a small remainder interest and reports it for gift tax purposes. He also asked what is the minimum GRAT term? The IRS will not issue rulings for terms of less than 5 years.

If the grantor of a GRAT dies during the GRAT term, Jonathan doesn't think that making the reverter payable to the probate estate alone will be enough to zero out the GRAT remainder interest. The annuity payments should continue for the full term, and should be payable to the estate. If the marital deduction is wanted, the trust should require that the annuity payments be equal to GRAT annuity amount or fiduciary accounting income, whichever is greater. The decedent's will should direct that those payments be distributed to the spouse immediately (to satisfy the requirement that all income be paid at least annually). The remainder interest should not be payable to the estate and then routed to the QTIP trust. The GRAT should itself create the QTIP trust for the remainder interest in the GRAT assets following payout of the GRAT annuity payments.

Steve reported on the Blount case in the Tax Court, which dealt with a buy-sell agreement, and which contains a good discussion on comparability requirements under section 2703. That case also required that company owned life insurance be added to the value of the company assets to determine the formula price specified in the agreement.

Steve reported on the Estate of True case, which was decided by the Tenth Circuit, also involving a buy-sell agreement, and which held that the provisions of the agreement did not control for estate tax purposes. The opinion overruled an earlier Tenth Circuit case which had been relied upon by the taxpayer as substantial authority. Jonathan noted that the appellate court affirmed the imposition of a penalty in the case even though the case relied upon by the taxpayer hadn't been overruled prior to this opinion.

Steve gave an extended analysis of various parts of the Uniform Trust Code. He noted that there have been five key issues of some controversy. First, the UTC substantially restricts the settlor's ability to override various provisions of the UTC, enumerated in section 105. Second, some have argued that the UTC cedes too much authority to the courts to question and override the exercise of a trusteeâ€™s discretion in making distributions. Third, some argue that the UTC requires too much information to be given to trust beneficiaries against the wishes of the settlor in many circumstances, which Steve stated is probably the most controversial point about the UTC. Of the ten states which have adopted the UTC, seven have changed the provisions governing disclosure of information to beneficiaries. Fourth, some argue that the ability of the settlor and all beneficiaries to modify or terminate the trust creates issues of estate tax inclusion under sections 2038 and 2041. Dick Covey stated in his materials that â€œthis concern is misplaced, although a definitive refutation of it is elusive.â€ Fifth, Steve noted that some have been concerned about the UTC expanding the rights of creditors, particular in cases where the trustee is also a beneficiary.

Steve concluded the presentation with a discussion of the New York state court case of Dumont, in which a corporate trustee was surcharged for failing to diversify trust assets even though the trust instrument directed the trustee not to sell Kodak stock for the purpose of diversification, and which stated that the trustee was not to be held liable for any diminution in value of that stock. That case is now on appeal. Jonathan observed that even language in the trust document purporting to relieve the trustee from any duty of diversification will not absolve the trustee, because under modern law the trustee can go to court to seek relief from those provisions, and the trusteeâ€™s failure to seek court relief will be held to be a breach of trust.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #3 (Monday, Cont'd)

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

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This Report contains additional coverage of the Monday Recent Developments session, first by Reporter Gene Zuspann and then by Reporter Jeff Weiler

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Monday, 1/10/05 - Introduction and Recent Developments Steve R. Akers Esq.
Pam H. Schneider Esq.
Jonathan G. Blattmachr Esq.
Outline Materials by Dick Covey Esq. and Dan Hastings Esq.

Report by Gene Zuspann Esq.

The authors of the materials are Dick Covey and Dan Hastings. Per SA, the materials are excellent. The speakers covered some of the materials but had much information to add that were not included in the book.

JB - where are we on the estate tax?

The question now is whether the estate tax will be repealed in 2010 or 2007. JB anticipates passage in 2006. The Administration believes that it currently has 59-60 Senators. They need 60 to override Byrd rule. At a minimum, and even if they cannot get full repeal, the7y can at least extend the repeal to 2015. The IRS had problem recruiting new employees after
2001 changes in laws. The current feeling is that the extension would effectively kill the estate and gift tax because of the time delay and to rehabilitate the law in 2015 would not be possible.

However, the contrary position has several points: 1. The deficit is large and the estate tax in 2010 is projected to produce $50 billion of revenue (assuming a 50% maximum rate with a $2 million applicable exclusion). 2. Bush had said that his primary agenda is to fix Social Security. JB proposed leaving the estate tax at this rate to help fix Social Security. Another suggestion is that the estate tax should be earmarked to fund wars - IRAQ, Afghanistan, because estate tax has historically a tax used to pay for wars.

JB has been told that carryover basis as drafted cannot work.

He discussed the blue ribbon panel studying the estate tax.

One alternative or new tax will be a value added tax (VAT). JB feels that it is more likely that a VAT will be adopted, at least to some extent. He believes this has more chance in passing than a national sales tax. One reason is that it is already an accepted tax in much of the rest of the world.

Tom DeLay is promoting HB 25 - fire the IRS, eliminate the income tax and have a nation wide sales tax. It would be paid on every transaction in which property changes hands and would even be imputed in some transactions. It would be paid on goods and services. The stated rate is 23% but it is a tax inclusive rate - the effective rate is 28%. It would also cover medical insurance, food and rent.

SA - Proposals will include changes in the private foundation rules that are dramatic.

PS - Discussed the IRS Priority Guidance Plan items under the heading Gifts, Estates and Trusts.
Walton regs under 2702
Final regulations under §664 regarding dividends and capital gains for CRT's
Guidance under 2036 regarding transfers with retained life estates.
Guidance under 2704.regarding the liquidation of an interest
200441024 regarding complete termination of a CRT (commutation) JB. - Amer Jobs creation Act
Loaded with provisions for businesses Collateral provisions
There is now a alternative deduction for a sales tax rather than income tax (However, JB pointed out that Bush now proposes that there should be no deduction for income taxes or sales taxes)
There was a change in the §754 election - This is now mandatory if there is a significant loss
A family member may elect under S-corp to treat all of the family as one shareholder.
Notice 2005-1. Stock appreciation rights. Almost all plans you have done have to be reviewed.

Changes to Circular 230
Penalties on listed transactions - cannot be waived by IRS
Tax opinion letter changes in Circular 230- may not rely on tax opinion letter

PS Circular 230
Circular 230 now applies to estate planners. Effective 6/20/05.
The publication now includes best practices and covered opinions. The revision is tighter than the proposed regulation. PS believes this includes almost everything we have in writing, including e-mail.
Procedures must be put in at firms that give tax advice
It provides disciplinary rules
It contains vague rules regarding other written advice.
Authorizes the creation of advisory boards within the Service.
Provisions to punish willful violations of the rules other than best practices rules.

Best practices: The categories pertain to client communications, factual and legal due diligence, providing accurate advice, and acting fairly before the IRS. The client should be told what the import of the opinion is. Attorneys need to take steps to put procedures.in place to insure compliance.

Tax shelters involve stricter standard. There are different levels of opinions.

Covered opinion. PS believes that much of what we (estate planners) do is a covered opinion.
Principal purpose is the avoidance of federal tax.

The attorney must use reasonable efforts to obtain reasonable facts and may not base ab opinion on unreasonable facts or representations. The opinion should not discuss audits or chance of success if settled.

SA believes that this change may be the most important thing that has happened last year. JB - the cost of complying with this makes it much more expensive. PS - there is a limited opinion - may have to use this often.

Note: At this point, the panel started into the materials. All of the above was discussed by the panelists but not included in the materials. The panel moved quickly and covered much more than the information included above.

JB - §643 regs
This is huge area of the law where the state law effects the income tax consequences.
The regs govern the switch from a straight income trust to a unitrust or from a power to adjust trust to a unitrust. The taxpayer may have a taxable exchange unless the conversion qualifies.
The conversion must be done pursuant to a state statute that authorizes the conversion. If the state does not have a statute, get a PLR or switch the situs and the governing law to a state with such authority.
At the moment, the payout is limited to 3-5%. See PLR.
2004-17-014 for a state statute allowing the trustee to select the % within the range.
Two broad rules re capital gains - one for when cap gains become part of trust accounting income and one for when cap gains become part of DNI. An example of an instance when you want cap gains in accounting income - QDOT. Must be done as allowed by state law and the governing instrument. To get to DNI, the regs are inconsistent. May also use the old regs.
Cap gains for a unitrust - there a different set of rules determine whether DNI. Trustee can be given discretion, instrument directs or state law. The trustee must be consistent.
JB suggests, that if the instrument contains a power to invade, that you do not want to do a conversion. You have much greater control as to when you put cap gains into DNI because the trustee can deem it. No consistency is required with regard to the election with different assets. Just because the trustee deems Microsoft stock sale as DNI, it does not have to be consistent as to IBM, GM or land. These are separate elections.

JB - Rev Rul 2004-64; Sec 671 & 2036.
“Good news rev ruling.”

Income imputed to the grantor from a grantor trust, where the grantor pays the tax – there is no gift. However, a mandatory reimbursement provision causes inclusion under 2036. If discretionary reimbursement then you have estate tax inclusion if there was a deal or if under state law creditors can attach the trust for the a mount of the reimbursement.

JB mentioned a problem an attorney had with 675()(C) - a power to reacquire the trust corpus by substituting other property of an equivalent value. A PLR requested for 2 years was finally withdrawn. The Service would not agree that this power would not cause estate tax inclusion. Jb recommended creating your grantor trust using some other means.

SA - very quickly discussed valuation issues
He mentioned 2 cases - the Green case (25%) and the Thompson case
(30%)- and the discounts.
He quickly discussed several other cases, and mentioned Helen Noble - TCM 2005-2 involving events shortly before death. Two early gifts were revalued by a sale after death for substantially more. Therefore, do not sell an asset before the estate tax audit is finished.

SA - FLP cases - Kimbell, Thompson and Strangi - all deal with 2036. Pg 50 -
Strangi I - Judge Cohen substantially expanded the area by including under 2036(a)(2).
Kimbell went off on fair consideration. It analyzed the issue using a 2 part test - bona fide and fair consideraton. Tax court included “arms length transaction - circuit court did not require this.

Strangi still on appeal to Fifth Circuit. Hearing March 7. ACTEC filed a brief and discusses the 2036 (a)(2) issue raised by Judge Cohen.

SA says that Carlyn uses a trust as the GP. The client should not be the Trustee but may have the right to remove and replace the Trustee.

JB - Letter ruling 200432015. How not to form an LLC to hold a life
insurance policy
John David Smith v Comm., 04-20194 (5th Cir) - no discount on estate tax return for income tax on IRA.

PS - GST
Five regs/procedures were announced
- Proposed amendments to regs dealing with automatic allocation of gst exemption and election out. Narrowed a little bit but not affect most of us. Pam’s advice - always make the election the first year and make them if any doubt at all and make them for current transfer and, maybe, for future transfers.
2 rev procs that simplify 9100 relief in very narrow circumstances
- Rev Proc 2004-46. A simplified alternate method to obtain an extension of time to make an allocation of GST exemption. It has to be filed before the due date of the estate tax return, but may be done after death.
- Reverse QTIP election under Rev. Proc. 2004-47. A valid QTIP election must have been made, the TP relied on a tax practitioner and the tax practitioner failed to advise about the reverse QTIP election.

- Prop regs have been issued under §2642(a)(3) governing qualified severance of trusts.
- the trust must be divided on a fractional basis, however the trusts need not be funded with a pro rata share of each asset held by the original trust, nor that the income tax basis be divided proportionately. However, the governing instrument or a state statute must authorize non-prorata funding.
- a state statute or the governing instrument must also authorize the severance.
- the regs create many more problems that they solve
- you must give notice to the IRS to be effective but PS discussed instances in which you may not want to give notice.
- severance must create a trust with an inclusion ratio of zero and one with an inclusion ratio of one.

Proposed regs have been issued on the predeceased parent exception to the GST tax.

JB - Grat regs.
Overall these are good regs.
Overruled the Schott case in the 9th circuit.
More important case was the revision of the regs held invalid in the Walton case. §25.2702-3(e), ex. 5.
- However, it does not say you can reduce the value to zero. JB uses a formula to reduce the gift to a small amount and file a gift tax return.
- The regs do not clarify the ability to use a 2 year GRAT (the term issue).

- Grat payments must continue for the term - reversion is not sufficient. Do not stop the payments after the death of the grantor.
- Annuity must be greater of the acctg income or the
- the instrument needs to make a specific bequest of the annuity immediately after death
- do not have the GRAT revert to the grantor’s estate - a QTIP should be created under a separate

document - JB does this in the grat document.

SA §2703 - Blount case and the requirements for a valid buy-sell agreement
The decedent modified to the buy-sell agreement after learning of his impending death without the consent of the other shareholder. The court did not honor the change and also required life insurance paid to the corp to be included in the value

True Case - pg 134
Penalty seems extremely unfair. Old law had allowed a book value sale price in buy-sell agreements the valuation method followed. The court held the TP did not act in good faith.
There was no professional appraisal.
The price was not appropriate when the agreement was entered into.
There was no negotiation when the contract was entered into.

SA - Uniform Trust Code -
The materials contain a 93 page summary of the UTC. SA did not follow the materials, but summarized the areas of controversy. The materials are an update of the articles previously published in Practical Drafting.

He discussed the activity in the UTC during the last year and referred to changes in the law. SA mentioned several areas of concern - duty to inform (Sec 813), power to modify or terminate (410, 411), inability of a settlor to change the duties or the obligations of the trustees in several areas (105 (b) and 105(b)(9)), creditors rights (Article 5), and the remedies for breach of trust. He also mentioned the ability to forum shop (107). This was a quick summary without time for detailed discussion.

Diversification of investments. - pg 261 SA - The Dumont case and duty to diversify. The instrument contained language that the Eastman Kodak stock was not to be sold and was to be distributed to the ultimate beneficiaries unless there was “some compelling reason other than diversification of investment for doing so.” The Court held this language was only a direction and would not protect the trustee from failure to diversify. Court held that duty to diversify was compelling given the fact of the case. All three panelists commented on this decision and the overriding duty to diversify, even if the language in the trust directs that the investment be held. SA had discussed this issue with an attorney drafting a trust and suggested the only way to avoid this was to add language that the investment could never be sold, and the attorney commented that he would never put such a provision in the document. JB suggested this may be a non-tax reason to create a LP to hold the stock and give the trustee LP units.

The session was very good with much added to the published materials by the panel. The pace was very rapid and getting down much of the presentation was virtually impossible.

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Report by Jeffry L. Weiler Esq.

Jonathan: Estate tax repeal.

Rumors are circulating that it is a sure thing. Poll of Senators shows 59 probable votes for repeal with 60 votes needed to overcome the Bryd rule.
There is trouble recruiting employees for senior government positions because of possibility of repeal. However, repeal may not happen. Cost is high - with exemption of $2,000,000 cost is projected at $50 billion (per year I think). Transfer tax revenues are about 1 ½ % of total US government revenues.

Pres. Bush's Panel to recommend tax reform will not issue report until 2006. Pres. Bush is pushing making tax cuts permanent (including repeal of estate tax) as a 2005 project. Social Security reform will be expensive and could impair repeal prospects. Carryover basis as currently enacted for 2010 will not work and must be revised. Could be value added tax paid by providers of services and manufacturers. Also, a national sales tax with repeal of IRC has been proposed (HB 25).

Steve: Likely to be dramatic changes proposed by Senate Finance Committee concerning oversight of charities.

Pam: Reviewed some of items on Treas Dept/IRS 2004-2005 Guidance Plan. Some interesting areas to watch: guidance under 2036 - transfers with retained life estates (probably FLP's), 2704 - liquidation of an interest, 2702 - qualified interests.

Jonanthan: 2004 Jobs Act. Reason for enactment was WTO ruling related to US companies with overseas sales. It allows personal itemized deduction for sales tax in lieu of state and local income taxes. Pres. Bush may propose eliminating deduction for both state and local income tax as well as the new sales tax deductions as revenue raisers. Also, new law requires 754 election if value of entity assets are below basis by $250,000. S corporation rules for number of shareholders liberalized by treating family tree as one shareholder.

Jonathan: Notice 2005-1 will require revisions to deferred compensation arrangement to get deferral (almost all plans need work).

Pam: Circular 230 revisions. (Jonathan: one of most important 2004 developments).

New Regs issued Dec 17, 2004 to be effective June 20, 2005. They have much broader coverage than merely tax shelters and will impact the way we practice law in the estate planning area. Best practices requirements do not create exposure to penalties but could be used in malpractice claims.
Requirements imposed for "covered opinions". This everything in writing that provides legal advice - letters, memos, emails. Law firms must have a person to enforce the rules and discipline non compliance. Note that IRC
6662 for tax shelters applies to income tax. However, the Cir 230 rules apply to any tax. Where advice is given, must investigate all aspects of the arrangement (which will take more time and higher charges to clients).
Much of what estate planner do is providing a "reliance opinion". Planning:
avoid giving % probability of success, avoid "more likely than not"
opinions. Also, can state prominently that the opinion is not for reliance (which clients are not going to appreciate - what are they paying for?). Certain requirements are set forth that must be included in opinions and restriction imposed on what can be relied on. Steve: this is
the most dramatic development of 2004! Jonathon: will increase cost of legal services. Providing a limited scope opinion may help.

Pam: Qualified Severance Proposed Regs (GST). She finds some problems in proposed regs that she hopes will be fixed before they become final. One problem is with effective date (12-31-00). ACTEC comments on treatment of discretionary pecuniary discretionary divisions.

The speakers next commented on portions of the outline.

Jonathan: FSA and RR 2004-5 allow a trust to receive a charitable deduction for a flow through from a partnership. Trust has no provisions authorizing charitable deduction.

Jonathan: 653 (b) final regs definition of trust income.

Effective for tax years ending after Jan 2, 2994 (sic.) - which means 2004.
Capital gain issues: allocating capital gain income to fiduciary accounting income, and allocating capital gain to DNI. State law authority is needed and governing instrument authorization or discretion.

Jonathan: 671 and 2036 - tax reimbursement provisions in grantor trusts - RR 2004-64.

If mandatory reimbursement required and not made, there is an additional gift. Will be inclusion in gross estate of grantor if grantor's creditors can get at trust assets. Suggests prohibiting reimbursement in trust terms.

Problem (and indigestion) concerning creating income tax defective grantor trusts. Many (if not most) estate planner use non fid substitution of assets based on Jordahl case. IRS refused to rule that this does not cause inclusion in gross estate. Using this approach may create a fight with IRS.
Suggests use substitution of beneficiary or give right to substitute to spouse.

Steve: Post death events and impact on valuation. Helen Noble TCM 2005-2 - Tax Court used post death sale (13 months after death) as valuation factor. Suggests - wait for conclusion of IRS audit before selling assets.

Steve: 2032 Prop Regs.for alternate valuation date. 9100 relief is available if 709 is filed within 1 year of its due date. PLR 2004-52-030 allowed 9100 relief.

Steve: Kimbell taxpayer showed 13 objective factors to support its position and CA 5 enumerated 3 tests: interest credited to partner's account was proportional to fmv of assets contributed, assets properly credited to proper capital account, at termination or liquidation distributions to partners from respective capital accounts. Having bona fide sale on formation will not prevent inclusion concerning later gifts of partnership interests. Partnership assets may not be in gross estate, but gif of partnership interest is at risk.

Steve: Thompson CA 3 requires a business purpose. Appears to require a business activity and majority of CA 3 disagrees with Stone and Kimbell.
Question for CA 3 - what about a business activity conducted with only a minority of partnership assets?

Inclusion of partnership assets in gross estate will a be problem with estate tax marital deduction for discounted value of partnership interests but partnership assets in gross estate at full value.

Suggests avoid grantor as sole general partner, allow transfer of general partnership interest (rather than conversion to limited partnership
interest) to avoid a lapse of rights.

Also, suggests trust with third party trustee as general partner. Note RR
95-58 that authorizes removal and replacement of trustee.

Jonathan: 2035 (b) gift tax in gross estate. PLR 200432016 confirms that the 3 year period for inclusion begins with the date of the gift and not a the beginning of the calendar year in which the gift occurred.

Jonathan: PLR 200432015. Transfer of life insurance to FLP and gift of FLP to family member resulted in life insurance in gross estate where death occurred within 3 years of the transfer - it was an "integrated transaction". Also, no marital deduction because life insurance was received by FLP and surviving spouse to not get at the funds.

Steve: Graegan case (56 TCM 387) developments - borrowing to pay estate tax and up front deduction on estate tax return for all future interest expense. Cal case permitted trustees to enter into 25 year loan - Klein v Hughes 2004 WL 838189 (Cal. App. 1 Dist 2004). Estate lost in Rupert (Dist Ct Pa. 2004 no cite provided). Estate could sell assets (right to lottery payments) to raise funds. Estate had burden of showing interest expense was necessary.

Pam: GST exemption.

PLR 200422051 split gift resulted in each spouse being transferor of ½ of gift.

Prop Regs on electing out to deemed (automatic) allocation of exemptions.
Reading tax return instructions and studying tax return is going to be easier than reading the prop regs. Suggests election on return for first year applicable to future years and can terminate the election for future years. Automatic applications under prop regs includes a formula allocation.

Simplified 9100 relief is available for late election of application of exemption. Can be after death but must be before estate tax return is due.

Jonathan: 2702, GRATs, proposed regs, Walton cases. Have annuity continue to be paid to estate after death for remaining term under GRAT. For marital deduction have payment from marital deduction trust equal to greater of fiduciary accounting income or annuity payment.

Steve: 2703 Agreements restricting transfers, valuation (buy sell agreement). Blount 87 TCM 1303 (2004) was a pre 2703 case modified after 2703 was adopted. Grandfather status was lost since modification was substantial.

Life insurance payable to company is required to be considered an asset of the company for valuing the company and company's obligation to purchase stock was not a permitted offset to life insurance.

Steve: Uniform Trust Code. (92 outline pages devoted to this topic.)

Major areas of controversy: court's authority to override exercise of trustee's discretion over discretionary distributions, too much info to be given to trust beneficiaries, will irrevocable trusts be included in gross estate due to modification authority, courts ability to override settlor's ability to use trust terms.

Steve: Diversification required of trustee. Dumont, NYLJ, July 13, 2004, page 19. Trustee held liable for loss for failure to diversify trust assets (stock) even though trust agreement authorized retention. Case is on appeal. Very difficult, if not impossible to fully protect trustee from not diversifying through trust provisions.

Jonathan: Suggests that settlor put asset into a FLP and then put FLP interest into trust. Trustee will not be able to sell FPL with restriction in partnership agreement.

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Report #4 (Technology)

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

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This report covers the software and other vendors who are exhibiting at the Institute.

Report by Jason Havens Esq. (with some update edits by Joseph G. Hodges Jr. Esq.)

The number of software and other vendors at the 2005 Institute has grown to 113.

A complete list of those vendors was posted previously. The software vendor list this year includes, in alphabetical order:
Authoritative.net & zCalc
BNA/Tax Management, Inc.
Brentmark Software. Inc.
CCH Tax and Accounting
Connect2a.com, L.L.C.
Eidelman Associates
Estate Valuations & Pricing Systems, Inc./EVP Systems, Inc.
EstateWorks
FASTER Systems, LLC
Financial Data Service, Inc.
Heritance System by DataTech SoftWare
InterActive Legal Systems
LAWGIC LLC
LexisNexis
ProDoc, Inc.
RIA
Schumacher Publishing, Inc.
The Lackner Group, Inc.
Thomson / Fast -Tax
Thomson West
Trusts and Estates
WealthCounsel, LLC
WealthWise, LLC

Following are some initial highlights and themes that should help attendees to focus on the "latest and greatest" technology and practice resources available to estate planning (trusts and estates) lawyers. This is the official "first round," which shares highlights of our initial visits with the 2005 software and other vendors. These highlights are classified in categories (generally in alphabetical order) that will hopefully prove helpful to list members.

A. CALCULATION SOFTWARE:

1. Estate & Gift Tax (TM) Planner by Bureau of National Affairs (BNA) (http://www.bna.com): BNA has supported their Estate & Gift Tax Planner

(http://www.bnasoftware.com/product/default.aspx?prod=etplanner)
for sixteen years. Like the Intuitive Estate Planner, the Estate & Gift Tax Planner performs numerous calculations and has a similar "spreadsheet"
look and feel. The Estate & Gift Tax Planner also includes the ability to produce presentations. A "demo" version is available at the BNA booth. The Estate & Gift Tax Planner costs $1,195 for a single-user version according to the BNA website.

2. Brentmark
(http://www.brentmark.com/): Brentmark's Kugler Estate Analyzer (TM)
(http://www.brentmark.com/kugler.htm) has now been offered for approximately two years. The program uses three
steps: client information, assets & liabilities, and techniques. The program combines Brentmark's Estate Planning QuickView and Estate Planning Tools capabilities in that you can perform calculations and illustrate planning techniques with flowcharts, such as generation-skipping transfer (GST) trusts, qualified personal residence trusts (QPRTs), grantor-retained annuity trusts (GRATs), charitable remainder trusts (CRTs), charitable lead trusts (CLTs), sales to grantor trusts, family limited partnerships (FLPs), and testamentary charitable gifts. The Kugler Estate Analyzer is still advertised on the Brentmark website at a price of $595 for a single-user license (with a $199 annual maintenance fee) or $570 if downloaded from the Brentmark website. You may demonstrate the Kugler Estate Analyzer via Brentmark's site (http://www.brentmark.com/download.htm#Kugler) or by stopping by the Brentmark booth, where Jane Schuck and others will gladly give you a personal tour.

Brentmark, which is celebrating the company's 20th anniversary this year, also offers the Retirement Income Navigator (TM); the Pension & Roth IRA Analyzer, which was used throughout Ed Slott's new book on the subject; and many others. Brentmark introduced the Asset Transfers System, which tracks transferring and retitling assets for a client, several years ago. One of the best features of Brentmark's website is the inclusion of most product user manuals on the "Downloads" page: http://www.brentmark.com/download.htm. You can view each manual in your Adobe Acrobat Reader and decide whether you would like to purchase a particular product. Most products also feature a "demo" version, which are all included on the "Downloads" page and are available at the Brentmark booth as well.

3. Intuitive Estate Planner by Thomson/West (TM)
(http://west.thomson.com/): Besides the RIA products, including Warren, Gorham & Lamont's superb treatises and the various journals of that group, Thomson/West has recently released the eighth version of its comprehensive program known as the Intuitive Estate Planner (IEP)
(<http://west.thomson.com/customerservice/software/iep.as).
The IEP is authored by Donald H. Kelley and Konrad Schmidt, III. The IEP calculates and illustrates most estate planning techniques, from split interest trusts to non-resident spouse situations to gifts (even including calculation of the "gross-up" rule under Internal Revenue Code § 2035(b) for taxable gifts made within three years of death). The IEP coordinates a client's assets with the schedules of the federal estate tax return. The IEP offers the ability to produce customized presentations based on slides created from a client's illustration, pre-formatted slide shows, or your own customized slides. A slideshow demonstration and software patch files are available via the IEP page of the Thomson/West website. The IEP is priced at $895 for a single-user license according to the Thomson/West website.

Of significant interest, the IEP is working on a seamless link to the Lackner Group's 6-in-1 Windows-based tax preparation system (below) and also to other legal software systems, such as Abacus Law Gold (practice management system) and, as a result of the Abacus Law Gold link, to HotDocs. The ability to migrate and link data to various computer programs and systems within an office is critical to efficiency. This commitment by the IEP is commendable and should make single-entry input of data -- or at least most data -- a reality.

4. ViewPlan Advanced (TM) by Commerce Clearing House (CCH) (http://tax.cchgroup.com/): CCH's ViewPlan Advanced has also received a warm welcome from practitioners over the past two years. This program integrates the features of the basic CCH ViewPlan, Beneview, and Factuary modules. You can calculate and illustrate more than twenty different asset transfer techniques including CRTs, NIMCRUTs, CLTs, GRTs, QPRTs, and SCINs. The graphical flowcharts are accompanied by built-in calculation logs. ViewPlan Advanced works seamlessly with other CCH products such as Enteract (TM) financial planning and Pro System fx (R) tax software programs, and uses Microsoft standards. ViewPlan Advanced is still priced on the CCH website at $1,490 for a single-user license.

B. DRAFTING SOFTWARE:

1. Drafting Wills and Trust Agreements by Thomson/West (TM) (http://west.thomson.com/): Thomson/West has supported its Drafting Wills and Trust Agreements (DWTA) (http://west.thomson.com/store/product.asp?product%5Fid=DWTA), which was originally authored by Robert P. Wilkins and is now co-authored by Michael L.M. Jordan, for nearly fifteen years.

Major news regarding DWTA was announced in 2004. In the past, DWTA was based on CAPS (Capsoft), in contrast to several other drafting systems based on the more progressive (and technologically-superior) HotDocs engine (below). As of late 2004, however, DWTA became the first major drafting system to operate on the GhostFill platform. (GhostFill is the engine used inside of the popular Amicus Attorney "front-end" practice management system for its Amicus Assembly document assembly option.) In fact, Bart Earle's "Test Drive" column features GhostFill and specifically mentions DWTA in the most recent issue of Law Technology News (Dec. 2004 -- vol. 10, no. 12): http://www.lawtechnews.com/r5/showkiosk.asp?listing_id=477883.

Pricing for DWTA is $875. The DWTA form volumes (http://west.thomson.com/product/13513203/product.asp) can still be purchased for $390 based on the Thomson/West website.

2. Lawgic (http://www.lawgic.com/): Lawgic also functions as a "what-you-see-is-what-you-get" program. The distinguished estate planning attorneys at the international law firm of Holland & Knight, LLP have been updating the Lawgic Wills & Trusts products, including Florida and Georgia, which they originally authored. Well-known co-authors John Arthur Jones, Edward F. Koren, Richard L. Stockton, and Bruce Stone have used their well-drafted, "plain English" provisions to provide updated, state-specific systems for California, Florida, and Georgia.

Lawgic offers wills, disability planning documents, and a number of trusts (from revocable inter vivos trusts to insurance trusts to various grantor trusts), as well as ancillary documents and client letters. Lawgic is one of the only drafting systems that offers state-specific documents with state-specific legal commentary on various issues that arise from one state to another. Carlyn S. McCaffrey, a distinguished estate planning practitioner at the international law firm of Weil, Gosthal & Manges, LLP, agreed last year to oversee Lawgic's New York Trusts & Estates product and the initial release of this new product is now targeted for spring of 2005. Lawgic representatives are discussing the addition of other distinguished practitioners as they release Wills & Trusts products for other states. In fact, Maryland was added last year, which is overseen by Abel J. Merrill. Notably, all Lawgic authors are fellows of the American College of Trust and Estate Counsel (ACTEC).

A ”Getting Started Guide” is available within the program and via the Lawgic website. Lawgic’s website offers some excellent “Product Training Videos” in the “Support” portion of their site (under “Training”). Lawgic is priced at $1,200 for a full version (single-user license) according to the Lawgic website. A new development is the availability of monthly subscription pricing, which is similar to ProDoc's drafting system subscription (below) and allows you to obtain Lawgic at a low cost and cancel the subscription at any time without penalty (except for the first non-refundable month) according to the Lawgic website.

3. ProDoc (http://www.prodoc.com/): ProDoc offers Ronald Lipman’s will and trust forms, the Florida Lawyer Support Services, Inc. (FLSSI) probate and guardianship forms, and probate management and accounting software as a part of its Estate Planning Library, which is advertised at $95 per month. Other practice systems are available. ProDoc has offered Florida and Texas versions for some time, and is about to start offering California. A new feature of ProDoc is the Small Office Suite, which is essentially a case management program (somewhat similar to Abacus Law, Amicus Attorney, PC Law, or Time Matters) that affords contact management, calendaring, and time billing capabilities. ProDoc offers a user forum to its subscribers as well, which is generally moderated by Mr.
Lipman.

4. WealthDocs by WealthCounsel (http://www.wealthcounsel.com):
WealthCounsel will probably again be a popular booth. Their WealthDocs drafting system functions as a “what-you-see-is-what-you-get” program and includes various “practice systems” (or modules) built on the HotDocs document assembly platform (below). WealthCounsel includes more “practice systems” than most other drafting systems, from various trusts to family limited partnerships to a comprehensive charitable system that even features private foundations.

WealthCounsel membership includes discussion lists (including a public one with 1,800 participants, which is also free to non-members), continuing education, and an impressive knowledge base. Notably, Louis Mezzullo and Natalie Choate respectively added a buy-sell component and a retirement planning component to WealthDocs' latest version 6.1 update; both of these additions are still in a testing mode, however, and will probably be finalized in the first quarter of this year. Brian Albee, who debuted his TrustDocs drafting system last year at the Heckerling Institute, joined WealthCounsel as their technology director in the fall of 2004. Mr. Albee is designing a trust funding system to be released by WealthCounsel this year.

WealthCounsel still offers two payment options based on their website: (b) a $3,900 initial payment plus $390 per month for twelve months; or (c) $7,900 paid in full for the first year. However, please check with the WealthCounsel booth for special Heckerling Institute pricing. Also, note that this pricing is about to increase if it has not already.

WealthCounsel will again sponsor a post-Heckerling session, called "Putting Heckerling into Practice," to discuss topics and techniques presented at this year’s Institute. Mr. Mezzullo will moderate this year's session. WealthCounsel costs more than other drafting systems, but you obviously receive additional services such as these types of post-program sessions and timely updates. You should remember that pricing is only one factor to consider in selecting a drafting system.

5. Wealth Transfer Planning by InterActive Legal Systems (http://www.ilsdocs.com): Jonathan G. Blattmachr, a distinguished estate planning attorney at the international law firm of Milbank, Tweed, Hadley & McCloy, LLP in New York and well-known author, originally authored his Wealth Transfer Planning program. Wealth Transfer Planning, a “what-you-see-is-what-you-get” program, is now co-authored by Michael L. Graham of Dallas, Texas.

Wealth Transfer Planning offers (1) numerous modules, which are similar in breadth of scope to WealthDocs' "practice systems" (above), (2) polished language, and (3) built-in legal knowledge dialogues, which guide you through the decision-making process in drafting a document. Major news regarding Wealth Transfer Planning was announced in late 2004. Wealth Transfer Planning intends to convert to the popular HotDocs engine/platform (below). The official release of this new Version 3.0 is anticipated in early 2005. The beta version that is being shown at Heckerling is pretty slick and offers a lot of promise for significant functional improvements.This will address complaints from some users regarding the stability of Wealth Transfer Planning's programming, and will also make Wealth Transfer Planning another worthwhile option for those who want to migrate data to the HotDocs system.

Last year, Wealth Transfer Planning added a moderated discussion list, similar to the WealthDocs discussion list for its members (below). Wealth Transfer Planning still currently costs $2,995 for a single-user license according to the InterActive Legal Systems website, but it is scheduled to go up to 3,995 with the release of the new HotDocs Version 3.

6. WinDraft/EP Expert (TM) (http://www.lawtech.com/WINDRAFT/EPEXPERT/):
EP Expert uses an underlying engine, WinDraft, to produce documents. The WinDraft/EP Expert system represents one of the only notable options still available to create a "do-it-yourself" drafting system due to the end of support for Data Tech Software's ThinkDOCS drafting system. In other words, you can basically build your own document assembly system with your own forms using WinDraft/EP Expert.

WinDraft/EP Expert has several unique features, including an outline checklist interface to answer all applicable questions quickly and then produce a whole set of documents for both spouses. It then can automatically save each document in DOCS Open or iManage, and fill out each profile with names and descriptions. A particularly useful feature is the “drag-and-drop” interface, which lets a user enter contact information just once for husband, wife, children, and fiduciaries, and then drag-and-drop each person into various roles for the client’s documents, e.g., associating a person with a fiduciary role such as trustee or personal representative, or designating the person as a beneficiary. This program also works with DOCS Open or iManage document assembly software.

A number of large firms use WinDraft/EP Expert to produce their custom forms based on their own language. Smaller firms can implement WinDraft/EP Expert as well. WinDraft costs $495 for a 5-user license, and EP Expert, the estate planning module, costs $4,500. However, for Heckerling Institute attendees, WinDraft/EP Expert is being offered at half-price ($2,497.50) according to company representative Dan Marcum (dan@lawtech.com).

7. HotDocs (R) by LexisNexis (R): LexisNexis recently announced the release of HotDocs version 2005 (the seventh version of HotDocs). HotDocs 2005 includes several important new features: (a) integrated database connection, (b) integrated document comparison of HotDocs-generated documents when answers have changed, (c) integrated Microsoft (R) Outlook

(R) connection, (d) the ability to view variables in the assembled document at the "Document Preview" tab, and (e) the ability to jump from a variable in an assembled document to the place where it is asked in the HotDocs interview and vice versa. Please note that most, if not all, of these features are not available for Corel's WordPerfect (R) due to (a) a critical technical feature that allows one application to drive another, which is not present in WordPerfect, and (b) the lack of a useful display engine for WordPerfect documents. HotDocs is still working to overcome these obstacles regarding WordPerfect. Another significant feature in HotDocs 2005 is the ability to publish templates for use with HotDocs 2005 Server, which is the server-based, interview-in-a-browser version of HotDocs (a vast improvement over HotDocs Online version 6, with a friendly browser interface that mirrors the desktop interface). Foundational to the new features, HotDocs allows you to program all types of variables in order to automate your own (or another's) documents. The American Bar Association's HOT DOCS IN ONE HOUR FOR LAWYERS (2d ed. 2002), written by Bruce W. Miller and available via the ABA website: http://www.ababooks.org.

C. TRUST ACCOUNTING & RELATED ADMINISTRATION SOFTWARE:

1. BNA (http://www.bna.com): BNA offers two automated systems: an updated 706 program that already incorporates the increased applicable exclusion amount and a newly-updated 709 program. The
709 program now allows you to move gifts easily within the return by highlighting and “right-clicking” on the particular gift that you want to move to a different part of the return. Navigation within the 709 is also improved. “Demo” versions for both products are available at the BNA booth.

2. EstateWorks (http://www.estateworks.com):
EstateWorks is a web-based system that tracks and assists with the preparation of estate administration matters. Users can “click” through any part of the program and can see at a glance the status of cases and a checklist for each case. EstateWorks generates documents and merges data into word processing files and other formats.

3. FASTER Systems, LLC
(http://www.fastersystems.com): FASTER software offers a single-entry system for fiduciary accounting. Note that the FASTER operating environment is based on the ASP or Application Service Provider model. This means FASTER provided its software through an online-hosted environment. While it offers certain efficiencies, this may or may not be the sort of working environment that will best meet your needs and those of your clients.

4. Financial Data Service, Inc.
(http://www.financialdata.com): This program produces the 706 and 709 transfer tax returns, as well as probate reports and other items.

5. Heritance System (TM) and Quick & Easy (TM) by DataTech SoftWare, Inc.:
DataTech’s Quick & Easy (http://www.quickandeasy.com) (tax preparation) now offers a complete suite of estate administration tools called Heritance System (http://www.heritancesystem.com). You may also purchase individual tax and fiduciary administration modules from the main Quick & Easy website. The jury is still out as to how effectively DataTech has integrated it's Quick & Easy forms into its new Heritance environment, let alone how complete and robust their estate administration and tax forms really are, so a beta test of this system in your own offices is highly recommended.

6. The Lackner Group, Inc.
(http://www.lacknergroup.com): The Lackner Group, Inc. has consistently offered a single-entry

estate administration program known as the 6-in-1 Estate Administration System. This system produces the 706, 1041, the accounting and inventory for the estate administration, and relevant state tax forms as well. The 6-in-1 Estate Administration System is a Windows- or Mac-based system that includes the latest tax preparation forms. The Lackner modules are priced separately and are very affordable. This system has been around virtually since the beginning of the development of fiduciary accounting software under the able leadership of Vince Lackner, which speaks highly for its stability and completeness, and is well worth serious consideration by anyone who is looking for a new system or to replace an existing one (such as the West FAS and ProBate FAS, both of which have gone out of business in the last year or so).

D. APPRAISAL & VALUATION SOFTWARE:

1. Estate Valuations & Pricing (EVP) Systems, Inc. (http://www.evpsystems.com): EVP has released an updated version (as of July 25, 2004) of its superb stock and bond valuation software. Existing users are urged to upgrade to the current version due to market changed that occurred with the Regan funeral week. This company continues to improve this product, and it is linked to every popular fiduciary accounting program we are aware of. In addition, it is still the primary on-line source for values for the IRS. It's newest Version 7.04 comes with a new interface and drop down menus, and soon to be released Version 7.1 will allow for the valuation of foreign securities.

2. Other appraisal and valuation vendors abound, and will be included later as time permits.

E. RESEARCH SOFTWARE, SERVICES & RESOURCES:

1. American Bar Association (ABA) (http://www.americanbar.org & ABA Section of Real Property, Probate, and Trust Law (RPPT) (http://www.americanbar.org/groups/real_property_trust_estate.html): The ABA offers some of the best practice resources available to lawyers and particularly to estate planning (trusts and estates) lawyers. For example, by joining the RPPT Section, you receive electronic access to the current issues and archives of Probate & Property magazine and the REAL PROPERTY, PROBATE & TRUST JOURNAL; both archives are browsable and searchable. You also receive discounts on the numerous treatises published by the ABA for estate planning lawyers.

2. BNA (http://www.bna.com): As most of you know, BNA offers excellent research tools, including the well-known Tax Management Portfolios (one of my favorite research tools).

3. CCH (http://tax.cchgroup.com): CCH also offers excellent tax and estate planning research tools.

4. LexisNexis (R) (http://www.lexis.com): Lexis features numerous estate planning titles in its Tax Law Library, including the University of Miami Philip E. Heckerling Institute on Estate Planning materials. You may also purchase the presentation materials on CD-ROM again this year.

5. Thomson/West (TM) (http://west.thomson.com):
West offers a number of estate planning research tools as well.

6. Trusts & Estates
(http://www.trustsandestates.com)
Magazine: Trusts & Estates, known as "The Journal of Wealth Management for Estate Planning Professionals -- Since 1904," is an excellent resource. As announced last year in the final report

(Report 15 of 2004), Trusts & Estates now offers online access to its issues published over the last ten years or so. The online archives include text, rich text with images, or portable document format (PDF) versions of various articles, depending on availability; most of the newer articles are available in all formats. The search feature could be improved a bit and the PDF files could be published with a product like Adobe (R) Acrobat's Distiller program so that they are searchable on your own drive or network, but overall this is a tremendous value. Pricing is $199 for a one-year subscription or $299 for two years based on the Trusts & Estates website; however, you can find excellent discounts if you are a member of a member council of the National Association of Estate Planners and Councils (NAEPC) (http://www.naepc.org/member_services.web),
which offers a substantial discount on subscriptions as an "affinity"
partner.

F. MISCELLANEOUS VENDORS:

1. Connect2A.com (http://www.connect2a.com/):
Connect2A.com allows estate planning professionals to track their clients' assets and estate planning techniques via an Internet-based service that is encrypted and more secure than almost all private law firms' internal servers. Connect2A offers excellent training, from their Internet-based presentations powered by WebEx technology
(http://www.connect2a.com/C2Ademo.html),
which cover basic aspects of Connect2A, setting up trust information in Connect2A, and the trust funding process of Connect2A, to their in-depth training sessions for the estate planning team. One of the most attractive aspects of Connect2A's service is the ability to track asset and beneficiary changes during the trust funding process. Connect2A's system is also compatible with HotDocs and thus is compatible with other programs (above).

Connect2A has released several new features including their encrypted communication system, a document storage/sharing service called Document Connect (TM), additional access for guest members and guest clients, and more administrative abilities to add new members. Some of these services incur additional costs depending on the level of additional usage. The primary Connect2A service still costs $60 per month, billed quarterly, based on their website.

2. The Capital Trust Company of Delaware
(http://www.ctcdelaware.com/): As many of you know, the Capital Trust Company of Delaware's site has been one of my favorites for a long time. It includes many useful Adobe Acrobat one-page summaries on basic and advanced estate planning techniques, which are excellent when explaining a concept to a client who would prefer a picture. Presentations are also available, as well as sample forms and provisions and extensive information on the application of Delaware law. Most of the mentioned materials are located in the "Personal Trust Services" area under the "Trusts" heading on the top navigation bar.

Registration is no longer required to access these materials. Visitors may still register for a free e-newsletter, however, which contains planning discussions and recommendations from some of the helpful Capital Trust Company of Delaware team members.

3. Schumaker Publishing, Inc.
(http://www.estateplanning.com): This company markets packaged websites for estate planning attorneys.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann &

Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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

Report #5

(Monday and Tuesday A.M.)

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This Report contains additional coverage of the Monday A.M. Fundamentals program and coverage of one of the four Tuesday morning general sessions.

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Monday, 1/10/05 - **FLPs and LLCs from A to Z** Louis A. Mezzullo Esq.

Report by Shelly D. Merritt Esq.

Mr. Mezzullo gave a comprehensive presentation on issues relating to family limited partnerships and LLCs. He first addressed what type of entity to use for a family entity. It generally comes down to either a limited liability partnership or limited liability company. For several reasons stated throughout the presentation, Mr. Mezzullo prefers LLCs if the applicable state statute meets certain requirements discussed below.

He pointed out that the nature of the assets affects the type of entity to use. For example, if the client has an active business, it may be preferable to use an S-corporation in order to be able to treat some income as dividend income to avoid the additional 2.9% self employment tax.

Characteristics of an interest in an entity affecting discount on value:
1. Management rights add to value, lack thereof decreases value
2. If a member/partner has the right to require the entity to buy his
or her interest at any time, this also adds to value, lack thereof decreases value.
3. If a member/partner can transfer freely, adds to value, lack
thereof decreases value.

Tax issues

1. Qualifying a transfer of an interest in an entity for annual gift tax exclusion. Hackle case involved LLC with no steady stream of income. Court held that where donee could not transfer full membership interest to a 3rd party, a gift of the interest doesn't qualify for annual exclusion. To avoid Hackle, Mr. Mezzullo suggests providing in the operating agreement that a member/limited partner can transfer his or her full ownership interest to 3rd party after first offering to the company/partnership (i.e., the transferee receives full membership/limited partnership interest instead of assignee interest). This does not affect discount much, if any, since the membership/limited partnership interest has no voting rights.

2. IRC §2036(a) Issues. Kimbell v. U.S., 244 F. Supp 2n 700, 91 AFTR 2d 2003-585 (N.D. TX 2003) and Estate of E. Stone III, T.C. Memo 2003-309 both held that 2036(a) did not apply to the initial transfer to the partnership since the transfers fell within the bona fide sale exception to

2036(a). Both found non-tax reasons for the entity. He advised that it is best to have other owners own non- deminimus interests in the entity when the decedent dies in order to avoid IRS argument that the only reason the entity was set up was to avoid tax (i.e. where decedent owns almost all LP interest and child owns small GP interest at death).
3. IRC §2036(b): If a transferor retains the right to vote stock that is transferred to an FLP, the value of the stock will be included in the transferor's estate. This is the rule under Bynum. Two options for avoiding this result: 1) With respect to voting rights, provide that all members/partners of the entity can vote the stock in proportion to their ownership interest in the entity, or 2) Have another entity own the right to vote the stock, not the family members.
4. IRC §2701: Provides that if an older family member transfers an interest in an entity to a younger family member and the transferor retains a senior or preferred equity interest, then special valuation rules apply causing the gift value to be increased.

a. Can be avoided if there is only one class of equity interest.
b. If there is more than one class of equity interest and the retained interest is a "qualified payment right," then right can be taken into account in valuing the transfer to the lower generation to decrease value. But, if payments are not actually made, then you have a problem.

5. IRC §2703: Provides that any restrictions (that are not commercially reasonable) on right to transfer an interest in an FLP are ignored when determining the value of the interest.

a. Transfer restrictions typically used in FLPs are generally commercially reasonable because same restrictions would be used with non family members.
b. Several cases have held that §2703 does not apply to disregard the entity altogether.

6. IRC §2704(a): Provides that a lapse of a voting or liquidation right results in a taxable gift if during the transferor's lifetime or in an increase to the estate of the transferor, if at death. For example, if an older family member is a GP and the GP interest is converted upon his/her death to a LP interest, the dimunition in value of the interest is added back.

a. Have a corporation serve as the GP to void application of 2704(a). No death, no lapse.
b. If state law provides that GP's withdrawal causes dissolution of partnership, then this section applies.
c. Will not apply where manager of an LLC dies because death of member in an LLC does not cause dissolution of the LLC. One argument in favor of using LLCs instead of LLP.

7. IRC §2704(b): Applicable Restriction (a limitation on the right of an owner to liquidate his or her interest, if the restriction is more restrictive than state law) is ignored for valuation purposes. There are cases that provide that an Applicable Restriction is only the right to dissolve the entity, not just the member's/partner's interest in the entity.

Non Tax Reasons for Having FLP

1. Limited liability to members/partners

2. Retention of control
3. Continuity of life
4. Restrictions of transferability
5. Use as management company for other business entities
6. Restrictions on management and voting rights
7. Protecting assets from liability
8. Protecting assets from owner's creditors (creditors can only get charging order, if creditor goes after interest, becomes assignee and must pay tax on income attributable to interest). Keep property as separate property for marital property purposes.
9. Dealing with recalcitrant family members. Provide for arbitration in agreement, payment of legal fees if challenge, etc.
10. Desirable tax characteristics: (Very important to convey to clients that entity is not all about taxes)

a. Partnership tax treatment
b. No restrictions on ownership (s-corps have restrictions)
c. No restrictions on capital structure
d. Tax Free formation - tax free incorporation more complicated than formation of partnership. Corporation - owners transferring assets to form corporation must own at least 80% after formation.
e. Tax free contributions
f. Tax free withdrawals
g. Basis step up. Partnerships are allowed to make 754 election to step up inside basis on assets owned by partnership. Corporations can't do this. Downside to FLP planning, children have lower basis due to gifts (carryover basis) and discounts on parents' deaths. (See examples in appendix)

Formation of Entity Issues

1. If have validly formed partnership, can make gifts from the very beginning immediately after formation.
2. If put something like a vacation home into the entity, it may be better to put into an LLC if the state LLC act does not require it to have a business for profit. A partnership is by definition a business of more than one person for profit.
3. Investment Company Issues. Causes recognition of gain upon transfer to entity of appreciated property to entity.
4. Contributions of property subject to liabilities can cause gain.
5. Family partnership rules - Capital must be income producing factor and donee must have economic interest in partnership/LLC. If don't satisfy these rules, income of partnership is reallocated to the senior family members.

Income Tax Issues When Dissolving or Making Distributions from Entity

1. Generally, a partner only recognizes gain in connection with a distribution from the partnership to the extent that any money (marketable securities are treated as money) distributed exceeds his or her basis in the partnership. There are several exceptions to the general rule.
2. Exception: If appreciated property is contributed to a partnership and then distributed to another partner within 7 years, donor must recognize the built in gain on the property. Same is true if other property is distributed to the donor partner within 7 years.

Drafting Issues

Provisions in agreement to focus on:
Allocation of profit and loss
Allocation of distributions
Restrictions on transfers
Events causing dissolution
Voting and management rights

1. Need to know default provisions in state statute. IRC §2704(b): If agreement is more restrictive than default rules, then have applicable restrictions.
2. Articles of Organization should provide the following:

a. Provide whether member or manager managed. (Recommends manager managed)
b. That there is only one operating agreement and it can only be amended by percentage set forth in Articles. Want this in the Articles so that a non-managing member has no apparent authority to bind LLC and also to defeat the argument that the members/partners have an oral agreement that is part of the operating agreement. Some states permit oral amendments to operating agreements and some states allow more than one operating agreement.
c. Everything else should go in the operating agreement.

3. Contributions and Distributions

a. Senda and Shepherd cases held that a contribution of property to a partnership/LLC by parents which resulted in an increase in value of children's ownership, was a transfer of the property to the children rather than to the entity. Make sure that additional membership interests are first given to the contributing partner/member (i.e., credited to the contributing partner's capital account) and then transfer the membership interests to the children by assignment.
b. Should provide in the agreement that consent of all members/partners is required before founding (or any other) members can make capital contributions to entity. Generally don't want one owner to be able to increase his or her interest without the consent of the other members.
c. Provide for capital calls in the agreement. May make it more difficult to sell interests. In addition, can possibly be a way of getting rid of a disruptive member.
d. Provide that non pro-rata distributions in kind can only be done with consent of person receiving distribution.
e. Permit transfer of interest by member/limited partner only after offering to the company or other members to purchase at price 3rd party willing to buy for.
f. Agreement should allow member/limited partner to sell full interest to 3rd party after giving right of first refusal to company and/or other members/partners to avoid Hackle issue.
g. Dissolution and Liquidation. Watch out for 2704(b), look at state law. Agreement cannot be more restrictive.
h. If concerned about spouses owning interests in the entity, provide in the agreement that a transfer can be made to a trust for benefit of spouse but not outright to spouse. This will allow gifts of interests to a QTIP.
a. Custodial gifts. Provide in the agreement that upon attaining age 21, custodial interests can be transferred to the child and that such a transfer is not a prohibited

transfer under the agreement.

Circular 230 Final Regulations - Requires limited scope opinions if attorney so much as mentions tax issues relating to partnerships etc. (i.e., attorney should provide in writing that he/she is not giving an opinion on 2036(a) etc).

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Tuesday, 1/11/05 - Asset Protection Other Than Self-Settled Trusts Steven J. Oshins Esq.

Reported by Gene Zuspann Esq.

This presentation will focus on Trusts - and particularly Beneficiary Controlled Trusts (BCT)

A BCT is a trust in which the primary beneficiary is the sole trustee or is a co-trustee and has the power to replace the other trustee.

The BCT usually includes a special power of appointment that allows the primary beneficiary to eliminate interference by remote beneficiaries. It waives the Prudent investor standard. If a support trust, it must include a spendthrift provision.

Steve discussed support interests vs discretionary trusts. The support trust allows creditors to attack the trust because of rights of beneficary to go to court and enforce the support standard.

There are 4 exception creditors on support trusts under the Restatement
(Trusts) 2nd

He discussed several cases involving discretionary trusts and the inability of a creditor to force the trustee to pay funds from the trust for the claim against the beneficiary. He also mentioned a case that allowed the IRS to obtain payment from a support trust.

Steve suggests that the trusteeship be broken up - use two trustees. The primary bene is the investment trustee and he/she would select the other trustee. The bene/trustee has the power to remove and replace the other trustee.

Dynasty Trusts - if the BCT makes sense for one generation, shouldn’t it also make sense for multiple generations. The client does not need immense wealth, “such as the Gettys, the Rockefellers and the Blattmachrs.” It often makes sense to use a dynasty trust that retains the client’s assets in trust for several generations to protect the beneficiaries and to allow the trust to grow.

Inheritor’s trusts - a BCT dynasty trust with discretionary powers. The client sets up the trust and the parents change their estate plan to pour the client’s inheritance into the trust rather than outright to the client.

Opportunity shifting - the shifting of income or wealth from the client to others. A third party (the parent) creates the trust with some ‘seed’
money and the client uses the seed money to create an entity to acquire or start-up a business. This is a third party trust rather than a self-settled trust and allows creditor protection for the client even though the trust is later worth a substantial amount. It can allow the client to avoid many issues in a

divorce. The client only owns a small share of the entity.
Discretionary trusts - generally creditor proof because there is no standard of distribution. Steve only discussed the UTC for a few moments. He refers the audience to the materials written by the UTC committee and his materials. There are a number of concerns being voiced about the UTC from many people in the country, and Steve concludes that there are issues with the UTC that need to be addressed.

In 12 states, a remainder interest in a trust is marital property. In those states, a dynasty trust could be used to avoid the problem.

Charging orders - pg 66. Corporations do not have the advantage of charging orders but LLCs and partnerships do. A charging order gives the creditor only the rights of an assignee. The law varies on this issue from state-to-state. The materials include a list of cases from different states.

Steve discussed the Ashley Allbright case (a Co bankruptcy case) which held that a singe member LLC does not get the benefit of a charging order.

Disclaimers and existing creditor problems. The Drye case (pg 86) held that a disclaimed inheritance qualified as a property right under IRC §6321 and allowed the IRS to recover its tax lien. Steve believes that disclaimers still work against many creditors.

Tenancy by the entirety - there is now a case (the Craft case) that holds that for federal law purposes, the TBTE will not protect the debtor. However, the TBTE still works in states where it is applicable.

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Report #6 (Tuesday, Cont'd)

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

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This Report contains additional coverage of the Tuesday sessions. Since some of this relates to charitable planning, a copy of this Report is being sent to the GIFT-PL and Planned Giving lists.

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Funding Bypass and QTIP Trusts with Retirement Plan Assets Prof. Christopher R. Hoyt

Report by Herbert L. Braverman Esq.

Christopher Hoyt is a professor at the University of Missouri (Kansas
City) School of Law, who presented a discussion on funding trusts with retirement plan assets. Professor Hoyt reviewed the strategies for estate tax and income tax planning that are available to us and to our clients under various circumstances with a particular focus on the use of stretch IRAs and of charitable remainder unitrusts (CRUTs).

He began by reviewing the minimum distribution rules for retirement accounts and he reminded us of the 10% penalty for most distributions taken before 59 1/2 and the odious 50% penalty imposed when an account owner does not take appropriately large distributions after attaining the age of 70 1/2 or retiring , whichever occurs later. Professor Hoyt noted that minimum distributions during lifetime are essentially the same, regardless of who or what is named as beneficiary. On the other hand, after the account owner's death and in particular as of September 30 of the year following death, the identification of the designated
beneficiary's) is of prime importance. This is so because the decedent's IRA can be a stretch IRA with payments spread over the life expectancy of the designated beneficiary (DB). Using the government's Uniform Lifetime Distribution Table and the life expectancy table, Professor Hoyt illustrates the relative wisdom of naming a young DB and paying the tax favorable IRA over an extended period of DB life expectancy.

Professor Hoyt took the time to point out that the Japanese who eat no fat outlive Americans and the French who eat a lot of fat and drink a good bit also outlive us; so do the wine-drinking, fat -eating Italians--his conclusion is that it must be "speaking English that kills you!"

He then turned to the integration of income tax and estate tax planning. He presented some interesting statistics to illustrate how few 706's will be filed in the future under the current tax regime--perhaps as few as 200 per state in 2006--and , therefore, how much more important income tax planning for retirement funds will be.
He referred to Mrs. Sam Walton as one of the wealthiest woman in the world and suggested that Senator Kerry refers to her as "the one that got away."

Professor Hoyt reviewed the advantage a surviving spouse has as the DB, namely, the ability to do a rollover IRA and treat the new IRA as her/his own. He noted 3 problem areas: (1) when the IRA owner is not married and, of course, has no surviving spouse; (2) when the IRA owner is in a second marriage (with children from the first marriage); and (3) when the IRA owner and spouse is subject to estate tax. In these cases, after paying some attention to the use of other approaches that may be somewhat helpful in some circumstances, such as annuities and QTIP trusts, Hoyt demonstrates the income tax and estate tax advantages of using the two-generation CRUT arrangement, where possible. This CRUT is named as beneficiary of the retirement account and then pays a long stream of income payments to the account owner's spouse for life and then does so for their child(ren). For a more detailed treatment of the technical issues associated with using CRUTs as a bypass trust/QTIP trust for income in respect of a decedent, the Professor refers us to his article in TRUSTS AND ESTATES (May 2002), "When a Charitable Trust beats a Stretch IRA". A copy of the article is also attached to his outline, but a detailed discussion of the article is beyond the scope of this report.

Professor Hoyt also discussed basic tax planning strategies for married individuals. Where there are no estate tax concerns, a spousal rollover of retirement benefits, followed by a stretch IRA for the children should suffice.But what if there are estate tax concerns that would normally call for the use of a conventional bypass trust? First , try to fund the bypass trust with non-IRD assets. If these are insufficient, some retirement assets will have to fund the full credit shelter amount. Where there is sufficient wealth, Professor Hoyt suggests several strategies:

1. give some retirement assets to the children in stretch IRAs or to other beneficiaries who are considerably younger than the spouse.

2. consider establishing a conduit bypass trust to reduce both the size of the required distributions and the income tax rate imposed on them.
A rollover to spouse is still better, if the surviving spouse lives a long life.

3. consider a 2-generation CRUT. This can result in estate tax and income tax advantages similar to a 2-generation IRA rollover.

4. for "young" surviving spouses, use an IRA rollover to achieve substantial income tax objectives, even though the assets will be in her/his estate in the distant future (who knows what the estate tax system will be then?)

Similar integrated estate and income tax planning strategies can be used when considering the use of retirement assets to fund QTIP trusts.

As for the unmarried individual with out estate tax issues, the use of the stretch IRA is probably the best alternative, but the use of a CRUT as a beneficiary would still be available. Where estate taxes are likely to be suffered, Professor Hoyt recommends a charitable bequest of retirement accounts and other IRD assets to avoid the "double whammy of estate and income taxes."

I think this is a full report of the session, but I recall the Professor quoting President Bush as saying that it is important to right 90% of the time and not worry "about the other 6%."

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Deference and the End of Tax Practice
Prof. Michael Gans

Report by Connie T. Eyster Esq.

This presentation addressed the issue of how much deference courts are apt to give to IRS regulations, rulings and other agency pronouncements when making decisions on tax court cases, and how the court decides the level of deference.

The speaker believes that a sea change on this question is happening in administrative law, which change could have a significant impact on how we advise clients, write opinions on tax issues, and litigate tax cases as this change begins to impact our area of the law.

Prof. Gans indicated that he believes the IRS has been publishing more guidance in recent years and will continue to do so in order to garner further support for the deference argument in the courts. It is not clear to what extent the IRS realizes their expanding power under this deference principle, but practitioners need to be aware of the arguments and take them into account.

There was a confluence of events that led Prof. Gans to believe that there was a dramatic change happening with regard to deference issues.

1. In 1996, the U.S. Supreme Court decided a case called Smiley v.
Citibank, 517 US. 735, which was a non tax case discussing the scope of an administrative deference case called Chevron, U.S.A., Inc. v.
Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). This was a unanimous opinion, which, if applied in the tax area, will turn many of our notions of deference upside down.

Immediately before the Chevron case was decided, courts applied deference in two different ways. "Legislative regulations," which are regulations issued by the service out of an express direction in the legislation granting such authority, were given deference that was very hard to overcome. A legislative regulation would not be given deference only if the regulation was arbitrary and capricious. All other types of regulations, including those issued generally under IRC § 7805 (which generally allows the IRS to promulgate regulations interpreting the code called "interpretive regulations") were given "Skidmore deference." Whether the court decided to give deference to these non-legislative regulations would be determined based on a variety of factors such as whether the court thought the interpretation by the agency was correct, whether the statute was amended or reenacted after interpretation was issued, whether the agency was involved in litigation when the regulation was written, and whether the regulation was written contemporaneously with the passing of the statute.

Chevron purported to establish a new theory of deference, which was discussed in the case of U.S. v. Mead, 533 U.S. 218 (2001). Under this new deference standard, the court will first look to see if a statute is ambiguous or silent on the issue presented. If it is not silent or ambiguous, then the court will use the express language of the statute to determine the issue. If the statute is silent or ambiguous, then the courts will defer to the agency regulation issued on that question, if the regulation reasonably resolves the ambiguity.

Smiley tells us that this new standard will be used, even when the traditional Skidmore factors would have indicated that no deference should be given to the agency regulation. Smiley was a non tax case that was unanimously decided by the Supreme Court. In that case, the statute at issue was enacted 100 years before the regulation, but the fact that the regulation was not contemporaneous with the statute did not seem to impact the court's decision. Likewise, the regulation was issued after the transaction in the case had been consummated and after lower courts had issued rulings in the case. Nonetheless, although the agency issued the regulation while taking an adversarial position, the court still gave deference to the regulation. Further troubling was that the court upheld the regulation, despite the fact that the agency had previously taken contrary stances in other published notices.

Prof. Gans highlighted footnote 3 in Smiley case, in which the court said that even though the regulation applied retroactively to the transaction in that case, it was not, in fact, a retroactive application because the agency had not previously issued formal regulations on that issue (even though it had taken a position on the issue in other notices). This was the court's decision, even though, like the IRS, the agency in the Smiley case was prohibited from issuing retroactive regulations.

Under this analysis, Prof. Gans questioned why would the Supreme Court ever grant certiorari on a tax case? If the statute is ambiguous, all the IRS would need to do is issue a new regulation addressing the issue, which would be deferred to by the court.

2. Also making Prof. Gans aware of the deference issue was a 1997 decision in which the Supreme Court issued its decision in favor of a taxpayer by relying on the regulations. Three justices issued a concurrence which highlighted the issue raised in Smiley, that by giving the regulations so much deference, the courts have given the IRS the ability to change the outcome by simply issuing new regulations.

3. Finally affecting Prof. Gans's concern about the deference issue, were new regulations on the GST issued in 1999 regarding IRC Â§ 2601. There was a split in the circuits regarding how the lapse or exercise of a general power of appointment might affect the grandfathered status of a GST trust. Rather than appeal a case and request a grant of certiorari, the preamble to these regulations essentially stated that it was issuing new regulations to overrule the circuit decision that was favorable to the taxpayer (Simpson v. U.S., 183 F.3d 812 (8th Cir. 1999)) and affirm the decision favorable to the government (Peterson Marital Trust v. Comm'r, 78 F. 3d 795 (2nd Cir. 1996)).

Prof. Gans believes we will see more of this deference issue, which seems to be expanding the power of the IRS, rather than the courts, to decide tax issues.

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Report #7 (Tuesday, Cont'd)

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

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This Report contains additional coverage of the Tuesday sessions.

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Death, Estate Taxes, and Liquidity Needs - Three Strikes for the Family Business Dennis I. Belcher Esq.

Report by Connie T. Eyster Esq.

Mr. Belcher first discussed material not in his materials concerning a Graegin promissory note transaction used in the case of Klein v.
Hughes, 2004 WL 838198, an unpublished California opinion reported at p. 87 of the Recent Developments material.

The decedent in Klein died in 2000 with an estate worth $300 million.
The estate tax liability was approximately $200 million. Most of the trust assets were interest in limited liability companies from which the estate could not compel distributions and which companies severely
limited the rights of the estate to transfer its interest. To pay
the estate tax, the estate negotiated with the IRS to borrow $50 million from an unrelated third party, which was an LLC formed by a tax attorney. The LLC would borrow the funds from the decedent's company and then loan the money to the estate. To give the loan substance, the LLC stood to earn over $12 million in fees through this transaction. All of the principal and interest on the note at a date 25 years later with no interim interest due. Prepayment of the loan was prohibited, and thus the estate would incur $309 million of
deductible interest expense by the due date of the loan. Section
2053 of the IRC would permit a current estate tax deduction for all interest payable throughout the term of the 25-year loan, with no present interest discount, reducing the estate's liability for estate tax by $166.5 million. As stated in the materials, when you have estate liquidity issues, this case indicates the desirability of negotiating with the IRS over the payment of estate taxes. A hidden downside to this favorable result, however, is the income tax that would need to be paid on the interest earned on the loan.

Turning to the materials for this program, the speaker began by emphasizing that when speaking with a private business owner about estate planning, often the method for paying the estate tax burden is to purchase life insurance. However, in some instances the client is adverse to purchasing life insurance, life insurance might be prohibitively expensive for the client in light of all circumstances, or the life insurance currently held by the client will not cover all the estate liquidity needs. In those circumstances, the client might consider other alternatives to prepare for payment of the estate tax such as making a § 6166 election.

In order to make a § 6166 election, the following requirements must be met:

(a) the decedent must have been a citizen or a resident of the U.S.,

(b) more than 35% of the decedent's adjusted gross estate must consist of an interest in a trade or business, and

(c) the personal representative of the decedent's estate must make an election on a timely filed estate tax return.

If the estate qualifies for the election, it will be able to defer payment of the estate tax on the closely held business interests for
14 years. In the first five years of the deferral period, the estate can elect to make interest only payments. In addition, the estate receives a favorable, 2% interest rate on the first $540,000 of estate tax deferred and a rate of 45% of the federal underpayment rate for the balance of the deferred tax. However, the estate can no longer get income or estate tax deductions for the interest payments. Also, practitioners should be aware that IRC § 2035 adds a complication in that gifts made within 3 years of death are brought back into the estate to determine the 35% closely held business interest eligibility requirement.

Determining whether the decedent held interest in a trade or business can be a difficult determination, especially where the decedent held interest in rental real estate. The IRS takes the position that passive rental of real property does not qualify for the benefits of § 6166. However, the private letter rulings are all over the board on this issue. A net cash lease arrangement where the owner has no duties will not qualify for the § 6166 election. The more duties the owner has, the greater likelihood that the asset will qualify. Where the decedent is an owner of real estate that is leased to a company in which the decedent is a primary stock holder, again, the amount of duties of the landowner under the lease will determine whether the asset will qualify for the § 6166 election. The speaker suggests that duties of the landlord must be in the lease or the real estate must be conveyed to the corporation itself in order to assert the election.

An estate tax audit of the §6166 election will ask very fact specific questions such as:

What was the schedule of rental payments?

How active was the decedent's management of the property?

Who prepares and maintains the property?

Who takes care of utilities, gardening and other such responsibilities?

Who pays the bills?

Who inspects the property?

Who makes bank deposits?

Clients often have holding companies and those rules should be reviewed carefully (see p. 5-22 of the materials) if the client

expects to qualify for the §6166 election. Generally, the IRS takes
the position that if the sole asset of a company is stock in another company, it will not qualify for the § 6166 election. However, if a parent company owns 20% or more in value of the voting stock of another corporation or the corporation has 45 or fewer shareholders, and 80% or more in value of the subsidiary corporation is attributable to assets used in carrying on a trade or business, then the holding company and subsidiary will be treated as one company for the purposes of making the § 6166 election.

Note that the deferral of unpaid tax is accelerated if the business on which the election was made is sold during the deferral period.

One area that the IRS has really started to change its position on is the lien and bonding requirements (see pages 5-33 and 5-34 of the materials). In March of 2000 the Treasury Inspector General for Tax Administration issued a final audit report entitled, "The IRS Can Improve the Estate Tax Collection Process." The report stated that a vast majority of the § 6166 deferrals were not subject to liens and many of those not subject to liens were in default.

In addition to seeking liens on deferred assets, the IRS is now also seeking liens on the property held by the companies in which the estate owns interest. This is to protect against cases like that of IRS v. Skiba. In that case, the decedent had owned a car dealership and the estate made a § 6166 election for the business interest held by the estate. The car dealership started to do badly and the estate sold the underlying assets. When the business went bankrupt, the IRS was given the status of a general, unsecured creditor because, while it had an interest in the business itself, it did not have a lien on the underlying assets.

Now, the IRS is filing liens on underlying assets rather than on the trade or business interests that are reported on the estate tax return. Mr. Belcher cautions that negotiating with individual agents regarding these liens is a tricky business and practitioners should be wary that they may see some abuses by the IRS in this regard.

When doing estate planning, be aware that use of a sale to a defective grantor trust can disqualify the owner's estate for the benefits of §6166. The promissory note issued by the grantor trust will be the asset of the owner's estate, not the underlying business interest and the owner may not meet the 35% eligibility requirement.

An alternative strategy to relying on § 6166 when there are estate liquidity issues is to borrow money from a third party with a deduction for interest payments made on the loan, often referred to as
a Graegin note. In Estate of Graegin v. Comm'r, T.C. Memo 1988-477,
the issue involved the estate borrowed money from a company in which the decedent held an interest in order to pay the estate tax. The loan was structured with a balloon payment of principal and interest upon maturity of the note (15-year term). The estate, however, took an upfront deduction of the interest due on the note and the tax court allowed the deduction as an expense of administration. The IRS issued a litigation Guideline Memorandum in response to the Graegin decision stating that, in order for the interest to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. In addition, the loan must have substance and have commercially reasonable terms. (See p. 5-52 of the materials).
PLR's since the Graegin decision have blessed the Graegin note: PLR
199903038 and PLR 199952039 (see also PLR 200449031 not in materials).

Final words of advice:

If considering one of the Graegin notes, RUN THE NUMBERS. The income tax on the interest earned by the note may make the transaction less favorable than it may appear at first blush.

The IRS lien requirements make the §6166 election a more burdensome and more costly alternative.

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I Fell and My HIPAA is Broken
Michael L. Graham Esq.

Report by Eugene Zuspann Esq.

For Mike's Powerpoint presentation, go to http://www.ilsdocs.com:

HIPAA = Health Insurance Portability and Accountability Act of 1996

Although not defined in the HIPAA regs, there are two rules:
The Agency Rule addresses the situation in which a 3rd party is authorized to request a patient's Protected Health Information (PHI). This is the form that the client signs for the agent.
The Release Rule dictates the form and requirements for a request for the release of PHI. These requirements dictate the requirements for the form required by the hospital.

What do we have clients sign in order to obtain their PHI? - a form that meets the requirements of the Agency Rule.

Note that the term 'Authorization' is used in two different contexts.
- the form provided to the medical provider is very specific (the hospital form)
- the form provided to an agent allowing the agent to sign the hospital form is not as specific

The Release Rule sets out a number of elements that must be included in the release provided to the medical provider. Pg 15-16. Mike believes that you are not going to get all of this in your power of attorney or your trust agreement.

There are no magic rules describing the requirements of the Agency Rule. The document must include an authorization to make decisions relating to health care. His outline (pg 13) provides language for a power of attorney.

There is a problem with a springing power of attorney. This probably requires a physician to certify that the HCPOA is now effective. HIPAA does have the key to the springing power in §164.510(b)(3). If the individual cannot agree, the hospital may, in its professional judgement, determine that the disclosure is in the best interests of the patient and then the hospital may release the information. This is discretionary with the doctor or hospital and there is no requirement that the recipient be the health care agent that the individual has picked.

Will and trust drafting issues.

The client still need to sign
a medical power of attorney
a durable power of attorney
If possible, still sign one of the HIPAA release in Mike's exhibits. He adds language to the form

authorizing anyone appointed under a medical power of attorney.

The problem with documents arise when disqualifying an individual as executor/trustee if such individual is lacking competency. The executor/trustee has generally not given an agency document. You could seek an authorization from the person at the time of appointment but this is a bad way to start a relationship. You are also unlikely to put all required information in the will or trust agreement.

Mike's materials contain two alternative provisions that can be added to the instrument to deal with the incompetency of the trustee. The first provides that the fiduciary's continued service is conditioned upon the fiduciary's voluntary release of his/her PHI. The obligation to provide the release is purely discretionary with the fiduciary, but failure to provide a release is considered an automatic resignation. His language is in the materials at page 34. The issues in these provisions are harassment and the dependability of getting a certificate from physician.

An alternative provision (pg 33) requires that the fiduciary is required to maintain a currently effective release. Mike finds this very troubling. There can be an inadvertent termination of fiduciary status. There are also waiver of right issues and privacy issues for the fiduciary.

Another alternative is the appointment of a trust protector to make trustee decisions independently of proof (without cause). A fourth alternative is to appoint a family member to decide competency issues.

Summary
1. Add suggested language to the DPOA
2. Execute a medical power of attorney
3. Execute an actual HIPAA release form 4. Add specific language to your will and trust agreements

Q&A Session:

Q: Must a release be a single purpose release?
A: The one to the hospital does have a single purpose and must contain all of the language required by the Release Rules, but the one for the agent does not. However, you must have a separate document for psycho-therapy notes.

Q: Will releases that satisfy state law satisfy HIPAA? The release must satisfy HIPAA. However, the agency authorization for someone to sign the release will satisfy the HIPAA requirement because state law will govern the power of an agent.

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Report #8 (Tuesday, Cont'd)

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This Report contains some news coverage and additional coverage of the Tuesday sessions on FLPs and GRATS

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NEWS ITEMS

1) Alaska Trust Company, an exhibitor here at the Institute, has informed us that the Trust forms they used to provide on CD-ROM are now available for viewing and download in PDF format from their Web site at http://www.alaskatrust.com.

2) Apropos the discussion of Circular 230 during the Recent Developments presentation on Monday afternoon, ALI-ABA has just announced the following CLE session:

The New Circular 230 Regulations: What You Need to Know Wednesday, February 9, 2005, 1:00 - 2:30 p.m. Eastern

Join the American Bar Association Section of Taxation for a 90-minute Teleconfernce and Live Audio Webcast on The New Circular 230
Regulations:
What You Need to Know Wednesday, February 9, 2005, 1:00 - 2:30 p.m. Eastern

The long-awaited Circular 230 regulations were issued December 17, 2004, and will become effective in June 2005.

Learn what you need to know to comply with the new rules from Treasury and IRS officials and private practitioners who have played a significant role in the drafting of these much-anticipated regulations.

Our Expert Faculty
DONALD L. KORB, Chief Counsel, Internal Revenue Service, Washington, DC ERIC SOLOMON, Deputy Assistant Secretary (Regulatory Affairs) and Acting Deputy Assistant Secretary for Tax Policy, U.S. Department of Treasury, Washington, DC RONALD M. WIENER, Wolf, Block, Schorr & Solis-Cohen, LLP, Philadelphia, PA WILLIAM M. PAUL, (Moderator), Covington & Burling, Washington, DC

Register:
Phone: 800.285.2221 and Select Option "2", M-F, 8:30 a.m. - 6:30 p.m. Eastern

3) Northern Trust reports that it has update its form book The book includes will, trust agreements for

one settlor, trust agreements for community property, and miscellaneous forms such as irrevocable insurance trusts, CRUT, CRAT, QDOT and gift trust agreements.

The book is available for $250 but includes no disk or CD. An online product is available for $350 for the first year ($100 renewal) or $500 for multiple users ($200 renewal). The product is to be available in February
2005 at www.northerntrust.com. The brochure also indicates that the web version will allow the user to "use a state-of-the-art document assembly program" (not identified) to create documents.

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Current Valuation Issues Involving FLPs and LLCs
Presenter: John W. Porter Esq.

Reporter: Shelly D. Merritt Esq.

Mr. Porter gave an in depth update on IRS arguments against FLPs and recent cases affecting the IRS's position.

IRS Arguments Regarding Family Limited Partnerships

1. Substance over form argument (Murphy v. Commissioner). Argument that if the primary purpose for creating the partnership is to reduce transfer taxes, it can be ignored for tax purposes. Recent cases have pretty much eliminated this argument. So long as a partnership meets state law formalities, it is a valid entity for tax purposes regardless of motive (Kerr v. Commissioner and Estate of Strangi v. Commissioner)

2. IRC §2703 Argument. Section 2703 provides that any option, agreement, or other right to acquire or use property at a price that is less than fair market value of the property is disregarded when valuing the property unless it is a bona fide business arrangement, it is not a device to transfer the property to family members at less than full and adequate consideration, and its terms are comparable to similar arm's length arrangements. The government has used IRC §2703 to argue that the partnership agreement itself is an agreement under 2703 and therefore is disregarded for valuation purposes. The IRS has lost this argument and the cases have held that 2703 cannot be used to ignore completely the existence of the entity agreement itself. It's purpose is to ignore abusive buy sell agreements.

3. IRC §2704(b) Argument. Section 2704 provides that certain "applicable restrictions" must be disregarded in determining the value of a transferred ownership interest if certain requirements are met. An "applicable restriction" is a restriction that is more restrictive than state law. In Kerr, the IRS argued that provisions in the partnership agreement limiting a limited partner's right to liquidate was an applicable restriction under
2704(b) which must be disregarded when valuing the interests transferred.
The IRS also argued that a limitation on a partner's right to withdraw from the partnership was an applicable restriction. Fifth Circuit affirmed Tax Court's holding that these restrictions were not "applicable restrictions."
This argument is not being seen anymore in the cases.

4. Gift on Formation Argument. The IRS has argued that a gift occurs when
a partnership is created because the value of the partnership interest received by the person creating the partnership is less than the value he/she put into the partnership (i.e. due to discounts). The IRS

lost on this argument in Estate of Jones v. Comm'r and in Estate of Strangi v.
Comm'r. The Courts have held that so long as a partner's capital account is properly credited when property is contributed, the partner's interest in the partnership is based on his/her capital account, and upon liquidation, the partner receives the value of his/her capital account, then there is no gift on formation.

In Senda, the Court found that the parents had actually made a gift of the property contributed to the partnership directly to their children, rather than a gift of limited partnership interests. In this case, the parents made a capital contribution of stock to an existing FLP and on that same day purportedly made gifts of partnership interests to their children (the assignments were not signed until several years later). However, there was no evidence that the contribution was ever actually credited to the parents' capital accounts.

To avoid gift on formation, contributions to a partnership should be credited to the contributing partners' capital accounts before any transfers of limited partnership interests are made in order to make it clear that the gift is of the partnership interest and not the capital contribution.

5. IRC §2036(a) Argument

Elements of Section 2036(a):

1) Transfer by decedent

2) Other than a bona fide sale for adequate and full consideration

3) Under which transferor has retained either:

-(a)(1) the possession or enjoyment of, or the right to the income from, the property, or

-(a)(2) the right, either alone or in conjunction with another person, to designate the persons who shall posses or enjoy the property.

IRC 2036(a)(1)

The Service has succeeded using 2036(a)(1) where the facts of the situations are such that the partnership assets are not kept separate from the donor's assets. Some examples:

Commingling of partnership assets with personal assets

Contributing personal use assets to the partnership (i.e., contributing a house to the partnership) (Estate of Strangi v. Comm'r)

Assets of partnership used to pay personal expenses (Estate of Thompson v.
Comm'r)
Need to make sure that the decedent has enough assets outside partnership to live on - if put everything in, it makes it easier for government to argue that the decedent was using partnership assets to pay personal expenses.

Government has argued that in the case of an elderly person, there needs to be enough assets outside

of the partnership to pay estate taxes (Strangi).
Mr. Porter believes this is irrelevant, however, there is trend toward looking at post death events.

Section 2036(a)(1) can be avoided by taking precautions to make sure entity is respected.

IRC Section 2036(a)(2)

Where a senior family member retains a GP interest, the government has argued that he/she has the ability to make distribution decisions which controls who enjoys the benefit of the partnership.

Estate of Strangi v. Comm'r: In Strangi, the decedent formed an FLP with his children and a corporate GP. Mr. Strangi took back a 99% limited partnership interest and 47% of the 1% corporate GP. His children owned the remaining 53% of the corporate GP. Mr. Stangi's son-in-law managed the day to day affairs of the corporate GP and the partnership. His son-in-law was also his attorney-in-fact under a power of attorney. A host of bad facts supported finding that Section 2036(a)(1) applied. The government also argued that the son-in-law's power to control distributions as a manager of the corporate GP should be imputed to the decedent as his attorney-in-fact.
The taxpayer argued that any power to make distributions as a GP was limited by a fiduciary obligation of the GP to the limited partners (citing United States v. Bynum, 408 U.S, 125 (1972)). The Court disagreed finding that Bynum did not apply because a GP who also owns 99% of the limited partnership assets has no fiduciary obligation to de-minimus partners. In some disturbing dicta, the Court went on to say that even the right as a limited partner to vote on liquidation is a 2036 (a)(2) power since a limited partner can act in conjunction with the other partners to cause the partnership to liquidate. This issue will be addressed on appeal. Oral arguments are set for March 2005.

Kimbell v. United States, 244 F.Supp.2d 700 (N.D. Tex 2003). IRS successfully argued at the district court level that an FLP should be ignored under §2036(a)(2), but was reversed on appeal by the 5th Circuit.
In this case, the decedent's revocable trust formed an FLP with the bulk of its assets and took back a 99% limited partnership interest and 50% interest in an LLC GP. The 5th Circuit found that a 50% interest in the GP was not enough to control the beneficial enjoyment of the property.

To avoid 2036 (a)(2):

1) the partnership agreement should not provide that the GP has no fiduciary obligations.
2) the partnership agreement should require mandatory distributions of available cash to the partners to avoid the argument that the GP has control over the distributions.

Both 2036(a)(1) and (a)(2) can be avoided by satisfying the bona fide sale exception.

Kimbell

Bona fide sale. The 5th Circuit looked at objective facts to determine if the partnership was treated as separate entity, including non tax reasons for creating the entity. The Court seemed to focus on fact that in Kimbell, the decedent owned an 11% working interest which required active management. Therefore a valid non-tax reason existed for the partnership.

Adequate and full consideration test. The Court found that so long as the value of assets transferred to a partnership are properly credited to the capital account of the contributing partner, the partner's interest in the partnership is based on his/her capital account, and the partner receives his/her capital account upon liquidation of the partnership, then this test is met.

Estate of Thompson

3rd Circuit affirmed Tax Court's finding that §2036(a) applied and that bona fide sale exception was not met.

Bona fide sale. Court found that there was no non-tax reason for the creation of the partnership and therefore there was no "bona fide sale."
The 3rd Circuit noted that the fact that the partnership consisted mostly of marketable securities and that the investment strategy did not change once contributed to partnership was a significant factor in finding that there was no "business" purpose to the partnership. This is very disturbing since there can be many non-tax reasons for contributing marketable securities to an FLP, such as protection from partners' creditors or a divorcing spouse.

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Care and Feeding of GRATS

Presenter: Carlyn S. McCaffrey Esq.

Reporter: Herbert L. Braverman Esq.

Carlyn S. McCaffrey, who is as well known as any estate planning attorney in this country, discussed "The Care and Feeding of GRATs--Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring". The "grantor retained annuity trust" is one of the most powerful, currently available estate planning techniques. It is a trust that pays an annuity to its grantor for a specific period of time and then shifts the beneficial interest to another beneficiary or beneficiaries. It is a "qualified annuity interest" if its terms satisfy the requirements set forth in Treas. Reg. 25.2702.3 There are 8 governing instrument requirements, including: 1. annuity amount must be payable at least once in every 12 month period to the appropriate payee.
2. the funding of annuity payments by notes or certain other financial arrangements must be prohibited. 3. the annuity amount must be a fixed amount in dollar terms or percentage. The regs. Do allow modifications to the amount from time to time. 4. If a formula approach is used, there must be an adjustment provision to correct any errors in determining values. See Treas. Reg. 1.664-2(a)(1)(iii) discussing charitable remainder annuity trusts. 5. Additional contributions must be prohibited in the trust instrument. 6. Commutation must be expressly prohibited in the trust instrument. 7. The trust instrument must prohibit payments to or for the benefit of any other than the annuitant until the expiration of the qualified interest. 8. The term of the qualified annuity must be fixed in the trust instrument for (i) the life of the annuitant, (ii) a specified term of years or (iii) the shorter of those 2 periods.

The grantor will pay all of the income taxes on earned income of the GRAT; it is a grantor trust when properly prepared. Upon termination, the property of the GRAT is transferred to the remainder beneficiary(s) free of gift tax.

Carlyn's primary focus in the presentation was upon enhancing GRAT performance through careful structuring, investment selection and monitoring of GRAT performance over time.

She indicated the following structural issues in this regard:

1. Create a GRAT with no taxable gift(s); make the actuarial value of the annuity payments=the value of the property transferred to the GRAT.
A GRAT created without a taxable gift is known as a "zeroed-out" GRAT, as in the Walton case. I believe Carlyn prefers a small taxable gift to be properly reported, causing the applicable statute of limitations to begin running.

2. Short term GRAT versus long term GRAT. A shorter term minimizes the number of years of poor performance by GRAT assets and reduces the likelihood of grantor's early death during the term of the GRAT. On the other hand, the 7520 rate could increase dramatically and hamper the re-GRATTING plan and a change in tax laws could adversely effect the plan. Longer term GRATs lock in a low interest rate over a longer term and work well for non-marketable assets without cashflow . Nevertheless, a series of short term GRATs seemed to be her favorite approach.

3. Amount of each annuity payment was considered and it was suggested that a formula approach might prove best in many cases. Also keep in mind the use of graduated payments (see her table 5 on page 6-17).
Formula clause approach in GRATs is ok, unlike the IRS stance toward the use of these clauses in other planning devices.

4. Use single asset GRAT. This prevents poor performing assets from diluting good performance of other assets.

5. Use of income tax payment reimbursement clause. Best to make it discretionary for the trustee and to avoid it altogether if local law is a problem.

6. Marital deduction planning. Give grantor the power of appointment to do marital deduction for that portion of the GRAT that would be otherwise includable in her/his estate.

7. Avoid use of spendthrift clause.

8. Identify the remainder beneficiaries, either individual(s) and /or a free standing trust(s).

9. Use a power allowing an independent trustee to amend the trust as necessary.

10. Plan profit level carefully so that remainder beneficiary(s) gets the amount grantor desires as precisely as possible, as long as the property in the GRAT appreciates sufficiently.

Selecting investments for the GRAT carefully may enhance the probability of success. Assets mentioned by Carlyn included those with restrictions that provide a basis for discounting the value of the property transferred into the GRAT, assets with limited marketability like fractional shares or non-controlling interests in a family business, certain stock options and derivatives.

Monitoring the GRAT plan is also very important. Who will do this?
When to get out of an underperforming GRAT and start over with new arrangement? Protecting gains obtained in the GRAT and assessing mortality risk (how is the grantor feeling these days?) When and how to buy out the remainder of a GRAT. In short, planning is a dynamic process--don't neglect the follow up!

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1275 Broadway, Albany, NY 12204. Note that Special Session, workshop and fundamentals program materials are not published.

Report #9 (Wednesday)

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

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Errata: Report 7, which covers the HIPAA session that was presented by Michael Graham Esq. on Tuesday afternoon, mistakenly spelled HIPAA as HIPPA. The error was occasioned in part by the humor of the title of the presentation and in part by some of the Institute's CLE materials that were available in the Registration area, where the same spelling error appears. We apologize to Michael for our not catching this before the Report went out.

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This Report contains coverage of the Wednesday Fundamentals session

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Income Taxation of Trusts, Estates, Grantors, and Beneficiaries
Presenter: Prof Jeffrey N. Pennell

Reporter: Connie T. Eyster Esq.

Professor Pennell began his presentation by stating that it is his understanding that the IRS simply is not enforcing subchapter J of Chapter 1 of the IRC and they are not training their agents to be aware of the audit issues for 1041 returns. This also means, however, that there is little authority to answer questions you might raise.

Generally, it is no longer desirable to retain income in a fiduciary vehicle. Grantor trust rules were designed to punish taxpayers by forcing them to realize income that taxpayers were trying to bury in a fiduciary vehicle. Now the rules give exactly the opposite result.
Taxpayers now are taking advantage of the grantor trust rules to achieve a lower income tax bracket or to make a tax-free gift by absorbing a trust's income tax obligation and passing greater amounts on to the beneficiary.

With regard to simple versus complex trusts, Professor Pennell says that knowing the distinction is of very little value. The simple trust rules in subpart B of subchapter J are really just the reader's digest version of the complex trust rules. You can ignore subpart B because everything that applies is the same as exists in subpart C - except in one tiny circumstance that will be discussed later in the outline.

Distributable Net Income (DNI) is taxable income that is computed very much in the same way as it is computed for individuals. The fundamental rule is (see p.6 of the materials) that fiduciary entities are NOT pass-through entities the way you think of an S-corp or partnership. They are conduit entities. Distributions carry-out to the beneficiary DNI to the extent that distributions are made. The entity gets a deduction for the amount of DNI that is carried out.
The deduction is for the taxable portion of the DNI. To the extent of the entities' deduction, the beneficiary has inclusion. To the extent DNI is not carried out, it is taxable to the entity. That is what is expensive. These rules apply to garden variety trusts and to estates, which are always taxed complex trusts.

Subchapter E of Chapter 1 of the IRC deals with the grantor trust rules. To the extent that those rules apply, they trump the subchapter J rules just described.

Note (pg. 8-9 of the materials) that not every entity that you think of as being a trust or estate is subject to subchapter J. For instance an UTMA account is not subject to these rules because the income is already taxable to the ward without the need for these special rules.

Page 10 of the materials contains the definition of a simple trust.
Although generally not useful to know, a simple trust is required to distribute all income annually and does not provide for charitable distributions or set asides, and even then it is a simple trust only for years in which the trustee also does not distribute corpus.

For the purpose of subchapter J, income means fiduciary accounting income. This will depend on state law definitions of fiduciary accounting income, which may embrace unitrust legislation and principle and income allocations.

A complex trust is not a simple trust i.e., one that can accumulate income and/or a trust from which the trustee has made a distribution of corpus. Note that some trusts may be simple in one year and complex in another.

On page 13, Pennell suggests some reasons why a fiduciary may want to accumulate rather than distribute income, even though it may be taxed at a much higher rate. These reasons generally relate to the beneficiary, who may, for instance, prefer that the trust pay the tax rather than distributing income outright, where it might be subject to estate tax treatment in the beneficiaries estate.

Beginning on page 18 there are paragraphs describing how taxable income is determined differently for taxable entities as opposed to individuals. For instance, there is no standard deduction under subchapter J, but rather there is a deduction in lieu of the personal exemption which is $600 for estates and $300 or $100 for trusts depending on whether there are mandatory or discretionary distributions of income. Note that the deduction in lieu of the personal exemption is solely for the benefit of the fiduciary if there is a tiny amount of income that doesn't get distributed in the prior year, then the fiduciary can avoid the hassle of filing a return in that second year.

Other differences are that the 3% threshold on certain itemized deductions does not apply to fiduciary entities under §68. Under §67(e), the 2% loss of miscellaneous itemized deductions does not apply to fiduciary entities to the extent that the administrative expenses are unique to the fact that the assets are held by a fiduciary entity as opposed to an individual. The materials discuss case law in which this rule has been construed in particular with regard to fees paid to investment advisors. Some courts would say that such fees are unique and are not subject to the 2% rule, (see O'Neill Irrevocable Trust v. Comm'r, 98 T.C. 227 (1992)) while others would say that they are not unique (see Mellon Bank v. United States,
2000-2 U.S. Tax Cas. (CCH) and Scott v. United States, 186 F. Supp. 2d
664 (E.D. Va. 2002)).

Note, Professor Pennell is troubled about the extent to which § 67 applies and believes this is the kind of thing the government will focus on if it decides to start getting up to speed on these returns.
As a practical matter, smartest thing to do is to adopt a position and be consistent. Don't waffle and go back and forth one year to the next.

There are elaborate rules dealing with adjustments to determine the DNI, which are found starting on page 26 of the materials. Starting with our typical notion of taxable income for an individual the first adjustment is to add back the amount of the deduction in lieu of the personal exemption to calculate DNI. Then, add back any tax exempt income, which is included in order to allow DNI to work properly with other ancillary income tax rules such at §265. Tax exempt income carries out to the beneficiary with the same character so it is never actually taxed. Also, ignore the distributions deduction which is necessary to avoid circularity. The distributions deduction is limited to the taxable portion of the DNI which would make things difficult if the DNI were equal to taxable income after allowance of the distributions deduction.

Further adjustments exist with regard to capital gains. To the extent capital gain is allocated to corpus, it gets excluded from DNI.

Here is that special rule for simple trusts that Professor Pennell thinks is the one reason you might want to know the difference between a simple and a complex trust. If there is a stock-on-stock dividend issued that is allocated to corpus under the instrument or local law and is not distributed to the beneficiary, it is excluded from DNI.

Finally, electing small business trust income is not included in DNI because it will be taxed to the trust under special rules specific for that kind of trust.

The issue of when capital gain is included in DNI is a difficult and complicated issue, which begins on page 29 of the materials. The general rule is that capital gains of a trust are NOT includible in DNI, except in the year of termination or to the extent that capital gains is part of what is distributed in a current year. Capital gains will be included in DNI to the extent provided by regulation, which establishes a bifurcated rule: (a) if gain is allocated to income pursuant to a mandate that is provided by both state law and the terms of the document, or (b) if gain is allocated to income pursuant to fiduciary discretion, that is permissible under either state law or the terms of the document, and the allocation is done in a reasonable and impartial manner.

Pages 32.1 and 32.2 contain added elaboration on what is a "reasonable and impartial manner." Professor Pennell again emphasized the notion that you must be consistent in how you treat capital gains. Once you've done it one way, you are cast in stone, which may not have been what Congress intended, but is the posture the IRS currently takes.

Professor Pennell did note that a special rule applies for complex trusts where there is an accumulation of income (doesn't apply to simple trust because a simple trust is not permitted to accumulate income), which allows a trustee or an executor to make income distributions in the first 65 days of the new year, which distributions will be considered as having been made in the prior tax year. (See page 41 of the materials)

Page 42 of the materials begins a discussion of the Tier rule, which governs how DNI is carried out depending on whether distributions of income or corpus are made to the beneficiaries. Note that DNI carries out regardless of the character of the property distributed, but it does so in tiers.

Take the example where there are two beneficiaries who are both required to receive equal amounts of income (each receiving $25K of income in this example) and the DNI is $40K. Beneficiary 1 also receives a discretionary distribution of corpus of $50K. Each beneficiary still receives ½ of the DNI, despite the additional distribution of corpus to beneficiary 1. Both beneficiaries are first tier beneficiaries of 50% of the DNI because that is what the trustee was mandated to distribute to them out of current income. Other amounts properly paid (i.e., amounts other than income required to be distributed) are not taxable unless there is undistributed net income subject to old throwback rules.

Professor Pennell emphasized that in this area people need to pay attention to the separate share rule, which is a rule that has been ignored for a long time. This rule is used to prevent fiduciaries from manipulating the timing of distributions to achieve favorable tax results. When the separate share rule applies, substantially independent and separately administered shares of a single trust or an estate will be treated as separate for DNI allocation. This assures that the accumulation of DNI in one share will not affect the other shares. As stated on page 47, the separate share rule applies to any trust that divides post-mortem between a marital and bypass trust.
Regarded as two separate entities each dollar of income earned by the estate needs to be fractionalized so that we can calculate respective amounts of DNI to the two trusts.

"This is the devil." In normal probate administration, it may be awhile before you know the amount of the marital and the non-marital shares. You won't know the amount of the non-marital share until much later, to divide the dollar of income that comes in just after the date of death according to the fraction between the amounts.

Page 51 states that there is an exception to such rule where the value of the marital or the bypass trust is frozen in value as of the date of death and no income or interest is payable to that share. See footnote 43.14 regarding the need to substitute "interest" for "income" when freezing the marital share so that you do not run afoul of the marital deduction rules. Also, this technique may result in double taxation of the interest in order to avoid the mess of dealing with separate shares.

An important rule exists for certain specific bequests. For example, personal property specifically devised to individuals does not carry out DNI (see page 54.2 of the materials and IRC § 663(a)(1)). Many people think that a formula marital bequest should fall under this exception as well, but the government does not take that position.
The IRS says that at the moment of death, you do not know the exact amount of the marital bequest and thus is not specific enough to apply under this exception. It is, however, specific enough for allocation of gain or loss so can result in both DNI income taxation and capital gains taxation.

Page 77 discusses the selection of a tax year, which can be a fiscal year for estates but is usually a calendar year for trusts. This can enable some deferral of income for beneficiaries of estates, but can also result in bunching. Fiduciaries should think through these issues before choosing the tax year.

With regard to distributions in kind, these distributions carry-out DNI to the extent that DNI exists. § 643(e) contains a limitation on this rule. Certain in-kind distributions do not carry-out DNI to their full fair market value; rather, they carry-out DNI to the lesser of fair market value or basis. This applies in circumstances where the basis of the asset is less than the fair market value, for the reason that when the beneficiary sells the asset, the beneficiary will pay the gain of the difference between the sale price and the basis.
See pages 80-82 of the materials. Note that the trustee may elect to treat a nonrealization distribution as if it were a sale or exchange, intentionally recognizing gain on the distribution of property in kind. The beneficiary would receive a fair market value basis and the trust would pay the tax which may be beneficial if the entity is in a lower tax bracket than the beneficiary or if the entity has losses to off-set. Note that this election would apply to all in-kind distributions for that tax year. Professor Pennell says to BE VERY CAREFUL about this particular election.

On page 95 there is a description of other circumstances in which the distribution of DNI and/or type of distributions made to beneficiaries can create inequities. While this may result in income tax savings, it can run afoul of a fiduciary's obligation to treat all beneficiaries equally. Consider putting a provision in your documents that allows the fiduciary to make elections for income tax purposes without having to make a compensation adjustment to beneficiaries treated unequally.

Page 116.7 of the materials begins the discussion of IRD, which is Income in Respect of the Decedent. See IRC §691. This is income earned by the decedent, but which is collected post-mortem. There is no statutory definition for IRD. Illustrations of IRD are on page 117 of the materials: the decedent's final paycheck, installment note payments, and deferred compensation (such as in a qualified retirement plan).

One of the biggest problems with IRD is that under IRC §1014, IRD is NOT entitled to a new basis at death. Sometimes, however, the lack of receipt of a new basis is not such a bad thing because IRD is entitled to a deduction for the amount of estate tax paid on the asset. (See page 132-137 of the materials)

BUT, very important, under §691(a)(2) note that (page 139 of the materials) certain transfers of IRD cause an acceleration of the income represented by that right, such as distributions in satisfaction of pecuniary bequests. The transferor will be taxed for built-in liability in the year of distribution. Professor Pennell says this issue is as serious as a heart attack and you do not want to accelerate the built-in-income tax liability. If you have to use IRD to fund a pecuniary bequest (think marital share) this can be a bad result and should be considered carefully.

GRANTOR TRUST RULES

Professor Pennell begins the grantor trust rules discussion by describing a very common misconception. It is street wisdom that when a grantor trust exists, we ignore the trust for income tax purposes and all of the income and deductions and losses and credits, flow through to the grantor as if the trust did not exist. That vision is okay for a rudimentary understanding or explanation to your clients, but it is almost 100% WRONG. What the code and regulations say is that the entity exists, but the items of income, deduction and loss will be taxed through to the Grantor.

This misconception is based on Rev. Rul. 85-13, which basically promulgated this misconception as fact. The sale to a defective grantor trust planning technique is primarily based on this revenue ruling and on what Professor Pennell believes was a misstatement.
Professor Pennell later states that when the IRS wises up to this misconception, and the extraordinary planning techniques it allows, we may be in trouble. Primarily, Professor Pennell thinks that allowing a transaction to be neither a gift nor a sale is fundamentally wrongheaded and bizarre and will create problems down the road.

Note that under subchapter E of Chapter 1, "income" means taxable income whereas under subchapter J, "income" means fiduciary accounting income.

The most important and difficult aspect of grantor trust rules are the "portion rules" in the regulations that provide that you can have a trust which is defective with respect to income or with respect to the corpus or with respect to the whole of the trust. Depending on the type of provision that makes the trust defective, you may or may not have a trust that is defective for the desired purposes.

Professor Pennell does not think that the definition of "adverse party" is vague and problematic and thinks a practitioner should be very careful when relying on adverse party rules to make a trust defective for income tax purposes. (See page 153 of the materials).

Professor Pennell took special note of § 672(e), the spousal unit provision, which provides a lot of drafting opportunities where it would be much more palatable if the grantor's spouse has the power that makes the trust defective. However, there is uncertainty with regard to the effect of divorce on the defective nature of the trust and it is possible that a divorce would destroy the defective character.

Under IRC § 677, generally, a grantor is treated as the owner of any portion of a trust as to which the income, without the consent of an adverse party, either must be paid or, in the discretion of the grantor, grantor's spouse, or any nonadverse party, may be paid (or accumulated for future payment) to the grantor or grantor's spouse.
An exception to the grantor's liability under this section applies if the trustee has discretion to distribute income for the support or maintenance of someone the grantor is obligated to support or maintain. (See page 169 of the materials). This provision is meant to protect grantors. Notice what this rule does not say. This rule only applies to discretionary distributions of income and does not apply to mandatory distributions of income. It applies only to legal and not contractual obligations. It can create a limit on grantor trust status when that is otherwise not desirable. An "Upjohn" provision prohibiting distributions that discharge the obligation is not effective to avoid exposure. The provision would have to say that the trustee is prohibited from making any distributions for support or maintenance to someone the grantor is legally obligated to support or maintain.

IRC § 674 contains grantor trust rules regarding a grantor's power to control someone else's beneficial enjoyment of the property. Section
674(a) is very broad, without the exceptions listed in that code section, nearly every trust would be a grantor trust.

Exceptions in § 674(c) regarding powers held by persons other than independent trustees allows a trust to toggle between grantor and nongrantor trust status by the appointment and resignation of trustees where there is more than one trustee and some of the trustees are permitted to be related or subordinate parties.

Note that in §674(b) there are a variety of powers relating to distributions of income, corpus, or both the use of which can affect what part of the trust is defective for income tax purposes.

Most people use the §675 administrative powers to create grantor trusts. Professor Pennell likes the use of 675(3) which makes the grantor the owner over any portion of the trust that the grantor or the grantor's spouse actually has borrowed and has not completely repaid before the tax year began (which necessarily includes all amounts borrowed during the current tax year). Professor Pennell thinks that you could use this rule to make a loan on 12/30 of a year and repay it on 12/31, and still achieve grantor trust status for that year, without impacting status for the next year.

Many people rely on the power, held in a nonfiduciary capacity, to substitute property of equivalent value to achieve grantor trust status. IRC § 675(4) (c). There is no estate tax inclusion caused as a result of this defect. However, it is difficult to use this defect as a means to toggle grantor trust status on an off.

Note that a trust can have multiple grantors for income tax purposes, as can happen under § 678 when there are Crummey powers granted in a trust. This result creates "pseudo grantors." The creation of pseudo grantors is not limited to circumstances in which there is a lapse of a power in excess of the

5x5 power. (See page 187 of the materials).
However, if there is a regular grantor and a pseudo grantor who could be deemed the owner of the same portion of the trust, the regular owner will trump.

Starting on page 195, there is a discussion of the portion rules and which defective grantor trust provisions affect income, corpus of both. Professor Pennell believes these are perhaps the most important parts of defective grantor trust planning.

Page 205 of the materials discusses advantages of grantor trust treatment.

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Report #10 (Wednesday, Cont'd)

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

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This Report contains coverage of additional Wednesday sessions, including the GSTT and Q&A main sessions and Special Session 1-B on valuation of closely-held interests.

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We're Sorry, Your GSTT and Gift Tax Exemption Have Been Temporarily Disconnected. Please Plan Again Later.
Wednesday Morning, 1/12/05
Presenter: Ellen K. Harrison Esq.

Reporter: Jeffry L. Weiler Esq.

The presentation covered generation skipping transfer tax planning. The gift tax exemption remains fixed at $1,000,000 while the GST exemption follows the increase in the applicable credit amount - $1,500,000 for 2005, $2,000,000 for 2006, 2007, and 2008, $3,500,000 for 2009,. 0 for 2011, and $1,000,000 for 2012, The tax rate follows the estate tax rate. This is 47% for 2005 and 55% for 2012. The credit for gifts is mandatory and must be applied to taxable gifts. It can not be saved for future use.

Use of GST exemption and GST transfers could be deferred until 2010 if there will be repeal. However, if repeal does not occur, postponing the GST transfer could increase the cost of the tax.

The outline summarizes the GST rules.

Application of GST exemption to lifetime transfers was covered. A timely allocation is effective as of the date of the transfer. Requirements for gift tax returns were set forth in the outline and included reporting for transfers to trusts. A late election may be used to eliminate GST exposure for a trust with an inclusion ratio more than zero. To have a late election, the automatic application of the GST exemption must be avoided. A late election may be appropriate if the value of the trust assets subject to GST have decreased. A late election may be made any time on or before the estate tax return is filed. To make a late election will require filing two Forms 709, one timely to elect out of automatic application of the GST exemption and a later return to apply the exemption.

If a late election to a trust is made for the same year that a timely allocation is made to the same trust, a complex computation arises. The fraction is to be redetermined under Reg Sect . 26.2642-4.

In regard to ETIPs, an election to apply exemption may be made before the close of the ETIP but it does not become effective until the close of the ETIP. The amount of exemption to have a zero inclusion ration is determined at the end of the ETIP. No gift is made at the close of the ETIP. This results in use of GST exemption at the close of the ETIP but no additional -application of the gift tax exemption.

A transfer to a skip person will produce a GST tax unless the GST exemption is available to offset the value transferred. The IRC assumes that persons do not want to pay GST and there is an automatic application of GST exemption to such transfers. If a person does not want the automatic application of exemption to apply, then the person must elect out of the automatic application of GST exemption.
The rule applies to gift to trusts.
It is unwise to rely on the automatic exemption rules for gifts to trusts.
The automatic exemption rules could result in some exemption being wasted and may not result in an allocation to a trust where an allocation is appropriate (Crummey trusts with hanging powers).

Prop Regs were issued on July 13, 2004 for electing out of the automatic allocation - Prop Reg Sect 26.2632-1(b)(2). In regard to ETIPs, the election out is made at the end of the ETIP and it is unclear if the election out can be made in the year of the gift. To election out, there must be a statement attached to the return AND a box checked. Warning:
check the box.

EGTRRA provides for 9100 relief for late elections. IRS responded by issuing Notice 2001-50. On August 2, 2004 Rev Proc 2004-46 was issued to provide a simplified procedure for obtaining an extension of time to make a GST election. Rev Proc 2004-47 deals with a late reverse QTIP election.

IRC Sect. 2632 (d) permits a retroactive election where there has been an unnatural order of death. It is to be made on a timely filed gift tax return for the year of the non skip person's death.

The power to allocate GST exemption to a trust affects the beneficial enjoyment. The speaker states that the trust instrument should require the trustee to hold in a separate trust property entirely exempt from GST.

Where there is transfer tax concern about a beneficiary of the trust acting in a fiduciary position with the power to take certain action, use of an independent trust protector was recommended to take tax sensitive action. In Will, executor should be directed to apply exemption (or independent person could be appointed by executor if there is concern about the exercise being transfer tax sensitive). A grantor's power to allocate GST exemption to the trust and have the beneficial enjoyment altered causes concern. If the dispositive provisions of the exempt and non exempt trusts are the same, then the issue should not exist. Giving the trustee discretion to adjust trust shares for GST allocation rather than requiring it would eliminate the grantor's power to affect beneficial enjoyment.

Techniques for minimizing GST tax without incurring a gift tax were discussed.

One technique is funding a lifetime reverse QTIP. There can be no partial QTIP election with this approach. Spousal ETIP rules do not apply - Reg 26.2632-1(2)(ii)(C). There is no addition when the estate tax attributable to the QTIP trust is paid from another source. This permits preserving the exempt QTIP property. The QTIP will be grantor trust during the grantor's lifetime under Sect 677. To have capital gain taxable to the grantor, the trustee could be given the power to invade principal for the spouse. If grantor dies before the spouse, grantor trust status is lost unless action is taken. The trust assets could be invested in an S Corp with a trust QSST election which results in the surviving spouse QTIP beneficiary being tax under Sect 678 (e) without changing the identity of the transferor for GST purposes.

Qualified severances were reviewed. The outline enumerates 6 requirements for a qualified severance.

A qualified severance can be helpful at the end of a ETIP. Under Sect 645 a trust and an estate are combined and the separate share rule does not apply.

The ETIP rules preclude applying exemption to GRATs and QPRTs. The speaker suggest that remainder beneficiaries could sell for fmv their remainder interests to skip persons (sale of remainder interest by child to grandchild). However, the IRS may challenge this approach.

Annual exclusion rules and Crummey trust were discussed. The lapse of the withdrawal right may not be a taxable gift but it is still a generation skipping transfer unless certain requirements are met. It may be appropriate for the donor to allocate GST exemption to the gift. Cascading Crummey powers were explained. This technique shifts the transferor down a generation when there is a lapse of the Crummey power.

The gift splitting rules under Sect 2513 for gift tax differ from the gift splitting rules under Sect 2652 (a) for GST. Under gift tax rules, there can not be gift splitting for gifts to a spouse. With respect to gifts to a trust, it may be possible if the spouse's interest may be severed from other interest. Under the GST rules, one half of the gift is deemed to be by the spouse regardless of an interest of the other spouse.

Adoption rules are found in Prop Reg 26.2651-2. A person adopted before age
18 can qualify as a child for GST purposes. To avoid certain legal obligations of having the person concerned a child, the adoption could be timed to occur shortly before the person becomes 18.

Ways to avoid a GST transfer were provided: payment of tuition and health care expenses, making trust owned personal use assets (such as a residence) available for use.

The phase out and restoration of GST causes complications. The generation move down rule application is uncertain.

Conclusion: allow broad amendment power to an independent trust to person solving future problems.

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Question and Answer Session
Wednesday Morning, 1/12/05
Presenters: Jonathan G. Blattmachr Esq. ("Jonathan"), Steve R. Akers Esq.
("Steve"), Pam H. Schneider Esq. ("Pam"), and Catherine Veihmeyer Hughes Esq. ("Cathy") from the United States Department of the Treasury

Reporter: Jeffry L. Weiler Esq.

Cathy: Has no prediction on repeal. The Pres. Appointed the panel to make recommendations for tax reform. The report is due ASAP and not later than July, 2005. Legislative developments:2004 income tax deduction for Jan
2005 gifts for Tsunami relief, 15% tax on qualified dividends, Sect 529 changes in beneficiary at lower generations, 9100 relief for QDOT's tied to Sect 2032 9100 relief.

Jonathan: rent free use of trust property by beneficiary should not be income. Cash loan to beneficiaries are uncertain since there is no authority for treating them as income tax free (Sect 1274

and 7872 can apply). Claims on installment sale to an intentionally defective grantor trust, there should be no taxable income on death citing Frane case. Also, he claims there will be a basis step up based on a careful reading of Sect
1014 (b). Right to reacquire trust property in Sect 675 (4)(C) could be read to apply only to grantor and not to a third party. He believes it should apply to a third party also. However watch out for inclusion in gross estate where grantor can reacquire life insurance and voting stock in a closely held corporation. In regard to reacquisition and inclusion in the gross estate, Sect 675 requires the right to be in a non fiduciary policy.
The case relied on for no inclusion, Jordahl involved a fiduciary power. To avoid high state taxes suggests: change domicile, put assets into low tax state, use S Corp. To avoid additional state estate tax use a QTIP. To avoid state estate tax, convert assets to tangible property (gold, silver) and move assets out of high tax state.

Steve: FLP/LLC cases. To bullet proof, have donor transfer G/P interest to spouse so donor has no rights at death. To avoid 2035 three year rule, have transfer be a fmv sale. Amend partnership agreement to take away restrictive rights (increase value of interests) and have donor's child cash out child's interest (to shift value to child). Liquidate partnership to avoid 2036(a)(2) but application of 2035 is uncertain. Some say Judge Cohen in Strangi just is wrong.

Jonathan: Could get partnership/llc case into CA 5 (Tex and La) for better precedents by having one of the co executors in Tex or La. even if the decedent is domicile outside CA 5.

Pam: Cir 230 and the team approach to estate planning causes problems. One exception to application of rules is reliance on the opinion of others.
However, use of this exception will involve practical problems. Use of vacation property by grandchild and application of GST rules - no authority. Could state in trust agreement that the child can use the residence and the grandchild would tag along.

Cathy: Basis step up is available at death even if no estate tax return is required to be filed. Merely filing a non required return will not assure basis step up. Jonathan: get an appraisal to substantiate fmv at death.

Jonathan: Walton and GRATs. Have greater of annuity or fiduciary accounting income paid to estate if grantor dies.

Jonathan: Getting capital gain into DNI when state law and the trust are silent. Regs permit an invasion of corpus and trustee to deem it to carry out capital gain. Kathy: election under Reg is by asset class and not by individual assets.

Jonathan: Attempting to reduce estate tax at death of surviving spouse with QTIP. Sale of assets will be taxable to QTIP if built in gain. Having QTIP invest in FLP: Steve - concern with trustee's fiduciary duty to manage and invest properly, and concern with IRC Section 2519 gift of remainder.

Steve: Should be decision from court of appeals any day. To fix value suggests formula disclaimer or use of GRAT with formula value.

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Special Session Topic II -B Valuation of Closely Held Interests-Practical Issues Wednesday Afternoon, 1/12/05

Presenters: John W. Porter Esq. ("John") and Alex W. Howard Esq. ("Alex")

Reporter: Jeffry L. Weiler Esq.

Alex discussed appraisal items and John covered other areas.

IRS is putting three cases, McCord, Lappol, and Peracchio into a matrix, seeing where your case fits, and telling you what the discount will be. You must distinguish your case from these three cases and reject IRS matrix approach. IRS is ignoring cases that are favorable to taxpayer when focusing only on these three cases - see Dailey with 40% - 50% discount.

John: IRS appraiser was successful in convincing the Tax Court to slice and dice entity assets in McCord to get a low discount. There are flaws in the IRS appraiser's study.

John: In valuation testimony, the credibility of the expert witness is critical. Look at: credentials, testimony history in prior cases, experience with the type of asset involved, quality of past written reports. At trial the expert's report goes in on direct without testimony and then the IRS cross examines. The report must be good!

John: Consider asking appraiser who appraiser would not want to be against him, then have these person review the appraisal report and provide a critique of it. This prevents the IRS from using these persons.

John: Noble case. Problem with co authors of an appraisal report. Both co authors may be required to testify. Also, expert testifying must be able to vouch for everything in the written report.

John: Marketability discounts have been allow by the Tax Court in the 21% to 25% range in recent cases.

Alex: Key to value is rate of return and cash flow.

John: IRS says no tiered discounts citing Royal Martin but in this case the Tax Court allowed a 75% discount and the incremental discount under the tiered approach would be relatively small.

Alex: Corporations with built in gain. Negotiating point: if the is a liquidation approach must consider taxes payable. In business deals, much negotiation over the tax burden, basis step up for future depreciation, etc.

John: S Corps and tax effecting. Gross case and Adams Case. These case did not tax effect income. Alex: thinks government witness was correct. Need to look at market driven realities but IRS manual states should be tax effecting for flow through entities.

Alex: In real world it makes a difference to whom the S Corp is being sold
- a corp strategic buyer or an individual. John: For tax valuations, can not consider the nature of a specific buyer.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T.

Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #11 (Wednesday, Cont'd)

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

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This Report contains coverage of additional Wednesday sessions, including

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Special Session I-D - Disunification of GSTT and Gift Tax Exemptions Wednesday Afternoon, 1/12/05
Presenter: Ellen K. Harrison Esq.

Reporter: Shelly D. Merritt

After EGGTRA, the GST tax exemption and the exemption from gift tax are no longer unified. The gift tax exemption remains at $1 million, while the GST exemption is currently at $1.5 million and is scheduled to increase until 2010 when the estate and GST tax are repealed. This dis-unification creates numerous issues with gift planning.

In addition, because gift tax exemption is automatically allocated to taxable gifts, whereas GST exemption is not, it is possible that a person will have differing amounts of gift tax exemption and GST tax exemption.

In this workshop, Ms. Harrison focused on some of the issues raised by dis-unification as well as how to postpone generation-skipping transfers.

Cascading Crummey Powers

When a Crummey power lapses, for GST tax purposes, the power holder becomes the transferor with respect to the excess of the greater of $5,000 or 5%.
This rule can be used to shift the "transferor" for GST tax purposes down a generation. However, if there has been a timely made GST allocation before the lapse, then the transferor will not shift down. As a result, if the automatic allocation rules apply, the grantor must elect out of the automatic allocation of exemption if the trust is a GST trust. If the grantor does not elect out, then a portion of his/her GST exemption will be wasted on that part that the child becomes the transferor. The allocation must be done after the lapse of the withdrawal right as to a late allocation.

To avoid possibly including the trust assets in a beneficiary's estate under IRC Section 2036 when using "cascading Crummey powers," it is advisable to:

1. Make the beneficial interest wholly discretionary so that no power holder has the "right" to any amount from the trust;

2. Use independent trustees so that no power holder has the right to control beneficiary enjoyment; and

3. Establish the trust in a jurisdiction that prevents creditors from reaching trust assets to satisfy the power holder's debts.

Late Allocation of GST Exemption

A late allocation of GST exemption to an existing trust that has an inclusion ratio of more than zero may be an effective way to use the excess amount of a person's GST exemption over the gift tax exemption. For example, an allocation at the close of the "Estate Tax Inclusion Period" (ETIP) for a trust, such as a GRAT, will not constitute a taxable gift and no gift tax exemption would be needed to make the allocation.

A late allocation of GST exemption does not relate back but instead is effective on the date the gift tax return making it is filed. As a result, if there has been a taxable distribution before the late allocation, it will not be covered.

A late allocation cannot be made on timely filed gift tax return. For this reason, it is important to note that an extension for the taxpayer's income tax return automatically extends the gift tax return due date.

If a trust is subject to the automatic allocation rules and the taxpayer wants to make a late allocation, two gift tax returns must be filed. One to elect out of the automatic allocation rules and another to make the late allocation.

The new automatic allocation rules could cause existing trusts to have inclusion ratios. A late allocation of GST exemption can be used to give the trust a zero inclusion ratio. For example, if a trust was established in 1998 and gifts made to it but no GST exemption was allocated, the trust would have an inclusion ratio of one. If the trust meets the definition of a GST Trust under the new rules and contributions are made after 2001, then GST exemption will automatically be allocated to the trust for each of these contributions. The trust will end up with an inclusion ratio other than zero or one. This ratio will change each year that gifts are made to the trust unless the trust elects out of the automatic allocation rules.
This can be resolved by making a late allocation.

Late allocation to term life insurance policies

Another planning option is to make a late allocation to an ILIT holding term insurance right before end of each year when the interpolated reserve value is almost zero rather than making the allocation when the premium is paid at the beginning of the year. So long as the insured doesn't die before the late allocation is made and is effective, this will leverage the use of the grantor's GST exemption. As long as the contribution to the trust is made during the first quarter of the year, there will always be a timely return yet due so there is little risk to doing this.

Qualified Severances

A qualified severance is any division of a single trust into two or more trusts if the division is permitted by the instrument or local law, the trust assets are divided on a fractional basis, and the terms of the new trusts provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust.

Proposed Regulations 26.2642-6 dealing with Qualified Severances were issued on August 24, 2004. The regulations provide that if a trust is divided into two trusts, the new trusts will be treated as separate trusts for GST purposes only if the severance is a "qualified severance."

Requirements for a qualified severance:

1. The severance must be pursuant to the trust instrument or local law.

2. The severance must be effective under local law.

3. Each trust must receive a fraction of the total value of the trust (not a pecuniary amount).

4. The terms of the new trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as the original trust.

5. The severance must be reported on a Form 706-GS(T) "Generation-Skipping Transfer Tax Return for Termination," and must write "Qualified Severance"
in red at the top of the form and attach a Notice of Qualified Severance to the Return.

The proposed regulations provide that they repeal Treas. Reg. 26.2654-1(b) which allows for the severance of trusts that are included in the transferor's estate or created under the transferor's Will when certain funding requirements are met. Ms. Harrison believes this is an error in the proposed regulations. For example, if D's revocable trust makes a gift to a trust for descendants of the largest pecuniary amount that can pass to the trust without incurring or increasing federal estate tax and the residue to a marital trust, under T.R. 26.2654-1(b), D's GST exemption may be allocated to the pecuniary gift to the trust for the descendants. However, under the proposed regulations, this gift would not qualify for severance because it is not a fractional share gift.

Non-Qualified Severances (i.e., by not giving notice to IRS)

For purposes of Chapter 13, separate trusts are not treated as separate for GST purposes unless the separate trusts exist from the inception of the trust.

For example, T creates a trust for T's children that provides the Trustee with the discretionary power to distribute income or corpus to T's children. When the youngest child reaches age 21, the trust is to be divided into separate trusts for each child which provides for income to the child during life, principal to child's children on child's death. The separate trusts created when the youngest child reaches age 21 do not qualify as separate trusts for GST purposes since the trusts did not exist from and at all times after the creation of the trust. Any allocation of GST exemption to the trust either before or after the youngest child reaches age 21, will apply to the entire trust.

If a qualified severance of a trust that distributes per stirpes occurs, the division of a discretionary trust will cause the new trusts to be separate for GST tax purposes and a taxable termination will occur on the death of each non-skip beneficiary (child). Planning can be done to postpone a taxable termination with such a trust by making a non-qualified severance. The taxpayer can take the position under this scenario that since there is no qualified severance, a taxable termination does not occur until the last child (non-skip person) dies instead of upon each child's death, even though each child has a separate trust since the separate trusts did not exist from inception.

It may be a good planning strategy to provide that on the taxpayer's death, the residuary estate passes to one discretionary trust for all of the decedent's children for a certain period of time, such as 2 years, and then divides into separate shares for the children.

Discretionary CLATs

Discretionary CLATs can also be used to postpone a generation skipping transfer. If a charitable lead annuity trust (CLAT) gives an independent trustee discretion to select the charities to whom distributions may be made, no person has an interest in the trust for GST tax purposes until the lead interest ends. A transfer to a discretionary CLAT is not a direct skip and even if only skip persons have interests in the trust when the lead interest terminates, a taxable termination will not occur because an interest in the trust, as defined for GST tax purposes, will not have terminated.

Transferring Remainder Interests

If a remainder beneficiary of a trust sells or gifts his or her remainder interest to skip persons, such as the beneficiary's children, it is arguable that the "transferor" of the remainder interest for GST tax purposes should be the remainder beneficiaries and not the donor. For example, grantor creates a GRAT which passes to the grantor's child at then end of the GRAT term. After funding the GRAT, child gives his remainder interest to a trust for the benefit of the child's children (grantor's grandchildren). When the GRAT term expires, if the child is the transferor for GST purposes, there will be no generation skipping transfer because the child's children are not skip persons as to the child transferor.

However, the IRS ruled in PLR 200107015 that where a remainder beneficiary of a charitable lead trust (CLAT) makes a gift of his remainder interest, the remainder beneficiary is the transferor for GST tax purposes only to the extent of the percentage that the value of the remainder interest bears to the value of the trust at the time of the beneficiary's transfer and the original grantor remains the transferor as to the balance. In Ms.
Harrison's opinion, the statutory analysis for the conclusion in the ruling is flawed and the application of the ruling to other types of trusts, such as GRATs and QPRTs, is uncertain.

Gift Splitting

The gift splitting rules differ for GST tax purposes than for gift tax purposes. For gift tax purposes, gifts to a spouse, including interests in trusts, cannot be gift split. For GST tax purposes, the electing spouse is treated as the transferor of one-half of the property transferred, regardless of the interest the electing spouse is deemed to have in the transferred property.

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Special Session 1-E - Ethical Issues and Drafting Solutions in Medical Releases and Competency Determinations Wednesday Afternoon, 1/12/05
Presenters: Michael L. Graham Esq. and Gregory S. French Esq.

Michael L. Graham of Dallas and Gregory S. French of Cincinnati hosted a vibrant dialogue joined into by many of the attendees at this follow up session to Graham's HIPAA presentation on Tuesday at the Heckerling Institute. Based upon a case study prepared by French, the session attendees explored the Model Rules of Professional Conduct and the Aspirational Standards for the Practice of Elder Law

Of the National Academy of Elder Law Attorneys, the comments to the Rules and the ACTEC Commentaries to the Rules, as well as our mutual experiences, and struggled with the difficult questions involving individual capacity and family relationships that arise in our practices. The nuances of client identification, confidentiality, conflicts of interest, client capacity, fiduciary issues, long-term care planning and documentation dealing with health issues were examined in a lively session. The complexity of these issues is recognized by most attorneys who assist older clients and their families. The necessity of representation letters creating single or joint representation, even letters for multiple generations of a client family was agreed upon by the attendees. The proactivity of the attorney in connection with assessing client capacity, pursuing solutions for incapacitated clients and protecting client confidentiality was discussed. Attorneys should review the often counter-intuitive rules in their states and in the resources named above. There will be more and more circumstances facing us in the years ahead as our clients age and require different kinds of assistance than we have given them in the past. Embroiled in family relations gone "postal" and fueled by money -related issues, the attorney who wants to avoid liability while serving his/her client well will want to be familiar with the representation landscape and will be thankful that he/she has prepared for these issues as well as possible.
Although it is impossible to summarize the wide ranging discussions of this session, it is clear that every attorney is (or should be) well versed and well planned in this area.

The new 4th edition of the ACTEC Commentaries to the Model Rules will be published this year; get your copy and use it well, along with the other resources noted above.

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Special Session II-D - Practical, Professional and (Perhaps) even Profitable Solutions to Every Day Ethical Dilemmas
Presenters:
Alan Rothschild (AR)
Stacey Cole (SC)
Chris Gadsden (CG)

Reporter: Eugene Zuspann Esq.

CG -
1. After the Model Rules were passed, the estate planning bar realized that they were designed and promoted by trial lawyers and they were conformed to the needs of the trial bar.
2. The focus of this session is on the ABA Model Rules.
3. There are significant variations between the different states; generally, the ABA rules are far more restrictive that those in the states.
4. He discussed the ACTEC commentaries and state hotlines that the attorney can call for help.

Hypo #1

1. Originally, the clients were the deceased and the surviving spouse (SS); you drafted the estate planning documents for them; a bank is the executor and trustee and it retained you to represent them in administration of the estate.
2. Whom do you represent? The fiduciary
3. Must you tell SS whom you represent? Yes - there must be no question in the beneficiaries mind; in many situations you may also represent her if there is no

conflict
4. Must the SS be notified of her elective share rights? There is a
split here. CG believes that he should tell her and that she be advised to have separate counsel. It depends on her perception of your representation. She definitely needs to be advised that she has separate interests.
5. You may be regarded as the family lawyer because of your previous
relationship with the clients. See rule 4.3. If there is a conflict, you need to advise the family members that you do not represent them. If you can represent them, the engagement letter needs to clearly reflect this.
6. If the bank invests some of the estate's funds in the bank's
holding company stock, and it depreciates -
a. Do you raise this with the bank? Yes
b. Do you raise this with the SS? Not if they are the only client. See rule 1.6 but this rule is limited to bodily harm. Many states have broadened this. Look at your engagement letter. This answer changes if you are representing the family or if they believe you are protecting their interests. In that case, the attorney needs to withdraw.
c. One attorney puts the obligation into the will and trust so that the testator authorizes the waiver of confidentiality. He believes that with this waiver, counsel can disclose the breach of trust. If you cannot disclose and the bank will not consent, you have to resign.
7. Issue: If the H&W were long tern clients, must the spouse consent
to your representing the bank? - No clear answer.

Hypo #2
Client calls. He and his sister want you to update mom's estate plan

1. Who is the Client? Mom
2. At the interview, mom is capable of carrying on conversation but
always wants son to answer or confirm a decision. Son and Daughter want mom to give away most assets for gifting and Medicaid spend down
3. When Son suggests he leave so that you can discuss this with her
alone, she is not comfortable and asks that her son not leave
4. SC would not tape the execution - once you tape it, you are stuck
with it; If things do not go well, you are still stuck with the tape.
5. Mom dies and you receive a phone call from a third child (after you
prepared the documents)
a. She asks number of questions about the planning and her mother's
desires and asks whether you know about her
b. You should decline to answer anything and you should call you
carrier. At this point, if the existence of the child is unknown to the attorney, and the plan leaves the child out, then there is a problem.
c. The solution was in the planning. The attorney must set up an
office procedure and make sure it is followed. It should include a questionnaire and the questions should be asked and the answers noted.

Hypo #3 - Multi Jurisdictional Practice
A large client sells his business and moves to another state. The client returns to your office and asks you to prepare a new estate plan. You are not licensed in the second state.

1. Can you prepare the documents?
a. If you are competent to do the documents?

i. If so, and if the work you do for the client is in your state of
practice, then you may do the work. See rule 5.5 but this rule is only adopted in 11 states at this time.
ii. If not, you should either retain an attorney licensed in the second
state or send the client to such an attorney
b. The extent of contacts with the other state is relevant and you
must check the rules in your state and the rules of the other state. If the contacts are more than minimal, you should either refer this out or retain local counsel.
2. If you are the local counsel, you must define who is the
client? Is it the one that pays your fee. This needs to be clearly set out in the fee agreement and both the client and the referring attorney need to be clear.

Hypo #4
A client for whom you had previously done an estate plan (for he and his 3rd wife), approaches you to do a new plan for he and his new (MUCH) younger 4th wife. He does not seem to be willing to disclose all to his new wife and discretely suggests that he may want to make other gifts. At this point in time, you have no idea if there is a marital agreement. Client is a sizeable client, but had not done work with the firm for several years. You had referred him to another firm for the divorce from his 3rd wife.

Choices
a. Joint representation
b. You represent him and send his wife to another attorney
c. Separate representation. Few attorneys do separate
representations. (the priestly approach - each client has his own
confessional)
d. May want a termination letter for new spouse

The panel and the audience discussed the alternatives. Depending on the facts and further discussions with the spouse, the attorney (you) need to determine what is proper.

Hypo #5
You represent a large charity and a member of the board of the charity approaches you do to an estate plan that includes a CRT for the benefit of the charity. This fact situation is taken from Oregon formal opinion 91-116.

1. There needs to be a lot of care in this case.
2. Oregon decided that the attorney could not represent both the
Charity and the director unless you get written consent from both the charity and the individual.
3. AR believes the problem is that you have a continuing relationship
with the Charity.
4. AR cited a Maryland opinion where attorney was on the planned
giving committee of a church and was approached by a client to prepare a plan that involved the church. Maryland decided that he could not do estate plan for person desiring to give money to church. In Maryland this was complete bar.
5. In any state, at a minimum, you must disclose any conflict to the
client and review your state opinions and cases to see what may be done.

Hypo #6
Receipt of confidential materials intended for another.
This was at the end of the presentation. SC discussed the effect of this in several states and indicated

that it is not uncommon in litigation.

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Care and Feeding of GRATS

Presenter: Carlyn S. McCaffrey Esq.

Reporter: Herbert L. Braverman Esq.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #12 (Thursday)

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

First, a news item of interest from the Associated Press:

CBS Cancels 'The Will' After One Airing
Jan 12, 5:25 PM EST

The Associated Press

NEW YORK -- CBS lost "The Will" after just one night. This reality series, which logged a minuscule 4.2 million viewers on its premiere airing Saturday, has been axed by CBS, the network confirmed Wednesday.

Despite heavy promotion, "The Will" ranked 79th place in viewers, according to Nielsen Media Research, making it CBS' lowest-ranked show of the week.
(The week's most-watched show, CBS' "CSI," drew almost 29 million viewers.)

A reality show whose 10 participants vied to be sole heir to the fortune of a 73-year-old rancher, "The Will" thus joins a handful of other one-shot blunders in TV history. The most recent was "South of Sunset," a CBS detective drama with former Eagles rocker Glenn Frey, which debuted Oct. 27, 1993, then was never seen again. With a 6.1 rating, that show attracted what was deemed the smallest audience ever for a series premiere on any major network.

For the sake of comparison, "The Will" got a 2.9 rating.

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This Report contains coverage of the Thursday general session on Charitable Planning and the two special sessions on Technology - Demystifying the Numbers

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Charitable Remainder and Lead Trusts and other Charitable Planning Thursday Morning, 1/13/05
Presenter: Sanford S. Schlesinger Esq.

Reporter: Herbert L. Braverman Esq.

Sandy Schlesinger spoke to us on charitable planning and covered a variety of recent developments and sundry topics of interest. But, I do want to mention his far more substantial outline , which includes terrific discussions of 4 major charitable planning devices, namely, the charitable remainder trust ("CRT"), the charitable lead trust ("CLT"), pooled income funds and charitable gift annuities. For a thorough review and update on these charitable planning techniques, I recommend his outline. By the way, this is true for most of the speakers, who only have 45 minutes to cover some of the highest points in their respective outlines and other materials. Many go further in separate break-up afternoon sessions throughout the week, some of which are included among our reports on line. Nevertheless, we have to point out that these reports only scratch the surface of the fine work that our faculty has put into preparation.

Sandy spoke at length and with passion about what the future holds for charitable giving in the ever-changing economic and tax environment.
He asked the attendees if the charitable world and the insurance industry would be adversely affected by lower transfer taxes and/or complete repeal and , of course , the consensus was that both would suffer somewhat (but who knows how much exactly?). He suggested that giving would decrease by 8% to 14% as the credit amount climbs over the next few years and that, with repeal, the decrease might descend as much as 16% to 28% (heaven forbid).

He spoke about the AFR impact on split interest gifts and pointed out that a donor really has 4 bites at this apple. He/she could use the AFR in the month of the contribution, the rate in the month preceding, the rate in the second preceding month or, since the IRS publishes the rate for the next month on the 20th of the current month, the donor might elect to wait a month for an even better option. He indicated that a higher AFR rate generally favors the CRT and gift annuity, while a lower rate favors the CLT and gift of a remainder interest. He cautioned that low AFR rate could jeopardize a CRT that might fail the 5% exhaustion rule and /or the 10% minimum charitable remainder interest rule.

He also spent some time discussing the 4 tier taxation pattern for distributions from CRTs. He pointed out, as did Richard Robinson, that the rate changes under law changes complicate this system and present some opportunities; of course, he cautioned that all of these changes "sunset" as of January 1, 2009. However, the determination as to what is ordinary income and what is capital gain (at one rate or another depending on its source and character) is cumulative from year-to-year and is determined at the end of each trust year. Losses and gains in different tiers cannot be offset against each other. When a distribution comes from a particular tier, say ordinary income, and all of the income is in the same tax bracket, a pro rata portion of each class of ordinary income is deemed distributed. If the income is subject to tax at different rates, the higher taxed ordinary income is deemed to be distributed first. This concept that higher taxed income with a given tier is deemed distributed first is retained most recent proposed regulations in this area.

Sandy spent some time suggesting that contributing retirement accounts to charity, given a charitable disposition in a client, is a good idea when done in a testamentary format, even though there may be a net income tax in the arrangement because of restrictions on charitable deductions in our tax law.

Sandy reviewed the so-called Care Act, which is not yet federal law, which would allow tax free transfer of retirement funds to charity (i.e., no income tax and no estate tax inclusion--and no deduction either). This would be a healthy simplification that is accepted in Congress.

Sandy advised of the Donor Managed Investment Account that the IRS recognized in PLR 200445023. This technique is similar to the donor advised fund, but it is created for only one charity and enables a person to make an immediate charitable contribution, but retain the possibility that the amount passing to the charity will be greater in the future. This device also allows a broader range of investment alternatives.

Sandy spoke about ethical issues and the concerns now surfacing with respect to charities that are trustees in arrangements where they are also beneficiary(s) and professional that "steer" a client to a charity in which they have a direct or indirect interest.

Sandy noted that the government provided sample split interest trust forms are an acceptable starting points for drafting any of the provisions that our clients would profit from having included. His outline for the various vehicles mentioned above should be consulted for many further important points that may be discussed in his break-out session.

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Special Sessions 3-D and 4-D - Technology - Demystifying the Numbers Thursday Afternoon, 1/13/05
Presenters: Joseph G. Hodges Jr. and Roger L. Shumaker Esq.

Reporter: Joseph G. Hodges Jr.

When you dream up the idea of doing these (more or less) live reports from Heckerling, a natural consequence is that you also get appointed to be the reporter for your own sessions. I mention that here only so you will appreciate that, while I will remain as neutral and unbiased as I can in giving this report, some of my personal prejudices might show through.

Roger and I attempted in two repeat one and one-half hour session to cover the field in terms of the number crunching computer programs that are currently available, including many that will crunch the numbers for charitable gifts and planning. As is always the case with such an effort, you can't cover or mention every program, although we tried to make sure they all were mentioned in our written materials. In addition, a couple of new products were brought to our attention between the time our outline was submitted and this presentation was given, and those will be mentioned here.

As a preliminary matter, perhaps the biggest news item of the week was the fact that last Friday Thomson RIA acquired ownership of the zCalc calculation program that operated in tandem with the Microsoft Excel spreadsheet program. The previous owner will stay on as a consultant to RIA for some period of time.

Roger began the presentation by covering several factors that need to be considered in understanding the automation process and the necessary components of an estat and trust planning and administration process. Joe added to this a discussion of how to choose the right software for your needs and questions to address before you purchase. Roger then wrapped up this potion of the presentation with a review of some of the ethical concerns that are involved with using technology.

Joe followed this presentation with a discussion of the Brentmark Estate Planning Tools program [www.brentmark.com], which is the mirror image of the Leimberg NumberCruncher program. Both of these program have a very complete set of estate planning and financial planning tools, and the calculations are very fast and presented in a straight forward and understandable way. In addition, the reports produced are sufficient for client presentations and, in certain cases, attachment to tax returns. Joe added to this presentation a demonstration of TigerTables by Larry Katzenstein [www.tigertables.com]. This program includes calculations for life estates, remainders, annuities, unitrusts and pooled income factors with up to 10 lives, plus valuations of a life estate with a 5%/ $5,000 annual withdrawal right fir purposed of determining the previously taxed property credit.

Roger then proceeded with a demonstration of the BNA Estate & Gift Tax Planner program [www.bnasoftware.com]. Both Roger and Joe confessed to having been users of this particular product going clear back to the days when it was operated using an HP calculator mounted on a printer stand, so things have come a long ways since then. This product performs a number of planning calculations that many programs do not. Recently a number of split-interest calculations have been added, as has a new user inerface and the ability to product PowerPoint(tm) slides. At the end of Roger's presentation, Joe demonstrated some of the simpler functions this program can be used for by showing how IRD calculations can be easily and quickly done using a two-column comparison.

Joe then demonstrated the Estate Planning Quickview program that is also available from both Brentmark and Leimberg (see URLs above). Joe described this as a "down and dirty" but fast estate planning and presentation program that will present the calculation results in both numbers and bar graphs. What makes it unique is that it does it for 14 different planning scenarios all at the same time.

Roger then demonstrated the Intuitive Estate Planner program by Thomson-West .
Authored by Donald Kelley, this program is perhaps one of the most comprehensive calculation and illustration programs currently available for doing all of the common estate and gift planning calculations. It includes a general analysis plus illustration capacity plus several utility programs, sich as future values of investments, charitable split interests values, life estates and remainders, and present values of future payments.

Joe then quickly demonstrated the Kugler Estate Analyzer from Brentmark (see URL above). While the initial interface for this program is relatively simple, it will perform a variety of sophisticated calculations depending on the estate planning alternatives you want to examine for a given client.

Roger then quickly demonstrated and discussed the new Estate Profiler Pro program that was first seen by the two of us only a couple of weeks ago. This is billed as financial and estate planning software, and from the looks of it's multi-screen output (which tends to get confusing at times) it is just that. What is unique about this product is that it does indeed present all the data and calculation results on one screen, along with line charts that illustrate the results graphically. Unfortunately we did not have time to give this program a real run for its money.

Joe then turned to software programs that are dedicated to doing charitable gift planning calculations. One of his favorites was the Brentmark Charitable Financial Planner program. The real plus of this program is the ability of the user to quickly do what if alternative calculations when considering various planning alternatives. In addition, it is a very affordable product for smaller charities. As another cost-effectice alternative Joe next demonstrated the Crescendo Lite program [www.crescendosoft.com], which is a stripped down version of the institutional-sized program that Crescendo markets, but it comes with enough calculation alternatives to make it worth while for many small charities, especially since it comes with all the presentation tools and other communication tools and forms that the larger program has, albeit limited just to the calculations that are included. As another calculation alternative, Joe directed people to the following Web sites where free charitable calculators current can be found or even purchased for addition to the Web sites of financial advisors if
desired: Crescendo at www.crescendosoft.com/cres_home.jsp, PhilathroTec at www.ptec.com, and the Planned Giving Design Center at http://www.pgdc.com/usa.

The session concluded with a strong suggestion from the speakers that the flow chart and other graph capabilities of these programs be use to help insure the client's understanding of the various alternatives that are being considered and that print outs of the same be given to the client and placed in the client's file (along with any handwritten notes about the options considered and rejected and why), as a matter of good legal malpractice prevention. Also, everyone was encouraged to visit the web sites of the various vendors not only to learn more about the software in question but also what their current pricing might be.

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Report #13 (Thursday, Cont'd)

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

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This Report contains coverage of the FLIP general session and the Risk Management for Trustees general and special sessions.

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First some Announcements:

First, a special session dealing with Changes for Charities was added to the program after the formal program was printed. This was held on Thursday afternoon. We will try to cover this session at a later date, although we did not have any reporters there due to the late addition of this to the schedule.

Second, when the Institute adjourend at noon on Friday, 1/14/05 , Tina Portuondo, the Institute Director, announced that the official attendance for this year's Institute was 2,618 people, the second largest attendance the Institute has enjoyed since it's inception.

Third, and this is important, the dates for the Institute in January of 2006 were announced. They will be Monday, January 9th, through Friday, January 13th. The location and venue will be the same as this year.

Lastly, while the Institute adjourned on Friday at noon, there are several reports in the pipeline, as there is always a delay between the time the sessions are covered by our reporters and the time that their reports become available for editing and publication. In addition, as this report is being prepared and published, it is already Friday afternoon, and many of our reporters are on their way home from the Institute. They will be able to resume their reporting once they arrive home and have access to e-mail once again. So, please be patient and we will process and publish these reports as soon as we can. Most likely this task will go into the later parts of next week. In due course, all the reports will be posted on the ABA-RPPT Web site. Once that occurs, they will be compiled into one big PDF file with all the extra material edited out. We will announce all this on this list.

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The FLIP side of FLPs: Income Tax Issues
The FLIP Side of FLPs: Income Tax Issues
Thursday Morning, 1/13/05
Presenter: Samuel A. Donaldson, Esq.

Reporter: Shelly D. Merritt, Esq.

Mr. Donaldson's presentation highlighted some of the income tax issues relating to the formation, operation, and liquidation of family limited partnerships. He was quick to point out that the 45 minute presentation was not intended to be a full course on the issues, but more of a refresher on some of the more common issues.

FORMATION OF PARTNERSHIP

Generally, contributions to a partnership are a non recognition event for income tax purposes. There are two primary situations where gain can result when assets are contributed to a partnership:

1. Investment Company (Partnership) Rules under IRC Section 721(b):

Gain (but not loss) must be recognized if the partners create an "investment company partnership" and the partner's contribution of assets results in diversification of the partner's capital account.

A partnership is deemed to be an Investment Company if more than 80% of the assets consist of "portfolio" assets (generally, stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets) held for investment.

Diversification results where each partner contributes different securities to the partnership so that the end result is that each partner ends up with a share of different securities than those contributed.

A de minimis contribution of non-identical assets is ignored for purposes of these rules. The IRS has ruled that less than 5% of the total value contributed to the partnership qualifies as de minimis.

Ways to avoid Investment Company Rules

Make sure the partnership's assets consist of less than 80% portfolio assets upon formation.

If the partners forming the partnership are unmarried, advise each to contribute substantially identical assets to the partnership.

If the partners are married, have each partner transfer an undivided one-half interest in all of the assets to be transferred to the FLP. Since any transfers between them will qualify for the marital deduction, they can diversify their assets between themselves before contributing them to the partnership.

Have each founding partner contribute an already diversified portfolio to the FLP. A contributing partner's portfolio is diversified if no more than 25% of the portfolioâ€™s value is invested in any one issuer and if no more than half of the value of the portfolio is invested in five or fewer issues.

2. Debt in Excess of Basis IRC Section 752

If a partner contributes property that is subject to recourse debt to the partnership, the partner may recognize gain if the debt exceeds the partner's adjusted basis in the property. The reason for this is that when a partner contributes property to a partnership that is subject to debt, each partner is allocated a share of the debt. As a result, the contributing partner's share of the debt is reduced. Section 752(b) treats this reduction as a cash distribution and Section 731 generally provides that a cash distribution is taxable to the extent it exceeds a partner's basis in his or her partnership interest.

Mr. Donaldson pointed out that this is not generally a problem with FLPs because if the contributing partner is a general partner, then the debt stays with contributing partner because he/she remains liable on the debt. This is not the case for LLCs (and LLPs?).

OPERATION OF FLP

Income and Deduction Allocations

In Mr. Donaldson's opinion, maintaining capital accounts in accordance with 704(b) regulations is only necessary if the partnership has special allocations. If an FLP has special allocations, it may be subject to Section 2701. In addition, Section704(e)(2) requires pro-rata distributions of income from FLPs. As a result, an FLP typically does not have special allocations. In Mr. Donaldson's opinion, it may be better not to follow the capital account rules in the regulations, provided the FLP agreement requires all allocations to be in accordance with the partner's interests in the partnership.

Transfer and Distribution Restrictions

While transfer and distribution restrictions are typically used with FLPs to maximize discounts, Mr. Donaldson pointed out two income tax issues with these types of restrictions.

1. Reg. 1.704(1)(e)(2)(IX) - If a donee of a limited partnership interest is subject to substantial restrictions on transferability of the interest, the income attributable to the interest could be taxed to the donor under the argument that the donor has not given up control and therefore a completed gift has not been made.

2. When a donor gifts a LP interest, basis to the transferee is less than the transferor's basis due to the discounts resulting from the restrictions. Mr. Donaldson pointed out that this may not be bad since parents, who are in a higher tax bracket, will keep more of the basis, reducing their tax liability.

Death of a Partner

1. Close of Taxable Year. 706(c)(2)(A) provides that upon the death of a partner, the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a pro rata allocation based on the number of days in the period. Mr. Donaldson recommended to not provide in the partnership agreement that one approach or the other is required, but instead allow the remaining partners and the deceased partner's fiduciary to decide at the time which approach is better.

2. Adjustment to Basis Under IRC Section 754. Section 754 allows a partnership to step up the inside basis of its assets to equal the outside basis on the death of a partner. Mr. Donaldson pointed out that discounts on the partnership cause the fair market value of the partnership interests (the outside basis) to be less than the value at liquidation resulting in a less than full step up in basis on the assets.

LIQUIDATION OF THE FLP

There are two approaches to liquidation of an FLP:

1. Sell all of the assets owned by the partnership and then liquidate. IRC Section 704(c) requires any gain from the sale of appreciated property contributed to a partnership (built in gain) must generally be allocated to the contributing partner. Any excess gain is then allocated based on the partnership agreement. After this allocation of gain, a distribution of the remaining cash proceeds is taxable only

to the extent that the distributions exceeds a partner's outside basis.

2. In kind distributions of partnership property. Could give every partner a proportionate interest in every asset or cherry pick which assets go to which partners.

IRC Section 704(c)(1)(b) provides that if a partner contributes built in gain property to the partnership and such property is distributed within 7 years to another partner, the contributing partner must recognize the gain. A successor in interest to a contributing partner inherits this liability for the built in gain.

Exceptions:

-If property is distributed back to the contributing partner or his successor in interest.

-If a proportionate distribution of the built in gain property is made.

-Selling built in gain property and then distributing proceeds.

IRC Section 737 provides that if a partner contributes built in gain property to the partnership and within 7 years distributes other property to that partner, effectively this is a sale of the property and the contributing partner must recognize gain.

Exception

-Property distributed to contributing partner. Mr. Donaldson pointed out that a successor in interest is not an exception under IRC Section 737 - it does not have same language as 704(c)(1)(b).

IRC Section 731(c) provides that a distribution of marketable securities is deemed to be a distribution of cash. This gives rise to gain if the distribution exceeds the partner's basis.

4 Exceptions

-Contributing partner exception (no similar rule for successor in interest)

-Form an investment partnership: If 90% or more of the partnership assets are marketable assets, a distribution to a partner who did not contribute marketable securities will not trigger 731(c).

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Risk Management for Trustees
General Session Thursday Morning 1/13/05
Special Session 3-A, Thursday Afternoon 1/13/05
Presenters:
A.M. Session - William C. Weinsheimer Esq.
P.M. Session - William C. Weinsheimer Esq. and John T. Brooks Esq.

Reporter: Eugene Zuspann Esq.

NOTE: Due to limitations on reporting time available to cover these sessions, this report may not provide complete coverage of these sessions. If further coverage is obtained at a later date, we will publish it at that time.

The fact situation involved a typical A-B trust. The family trust provides mandatory income to the spouse and discretionary income between the spouse and the children. The marital trust mainly consists of 1 asset. The Trust provides that the trustee is directed to retain all shares of my beloved company without regard to the usual concern of diversification or otherwise. Later in the instrument is a provision that this stock may only be sold if necessary to prevent calamity to all concerned.

John Brooks started with a summary or the law:

There is an affirmative duty to disclose to the beneficiary. Restatement Trusts, 2nd §173 The duty to inform may be modified by the trust instrument or the state statutes. The fiduciary is obliged to provide complete and accurate information to the beneficiary.

There is a duty to account. To whom must the trustee provide these accounts? See the The instrument and any relevant statutes? Can the instrument override the statute? It depends on the language in the statute.

When does the statute of limitations run? Statutes vary - check your state. Consider providing a form to the beneficiary to sign and return which evidences the beneficiary's approval of the trustee's accounting and receipting for each year. This gives the beneficiary the ability to object on a timely basis rather than much later. The object is to take away the element of surprise (to the fiduciary). An approval of accounts is not a release. Pg 16 You can add language in the release so it specifically covers all actions by the trustee.

In a terminating trust, you may withhold a distribution until the beneficiary provides a release or until the court grants a release. You may not withhold other distributions that the beneficiary is entitled to receive.

There has been an erosion of the attorney-client privilege, and John thinks this will continue. There are exceptions to the attorney client privilege in the materials. The client's state of mind is material. This area is in a state of flux. As a general rule, opinions by counsel that have been paid for out of trust funds are discoverable. John said that he has never lost this argument.

The operating manuals and policy statements will be at the top of the plaintiff's list of things to see. John has kept some of these out as a trade secret. If you have not followed your own policy, you are in a defensive posture.

Communicate clearly with the client. Do not say you will do something and not carry it out - the client will be expecting action and this makes for an unhappy client.

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Report #14 (Thursday, Cont'd)

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

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This Report contains coverage of the Thursday Fundamentals Session involving While You Wait: The EGTRRA and What to Do While Congress Ponders the Fate of the Estate and GST Taxes
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Estate Planning While You Wait: The EGTRRA and What to Do While Congress Ponders the Fate of Estate and GST Taxes
Thursday, 1/13/05
Presenter: Howard M. Zartisky Esq.

Reporter: Connie T. Eyster Esq.

Mr. Zaritsky thinks that the estate tax will almost certainly be repealed. The House of Representatives has had enough votes for repeal for a long time and now the 60 votes needed in the Senate are almost certainly there.

For planning purposes, however, practitioners should not focus on what might happen but on the law we currently have.

Even if there is a repeal of the estate tax, estate planners will not be out of business. We will still need to plan for non-tax reasons such as creditor protection and there will still be state estate taxes, carry-over basis rules, and income taxation of retirement benefits to worry about.

Note that if you do a QDOT and the estate tax is repealed, you may be paying estate tax when no one else is paying that tax. It may be better to give property outright to a non-citizen spouse and use disclaimers to fund a QDOT if necessary.

The retention of the gift tax is more than a little relevant. Mr. Zaritsky believes that there must be one heck of a compelling situation to justify making a taxable gift now. Note that if a client made $675K worth of gifts before 2001- the client might not be able to make an additional $325 of gifts because of shifting rates. (See p.10 of the materials)

If the estate tax is not repealed, many bills in Congress now seem to suggest that there will be at lease a $5 million applicable exclusion amount.

With regard to carry-over basis rules, Mr. Zaritsky does not think you need to do any detailed planning for it now because even if the estate tax is repealed and we do have carry-over basis, those rules will likely look very different from the ones included in the statutes right now. We should be telling clients to keep better records.

Generally, the EGTRRA carry-over basis rules provide that each individual will have $1.3 million to allocate to basis in his or her estate and $3 million to allocate to basis for assets passing to a surviving spouse. Nonresidents only get a $60,000 basis adjustment. Mr. Zaritsky counsels against using "estate trusts" to obtain the marital deduction, as it might prevent the allocation of spousal basis.

The basis allocation also cannot be given to items carrying IRD. This will be a big issue for people with a lot of retirement plan benefits.

Note that substitution of carry-over basis for an estate tax will greatly increase the taxes on the surviving spouse.

Mr. Zaritsky thinks the repeal of the state death tax credit has an enormous impact on estate planning. There is a wide variety of rules out there right now. Practitioners must have a detailed list of the location of a client's assets, both tangible and intangible, before suggesting planning.

Note that, in Florida, the bar has suggested that it is unethical for an attorney from another state to provide advice on Florida state estate tax laws. If other states follow this rule, then it may be necessary to get formal opinions from local counsel when working with a client who has assets located in a state that has a state death tax.

With regard to testamentary planning, Mr. Zaritsky suggested that you may want to put alternative dispositions in your wills, which would take effect if the estate tax is repealed. However, he suggests only including such alternate dispositions if it is relatively easy to draft them. For instance, if a client would prefer that there were no marital trust or no family trust in the event that the estate tax is repealed, that would be an easy alternative disposition to draft. In other cases where the alternative disposition is more complicated, it might be worth waiting until actual repeal to deal with those issues.

Mr. Zaritsky next discussed whether we should be doing new planning for smallish estates. For estates where the assets of the married couple are less than the applicable exclusion amount, planners may choose to make no changes. However, as the applicable exclusion amount increases, practitioners should start looking at whether the non-marital share trust is growing too large and whether the failure to fund a marital share will make the surviving spouse uneasy or otherwise cause family tensions.

If the estate is over $1.3 million, but less than the applicable exclusion amount, there may be some opportunity to do carry-over basis planning, but Mr. Zaritsky suggests that he is reluctant to do too much planning here.

For estates between $1.5 and $2 million, Mr. Zaritsky again suggests that practitioners should review the size of the non-marital share trust to determine if it is worth capping it at something less than the full applicable exclusion, either because of family dynamics or because of carry-over basis issues. The problem of over-funding for carry-over basis rules was illustrated by the following example. Imagine an estate of $2 million. If on the first spouse's death, $1.5 million goes into a family trust and $500K is given to a marital share. On the second spouse's death there is no estate tax, but that spouse may have "extra" basis allocation that goes unused and assets distributed to the family trust on the first spouse's death will be stuck with their lower basis. One way to address this issue would be to put a specific provision in your documents allowing the trustee of the non marital share to distribute assets to the surviving spouse outright in order to allocate basis adjustment on the surviving spouse's death.

Whether practitioners decide to create a cap on the non-martial share or not, practitioners should look at their current marital deduction formula and figure out what will happen if there were no estate tax. You need to have a sense of what repeal would do to your documents to know the extent to which repeal should be addressed.

Another technique you might consider is the spousal power of appointment trust, which works as follows: Husband and Wife each establish a revocable trust which provides that upon death the assets will be divided into a marital and non-marital share. If husband dies before wife, he is given the power to appoint the assets of wife's trust to his estate to the extent necessary to take full advantage of the estate tax exemption. This ensures that both husband and wife's assets are included in the estate of the first spouse to die and ensures that the full applicable exclusion amount will be used on the first death.

Note that under current law, the assets that were in wife's trust will not receive a new basis on husband's death, but a bunch of PLR's suggest that is technique works just fine from an estate inclusion perspective. ACTEC has asked the IRS to give us a revenue ruling on the estate inclusion issue.

Mr. Zaritsky also likes the use of a total return trust as a planning technique in this environment. It is a nice way to eliminate fights when we have a very large non-marital share and a 2nd marriage. Note, practitioners should NOT promise beneficiaries that total return trusts will result in greater overall returns. Rather, the practitioner should focus on the family dynamic benefits. Also, Mr. Zaritsky suggests that, administratively, using January 1 as a valuation date is the best approach. With regard to defining the unitrust amount, use of a 3-5% is probably fairly safe.

Mr. Zaritsky also discussed the intersection between carry-over basis and the marital share. One big rule to know is that the $3 million spousal property election cannot be made on property passing to a general power of appointment trust (estate trust), but rather can only be allocated to distributions passing outright to the spouse or to a QTIP trust.

As a practice pointer, Mr. Zaritsky suggests giving direction to fiduciaries in your documents regarding how the basis allocation adjustment should be applied. First and foremost, the fiduciary should be given absolute authority to select which assets get which allocations, and should be exonerated for making basis adjustments that treat beneficiaries unequally so long as the fiduciary is acting in good faith. You may also want to give the fiduciary direction to allocate the basis adjustment first to assets which will generate ordinary income.

With regard to the differences in state death tax exemption amounts â€“ the decoupling can result in payment of state estate tax even when no federal tax is due. The easiest way to deal with this issue is to encourage clients to give away their property held in states where there is a state estate tax. Another planning technique may be to take a tangible asset and contribute it to an entity so that the ownership is now an intangible asset, although there is some question whether that technique will actually work based on applicable state law. One very important issue is to ensure that your client cannot be deemed to have more than one domicile. See p. 132-135 of the materials.

(Note that there is a correction in the materials on p. 137. Paragraph (d) should start "without regard to whether this affects the state estate death taxes.")

One way to address the issue of marital deduction formulas in a state where there is a state estate tax is to create several testamentary trusts as follows:
(a) create one trust that will hold property up to the applicable state exemption (assuming that the state exemption is less than the applicable federal exclusion amount).

(b) Create one trust that has QTIP provisions which Mr. Zaritsky calls the "spousal non-marital share"- that holds the amount of property which is the difference between the federal and the state exemption amounts. You can make a QTIP election for this trust which will be ignored for federal purposes because it is not necessary to make this election in order to reduce the estate tax to zero. See Rev. Proc. 2001-38. The election, however, may be respected for state estate tax purposes because it is necessary to reduce state estate taxes to zero. This technique will not work in a state that does not permit the making of inconsistent elections.

(c) Create one trust to hold the balance as a marital share.

In general, it is best to draft documents to be as flexible as possible. The easiest way to stay flexible is to give the trustee broad powers of distribution. Mr. Zaritsky suggests using an independent trustee and giving the beneficiaries broad powers to remove and replace the trustee.

Mr. Zaritsky concedes that disclaimers allow for a great deal of flexibility in planning, but in his experience, it is too easy for the beneficiaries to destroy this planning option post-death and practitioners would be unwise to rely too heavily on it.

Mr. Zaritsky's preferred flexible planning technique is to place all of the decedent's assets in a QTIP trust and allow the fiduciary to make a QTIP election with regard to some or all of the trust. The downside to this technique is that all of the trust income is distributable only to the surviving spouse.

Another, similar option, would be to put all of the decedent's assets into a "Clayton QTIP," which would permit the trustee to transfer the assets for which the QTIP election was not made to a family bypass trust. This would permit the sprinkling of income for assets not included in a marital share. (See p. 136 of the materials). The downside of this form of trust is that it cannot be used to create shares that are deductible for state death tax purposes but are not deductible for federal estate tax purposes.

In summary, with regard to testamentary planning, practitioners should:
1. Plan with law we have today
2. Plan for the state death tax credit by, to the extent possible, eliminating property held in states with a state death tax credit. If you can't get rid of that property, create different non-marital division for state and federal purposes.
3. Recognize the possibility of carry-over basis principles and authorize the trustee to make distributions of property to take advantage of surviving spouse's basis allocation
4. Use independent trustees and give them authority to revise the trust to accommodate changes in the law.

5. Consider reciprocal power of appointment trusts.

With regard to lifetime planning, Mr. Zaritsky again reiterated that you would need an extraordinary fact pattern to justify making taxable gifts right now.

If a client is making lifetime gifts, an ideal asset to give away now is one that has a low basis but which is unlikely to be sold suchh as an asset with sentimental family value.

Interfamily sales are also ideal transactions during this difficult period. They freeze estate tax values and do not incur a gift tax,

When using discount planning, practitioners should be cognizant that gifting during life throws away the option to allocate new basis at death and if the assets are discounted, you might never be able to get the basis up to fair market value.

Life insurance planning can still be valuable see pages 199-200 oof the materials. Never advise a client to cancel life insurance at the first meeting. Mr. Zaritsky suggests that funds should be borrowed against the policy first, and then terminated if in fact the policy is no longer necessary. He is very hesitant to dispose of a policy we can't replace.

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Report #15 (Wednesday / Friday)

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

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This Report contains coverage of the Wednesday general session by Richard Robinson on 15% tax on Dividends and Capital Gains and the Friday morning session by Prof. Thomas Callanis on Domestic Partners and Inheritance

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The 15% Tax for Dividends and Capital Gains - Use It or Lose It Wednesday Morning, 1/12/05
Presenter: Richard B. Robinson Esq.

Reporter: Herbert L. Braverman Esq.

Mr. Robinson brought to our attention again the new playing field for income taxation. Lower rates should prompt us to think about realizing gains sooner rather than later because of the lower rates we are experiencing. He points out that the maximum rate for qualifying dividends is reduced to 15% for individuals, estates and trusts. The rates for lower bracket individuals is reduced to 5%. For taxpayers in the 10% to 15% bracket, the rate is ZERO in 2008. This is a tax environment we have not had in recent memory.

For certain long term capital gains, property that had been taxed at 20% is now taxed at 15% for individuals , estates and trusts. Again, for lower bracket individuals, the tax rate is 5% and will be ZERO in 2008. These lower capital gains rates are scheduled to expire after 2008--Mr. Robinson is urging us to take advantage of these rates sooner rather than later. He notes certain exceptions, for example a 25% rate on certain recaptures and a 28% on certain collectibles.

"Qualified dividend income" means dividends received during the tax year from a domestic corporation or qualified foreign corporations received by a non-corporate taxpayer. Certain dividends are not "qualified dividends", such as those from a tax exempt corporation, certain dividends from a mutual savings bank, dividends paid by a RIC or a REIT, etc. But , Mr. Robinson focuses our attention on situations where qualified dividends make sense today.

Robinson discusses various situations where qualified dividends make sense for C corps and for S corps; similarly, he points out situations where redemptions are treated as qualified dividends for C corps and S corps, respectively, wither the attendant low tax consequences. His illustrations are numbers-driven with schematics that I cannot reproduce for you. My best advice is that you obtain a copy of his outline and follow the money! He shows us that flexibility and creativity can mean substantial windfalls to our clients. Though circumstances may dictate the use of dividend planning versus redemption planning (or both), both are important to keep in mind. For example, if stock basis is high, dividend treatment results in more income, but basis is not lost. Where there is significant capital loss carryforward, redemption treatment may be preferred. If stock has been held only a short time, dividend treatment produces a better result, provided the qualifying dividend holding period has been satisfied. Dividend treatment strips out earnings and profits on a dollar-for-dollar basis and may set the stage for an S election or future capital gains distributions from a C corporation.

Robinson then turned to the topic of maximizing the benefits of capital gains realized sooner rather than later. If the 15% tax rate goes away, accelerating income in a 15% year could result in tax savings of 264% (15% vs. 39.6%). In other words deferral does not always produce the best tax result; the future tax burden from an increased tax rate may be substantially more than paying a current relatively low tax.

He goes through detailed analyses to demonstrate the advantages of the current tax environment in a variety of other situations, including corporate liquidations, partnership distributions and liquidations, Stock sales to related parties followed by liquidations and sales between related parties, locking in appreciation at capital gains rates.
His breakout session will no doubt delve into even greater detail regarding these matters.

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Domestic Partners and Inheritance: Past, Present and Future Friday Morning, 1/14/05
Presenter: Prof. Thomas P. Gallanis

Reporter: Herbert L. Braverman Esq.

Professor Gallanis highlighted the apparent changes in the American family structure over several decades. He reviewed the demographics with us to show that there are many same-sex unmarried partners in this country and even more different-sex unmarried partners heading families in this country.

He noted that inheritance laws in this country are focused on marriage, whether formal, common law in some jurisdictions and under the putative spouse doctrine who held a good faith belief that they were married.
The professor review the contractual basis for inheritance rights in nonmarital relationships , citing the well-known case of Marvin vs.
Marvin (Cal. 1976) . The contract analysis bogged down in an exploration of "consideration". What was the consideration for the nonmarital relationship--sex, sex+, services , services +, etc. The Professor suggested a broader view of long term commitment, to replace the contractual analysis of the past; this would be done without a distinction between same-sex and different-sex unmarried partners.
There appears to be a growing recognition of the rights of nonmarital partnerships. See, for example, ALI Principles of the Law of Family Dissolution, chapter 6, and comment g to the Restatement Third of Property Section 2.2. Both suggest that a domestic partner, whether married or unmarried, should have certain rights.

Hawaii, Vermont and California appear to be moving in this direction, as does Maine with its recent legislation on the subject. Hawaii has reciprocal beneficiaries register the relationship and gain rights previously provided to married persons. Of course, this law is aimed only at persons who are prohibited from marrying under state law (same-sex partners and others, say a grandfather and his granddaughter).
Vermont had civil unions for same sex partners, but not for different-sex unmarried partners.
California passed legislation effective 1/1/05 providing certain economic rights to domestic partners there. Maine has similar law, focusing on relationships , long-term commitment and rights between partners , rather than on marriage alone.
Massachusetts is dealing with the issue also in what the Professor would call a progressive manner.

On the other hand, the country has not reacted uniformly to this trend.

The Defense of Marriage Act, passed in 1996, defines marriage as a "legal union between one man and one woman as husband and wife." 35 state passed their own Dumas with strong language e supporting only the historical and conventional. Alaska , Nevada and Nebraska adopted constitutional amendments banning same-sex marriage, although you can get some pretty snazzy trust in those jurisdictions. As for the Massachusetts experience, only New York and Rhode Island will respect a Massachusetts arrangement that is not conventional. Then, in 2004, as a backdrop to the war in Iraq, 13 states passed constitutional amendments denying recognition to same-sex marriages. Our country is thinking about a Constitutional Amendment of the same type, though Congress did not pursue this item on the President's agenda as yet.

Where should we be on this set of issues? Professor Gallanis feels we should apply inheritance rights on the basis of domestic partnerships to effect the intend of decedents, to protect families or households and to avoid economic disruption to households. This will require a new understanding of domestic patterns. It will come only in time, slowly as our society changes, although it is not clear that we will see such a change. Finally, the Professor attaches a model statute for your consideration. There is certainly a lot to think about in this arena.

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Report #16 (Thursday, Cont'd)

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

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This Report contains coverage of the Thursday Risk Management general session and Uniform Trust Code special session.

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Risk Management for Trustees: Happy Beneficiaries, Equal Empty Courtrooms Thursday Morning 1/13/05
Presenter: William C. Weinsheimer Esq.

Reporter: Eugene Zuspann Esq.

NOTE: This report supplements Gene's report on the special session for this subject that was published in Report 13.

Why is there a need for risk management?
1. There has been an explosion in the number and complexity of Fiduciary litigation cases 2. Most large firms and boutiques now have an estate and trust litigator 3. More money for the beneficiaries to fight for as death taxes go away 4. Baby boomers are more litigious 5. The Heirs website has materials on suing a trustee

Risk avoidance begins with the pre-acceptance of procedure - the screening process
Analyze the documents, the trust assets and the beneficiaries. Avoid trusts with high risk. Analyze profitability and avoid those trusts that do not meet your standards. Review prior account activity to try and determine if problems exist. If there is a prior trustee, why is the prior trustee no longer serving? If it due to litigation problems with the beneficiaries, determine whether this is a continuing problem.

The bottom line: When in doubt - decline!

Trustees often get sued because they fail to understand their duties as a trustee. The trustee must understand the terms of the trust and administer the trust by its terms. ACTEC is in the process of providing a document for trustees summarizing the trustee's duties that should be published this year. Look for unusual provisions in the trust document. The main message for clients acting as trustees is that they must "dot the i's and cross the t's."

The trustee must understand the duty to furnish information and communicate to beneficiaries. Periodic reports are helpful. Find out what the beneficiaries like. Know what your state law requires.

The trustee has a duty of loyalty and the duty to avoid conflicts of interest. The document may permit conflicts but explain those conflicts to the beneficiaries at the outset. Disclose, disclose, disclose.

The trustee has a duty of impartiality. This does not require treating the beneficiaries equally - treat them impartially. If the instrument directs that one beneficiary will be favored, understand and communicate that to the beneficiaries so they understand why certain actions are taken.

Handling trust investments (pg 18) The prudent investor act is enacted in
43 states. In some states, it was not clear whether this rule created an absolute duty to diversify in all circumstances. The emphasis is on process and procedure. The trustee must act upon the total portfolio. The law in this area is now to review the performance of the total portfolio - a total return review rather than focusing on separate assets. The Prudent Investor Rule is a test of conduct and not of resulting performance.

Diversification - Carefully look at the situation in the trust and document your decision. There is no defined set of asset categories that the trustee must consider. Diversification does not require the trustee to have some investments in land, some in Oil and gas, etc. There must not be a concentration of a class of assets. Set rules for defining and dealing with a concentration. If the trust has a concentration, you may not want to take the trust in the first place. If you are trustee, get consents or releases from the beneficiaries and possibly obtain court direction. Pg 21 contains a list of key factors to be used in formulating an investment program and document your decision. Some of these key factors are size and makeup of the portfolio, needs of the beneficiaries, liquidity and distribution requirements and the purposes and duration of the trust.

If the trustee is not a qualified investment advisor, the trustee should consider delegation of the investment functions. Even for the corporate trustee, delegation is prudent when the trust contains assets which are outside of the trustee's investment experience.

Unitrust conversion approach. Unitrusts came into being because of modern portfolio theory and total return concepts. Again, the trustee must set rules for defining and dealing with a concentration of assets. The same concepts are relevant to trustees with a power to adjust. State statutes should be analyzed to determine the obligations, duties and liabilities of the trust in exercising the power to adjust or to operate as a unitrust. The governing instrument should also give the trustee protection. The UPAIA provides trustees with significant protection for liability.
Unless it is evident to a trustee that a particular trust is a candidate for conversion, or unless a beneficiary has requested conversion, the trustee should take no action.

If the trust is an income trust with invasion provisions, it is best not to convert to a unitrust. He feels the same result can be obtained under §103 and §104 of the UPAIA. The trustee may wish to obtain the consent of the beneficiaries. He pointed out Jonathan Blattmachr's comments on Monday suggesting that a trust is much more flexible under the §643 regs if it is not a unitrust.

Delegation to advisors other than investment advisors.
1. UTC 807 provides much flexibility to delegate.
2. R 3rd Trusts states that historically you could not delegate administrative acts without explicit authorization in the trust instrument. R 3rd changes this.
3. The trustee should delegate whenever there are assets in the trust in which the trustee does not have expertise. Some examples are real estate, oil and gas investments, closely held bus interests and intellectual property.

If you are going to delegate, do not act blindly. You must supervise and monitor what is happening, get reports back from the agent, and act if something is wrong.

The trustee should be able to delegate to the co-trustee. You must check the state statutes. Ill does not have a power to delegate to the co-trustee. You also need to check the trust instrument. If there is no power, or if the instrument prohibits delegation, there is joint and several liability.

In discretionary trusts, review the scope of the trustee's discretion with the beneficiaries, explain the scope of standards, explain the scope of broader standards (general welfare and best interests), and, if the trust requires the trustee consider other resources of the beneficiaries, obtain such information.

Determine the language under the document to determine the method of making distributions. Determine priorities. Establish a format for gathering financial and family data from the beneficiaries which will be used to evaluate a requires for a discretionary distribution and give the beneficiaries advance warning that this data will be required before the trustee can exercise discretion. If there is full discretion, review state law and the instrument to determine what still must be done to advise the beneficiary. Make sure that you have sound procedures. Explain the rules of engagement to the beneficiaries. Document your decisions, pro and con.

In general, an attorney can act as trustee for the client, but they must advise the client of the potential conflict, and maybe advise the client to see other counsel to advise on the decision.

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Hot Topics on the Uniform Trust Code
Thursday Afternoon, 1/13/05
Presenters:
Prof. David English (DE)
Prof. Alan Newman (AN)
Suzanne Brown Walsh Esq. (SW)
Richard Davis Esq. (RD)

Reporter: Eugene Zuspann Esq.

DE Started with an overview of the code.

The UTC is the first effort to codify the law of trusts. Together with the UPIA, the UPAIA, this is close to a comprehensive body of law.

There are 3 areas in which people have significant concerns 1. Notice and the ability to waive by the settlor 2. estate tax (modification or termination of trusts by the beneficiaries) 3. creditor claims

The panel spent some time summarizing the law from the states where they are located - Missouri, Ohio and Connecticut.

Ohio made several changes to Section 504 on creditor rights. These include the addition of a discretionary trust with no standards - the trustee has sole and absolute discretion and a beneficiary cannot be the trustee.

DE discussed amendments made to the UTC last summer. There included making §105(b)(8) and (9) optional (allowing a settlor to waive the obligation to report), adding several alternatives to §411 (the modification and termination section that has caused 2036 and 2038 concerns) and changes to the creditor rights article.

The most changed provisions in the code involve the required reporting to the beneficiaries. Of 10 states that have passed the UTC, 4 have modified the statute and D.C. has put in a trust protector concept. Missouri allows waiver of notice to remainder beneficiaries. There is no consistency on the notice issue. This is a significant issue in all states.

DE discussed 411(a) - the ability to modify or terminate a trust, and the proposed changes to the statute. Almost all states now allow modification or termination in some form. This is either by statute or case law. Some states require court approval and some do not. The choices in 411(a) include adding court approval, making 411(a) prospective only or eliminating 411(a) altogether and relying on existing state law.

AN addressed the concerns raised by people worried about an expansion of creditor rights in trusts created by third parties, including spendthrift clauses and discretionary and support trusts. The materials contain a paper he has prepared analyzing these issues.

Further amendments are being considered by the ULC to Article 5 (creditor rights). The committee is looking at the definition of mandatory distribution. §501 will only apply if there is no spendthrift provision. It may enlarge creditors rights in a discretionary trust if the trust instrument does not include a spendthrift clause.

SW discussed the Connecticut changes and the removal of a trustee in §706.

Under §504, it does not matter whether the trust is a discretionary trust or a support trust.

RD spent time discussing special needs trusts (SNTs) and the creditor issues raised that could concern those trusts. There is an article posted on the web at www.oh-elderlaw.com on SNTs.
He feels:
1. SNTs do not need creditor protection to work. The government is not a creditor with respect to benefits paid. Generally, estate recovery only applies to probate assets.
2. Can the existence of an SNT be used to deny benefits?
a. If the trust is pre-1993 and a self settled trust - no. This was changed by OBRA in 1993. Now I understand the answer to be yes.
b. A 3rd party trust cannot be used to deny benefits if properly drawn.
3. SNTs are not countable assets.
4. SNTs are discretionary. Therefore, the beneficiary does not have the right to compel payment.
5. Distributions from SNTs are never in the hands of the beneficiary.

There has been concern about the Kreitzer (??) decision in Ohio. The trust in the case is distinguishable because it did not contain a spendthrift clause and did contain a support standard.

§814(a) does not change this result if properly drafted.

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Report #17 (Thursday, Cont'd)

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This Report contains coverage of the Thursday main session on Disclaimers plus Special Session III-E on the Reduced Dividend and Capital Gains Dividends and Special Session IV-B on Partnerships

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Disclaimers: When, Why & How To Say No To An Inheritance
Presenter: E. Diane Thompson Esq.

Reporter: Connie T. Eyster Esq.

A disclaimer is a refusal to accept an inheritance or a gift. It provides opportunities to revise the decedent's estate plan post-mortem and can provide income tax planning opportunities.

10 states have adopted the Uniform Disclaimer of Property Interests Act. The terms of that statute are discussed periodically in the presentation.

To be a qualified disclaimer under §2518(b), the disclaimer must:
- Be irrevocable and unqualified
- Be in writing
- Identify the interest being disclaimed
- Be signed by the disclaimant or the disclaimant's legal representative
- Be delivered to the transferor of the interest, the transferor's legal representative, the holder of title to the property, or to the person in possession of the property.

(Note that some states require the filing of the disclaimer in a particular place, such as in the land title records)

- Be made not later than 9 months after the later of the date of the transfer or the date the transferee turns 21. (Note that the UDPIA eliminates time requirements for filing a disclaimer for state law purposes, but you still need to comply with the time requirements for making a tax qualified disclaimer)

In addition, to be a qualified disclaimer, the disclaimant must not have accepted the interest disclaimed or any of its benefits which also prevents the acceptance of consideration for the disclaimer.

Finally, the disclaimer must pass to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the disclaimant.

§ 2518(c)(3) provides an alternative way of having a tax qualified disclaimer (called a "transfer disclaimer"):

Certain transfers are treated as a disclaimer if the requirements of
§2518(b)(2) and (b)(3) are met and the transfer is made to a person who would have received the property had the transferor made a qualified disclaimer. This provision was enacted for transfers made after 12/31/1981 that may not have met the state law requirements for an effective disclaimer.

Example: PLR9135043 involved a disclaimer of a joint tenancy interest in a state where local law prevented a disclaimer of a joint tenancy interest for which the disclaimant provided any of the consideration.
The consideration issue would not have prevented the disclaimant from making a qualified disclaimer under § 2518. Accordingly, the disclaimant transferred the property by deed to the person who would have received the property had a disclaimer been made and the disclaimant was considered to have made a qualified disclaimer under § 2518.

BUT, the speaker cautions that PLR 200437032 indicates that a transfer disclaimer is only available where the disclaimer was barred under local law but was permitted under federal law. It was not intended to be used instead of local law when state and federal law are consistent. (See pg. 10 of the materials).

In the charitable area, disclaimers can be used to pass property to a charity in order to receive a charitable deduction or effectuate some charitable purpose. Ms. Thompson cautions, however, that there could be problems where the disclaimant is a controlling member of a board of the charity receiving the disclaimed property, or in other instances where the disclaimant might be able to control the use of the disclaimed property.

Another way to use disclaimers in a charitable manner would be to devise property to a family member with similar charitable goals and then say that, if the family member disclaims the interest, the property will pass to a charity. This would give the estate the flexibility to receive a charitable deduction if necessary for estate tax purposes, or if estate tax is not an issue, then the family member could receive the property and obtain an income tax deduction by personally giving the property to the charity.

With regard to use in conjunction with the marital deduction, a disclaimer could be used to increase the marital share where too much property was given to persons for whom no deduction is available. (See p. 13 of the materials)

Another use would be to shape a trust to qualify for the QTIP election by eliminating the power to invade the trust for someone other than the surviving spouse. Usually, the person who would need to make the disclaimer is the person who would otherwise have received a right to a distribution of trust property had the disclaimer not been made.

Ms. Thompson also uses disclaimers to take advantage of the tax on prior transfers credit" ("TPT") which credit is for estate taxes paid when property has been included in the estates of two decedents within a short period of time and estate tax was paid in both estates.
By disclaiming property out of marital deduction in the estate of the first spouse to die, the personal representative could make certain property subject to tax in both estates, which could result in significant estate tax savings for the second estate (see p. 17 of the materials).

With regard to the GSTT, disclaimers can be used to prevent a GSTT transfer or to take advantage of unused GSTT exemption. It can be used to create a reverse QTIP in some instances to "fix" unanticipated issues. Note that to execute a disclaimer on behalf of a minor child, court approval is often necessary.

Disclaimers can also be used to allow a spouse to roll-over an IRA where persons other than the spouse were named as beneficiaries. A number of PLR's have been issued recently permitting this to happen.

Disclaimers can be used to ensure that the applicable exclusion amount will be used in full on the first spouse's death, or to ensure that a martial deduction is taken when a non-martial share would otherwise have been over funded.

Ms. Thompson's favorite use of disclaimers, is to qualify the estate for the alternate valuation (see p. 26 of the materials). In some instances, the alternate valuation is needed to adjust the threshold for qualifying for another election, such as the ones under §§ 303, 6166, and 2032 of the IRC. If you have situation where values are higher at date of death and lower at the alternate valuation date, but you are dealing with an estate plan where the estate tax has been reduced to zero, then disclaimers can be used to subject the estate to a small amount of tax, take advantage of the alternate valuation date and in turn qualify for other elections.

It is unclear whether use of a disclaimer can affectively bar creditors of the disclaimant. State laws are split on this issue.
Note that under federal law, a disclaimer cannot be used to avoid a federal tax lien. Some states have allowed disclaimers to be used, pre-petition, to avoid bankruptcy creditors. (See p. 37 for cases in Oregon and Oklahoma on this issue)

A disclaimer, generally, cannot change the heirs or next of kin for purposes of a wrongful death suit. But a NY court has held otherwise.
The downside could be that damages will be based on the loss of the person receiving the disclaimer, rather than on the loss of the disclaimant.

Problem areas with disclaimers:

1. Attorneys who fail to consider a disclaimer could be looking at large malpractice damages. In a Florida case an attorney who relied on a CPA's advise that disclaimers would not change the tax treatment ended up paying a large damage award as well as attorneys' fees for the plaintiffs.

2. A critical problem with use of disclaimers is that is not always clear who will receive the disclaimed property yet it is crucial for the practitioner to know this information before the disclaimer is made. Also, consider the collateral consequences of making the disclaimer on the marital deduction, charitable deduction, and additional administrative expenses.

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Special Session 3-E - Planning With Reduced Dividend and Capital Gains Rates
Presenter: Richard B. Robinson Esq.

Reporter: Eugene Zuspann Esq.

Prior to the change in the rates for dividends and capital gains, the normal planning required that the ownership of the corporation be bifurcated due to gifts and death. Except to the extent of basis, the two rates are almost the same (15% maximum).

The possibility of getting out some shareholders was often only possible with intra shareholder purchases because the redeeming shareholder did not want completely out. The result was that the corporation could not do a redemption of some or all of the shareholder's interest and still qualify under the exceptions to dividend treatment in §302. All of the money received would be treated as a dividend subject to the ordinary income tax rates. The reason for the problem exists because of the attribution rules in §318.

Before the 15% dividend rate, getting out and triggering dividend income was an expensive proposition. Now, unless the stock has a high basis, the tax on a dividend and the tax on a capital gain will be the same. If the liquidating stockholder has a high basis, then the redemption is not as attractive. The basis cannot be used against a dividend. The regs have been changed so that the treatment of basis is different. Now the loss of basis is suspended until the other family member sells their stock, which triggers the loss. Also, the loss will be a capital loss limited to capital gains + $3000 while the dividend will all be taxed.

You also need to get an appraisal before you do the redemption to avoid making an unintentional gift between the family members.

Rich spent some time discussing the relationship between §336 and §1239. Section 339 treats a redemption in which the assets are distributed to the stockholders as a deemed sale of the assets to the stockholders at the fair market value. §1239 reclassifies a sale of depreciable property to a related party as ordinary income. The result is that any gain recognized on the distribution of depreciable property will be ordinary income. The result if the property is not depreciable is that the gain is capital gain.

He discussed the illusion that there is no gain on liquidation of an S-Corp after the death of the stockholder (as the stockholder's stock). People are often advised that the gain in the corporation assets will go away after the death of the stockholder due to the step-up in basis. However, if the gain is ordinary income, this is not correct with potentially disastrous results. The gain is ordinary income, passed through to the new stockholders and the loss is a capital loss, limited to $3000 + capital gains. In Rich's example, the beneficiaries had $5mm ordinary income and a $5mm capital loss. Assuming no other capital gains, they had ordinary income of $5mm less $3,000 capital loss on this transaction.

He also discussed a way to avoid this effect. The attribution rules under §267 govern the definition of related persons. If the stock is inherited by the decedent's 3 children, they are related persons and §1239 applies. However, if the stock goes to 3 ESBT's, the result is that the gain is capital gain and is offset by the capital loss. This is because there is no attribution between the 3 ESBTs under §267. See materals pg 21.

He evaluated the possibility of triggering gain at 15% to step up basis so that goodwill is depreciable at the stockholder's rate (35% in this example). Rich says this usually works on a present value basis. There are instances that this is not good planning. If the stockholder has a life expectancy less than 15 years, he would not get to use all of the depreciation before his death and it would go away. Also, remember that the change to the law several years ago makes the goodwill an intangible depreciable over 15 years. If the corporation has purchased goodwill that it is depreciating, then the gain on this asset is ordinary income under §1239.

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Special Session 4-B - Come Into My Partnership, Said the Spider to the Fly
Presenter: Samuel A. Donaldson Esq.

Reporter: Shelly D. Merritt Esq.

In this break out session, Mr. Donaldson expanded on some of the income tax issues relating to partnerships which he covered in the morning session. He went over four problems during the working session. The first two problems concentrated on the application of the built in gain rules under the Code which provide that when the partnership has built-in-gain property and property is distributed to the contribution partner within 7 years of its contribution to the partnership.

IRC Section 752 involves an analysis under three code sections:

1. IRC Section 704(c)(1)(b) provides that if a partner contributes built in gain property to the partnership and such property is distributed within 7 years to another partner, the contributing partner must recognize the gain.
A successor in interest to a contributing partner inherits this liability for the built in gain.

Exceptions:

-If property is distributed back to the contributing partner or his successor in interest.

-If a proportionate distribution of the built in gain property is made.

-Selling built in gain property and then distributing proceeds.

2. IRC Section 731(c) provides that a distribution of marketable securities is deemed to be a distribution of cash. This gives rise to gain if the distribution exceeds the partner’s basis.

4 Exceptions

-Contributing partner exception (no similar rule for successor in interest)

-Form an investment partnership: If 90% or more of the partnership assets are marketable assets, a distribution to a partner who did not contribute marketable securities will not trigger 731(c).

3. IRC Section 737 provides that if a partner contributes built in gain property to the partnership and within 7 years distributes other property to that partner, effectively this is a sale of the property and the contributing partner must recognize gain.

Exception

-Property distributed to contributing partner. Mr. Donaldson pointed out that a successor in interest is not an exception under IRC Section 737 - it does not have same language as 704(c)(1)(b).

The amount recognized under these rules is the amount of gain that would be recognized by a partner if all built in gain property contributed by the partner to the partnership were sold.

Treas. Reg. 1.731-2(g)(1)(i) provides the order which the above sections are applied. First 704(c)(1)(B), then 731(c)(3)(b), and then 737.

Problems 1 and 2 :Determining the amount of pre-contribution gain recognized:

Step 1: Section 704(c)(1)(B) Gain: This Section determines what the distributee partner's share of the gain would be if the partnership sold the distributed asset for fair market value.

Step 2: Section 731 (c)(3)(b) Gain:

If the property distributed is marketable securities, determine the amount of gain recognized on the distribution - the amount that the value of the securities distributed exceeds the distributee's basis.

Step 3: Section 737 Gain:

Compute the gain under 737(a)(1) and (a)(2) and then use lesser number.

737(a)(1) - "Excess Distribution":

FMV of distributed property less the partner's outside basis in the partnership (taking into account the gain computed under 704(c)(1)(B) less cash received in same or related distribution).

737(a)(2) - "Net Pre-Contribution Gain":

Amount of gain the distributee partner would recognize (under 704(c)(1)(B)) if all property which had been contributed by the distributee partner within 7 years of the distribution had been distributed to another partner.

Final Step: Add up gain under steps 1-3 above and the end result is the total gain that must be recognized.

The distributee's basis in the distributed property is determined by 732(b):

Outside basis in the distributee's partnership interest plus gain recognized under Sections 704(c)(1)(B), 731(c)(3)(b), and 737 minus cash received

Problem 2:

The second problem focused on the fact that if the partnership is an "investment partnership" (90% or more of the assets of the partnership at all times are portfolio assets and the partnership is not conducting an active business), the distribution of marketable securities to an "eligible partner" does not give rise to gain recognition under 731(c)(3)(b).

An "eligible partner" is any partner other than those who contributed non- portfolio assets.

Problem 3: Income Tax Issues At Formation

This problem focused on which assets owned by an individual would be suited for contributing to an FLP. Mr. Donaldson pointed out that if investment assets are contributed, consideration must be given as to whether the partnership will be an Investment Company (80% of more of assets are portfolio assets) or and Investment Partnership (90% of assets are "investment assets" and there is no trade or business - investment assets can include investment real estate as well as marketable securities). There was also discussion regarding making sure the person forming the partnership retains enough assets outside of the partnership to avoid the argument by the IRS that he/she is using partnership assets for personal expenses.

Problem 4: Special Allocations

This problem focused on the pro-rata allocation requirements under IRC Section 704(e)(2) for FLPs and also the fact that special allocations can give rise to the application of IRC Section 2701 which provides that certain preferred rights are ignored for valuation purposes.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #18

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

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This Report contains coverage of Rev. Rul 2004-64 courtesy of the Leimberg Estate Planning Email Newsletter

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Since we are still waiting for the last of the reports from Miami Heckerling, we are including in this Report excerpts from a recent Newsletter from the Leimberg LISI Email Newsletter service with the permission of Steve Leimberg. This is an excellent e-mail service that currently costs $19.95 per month. Steve has been a reporter for us and a speaker at Miami in the past.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #769

Date 17-Jan-05
From Steve Leimberg's Estate Planning Newsletter Subject Rev. Rul. 2004-64 - Special Report - IRS Powerboosts Intentionally Defective Grantor Trusts

LISI Commentator Keith Schiller has prepared a special report on Rev. Rul. 2004-64 and its impact on Intentionally Defective Grantor Trusts (IDGTs) for Leimberg Information Services members.

Keith notes that, while Intentionally Defective Grantor Trusts (IDGTs) are not for the faint of heart, they received a significant estate, gift and income tax boost when the Service issued Rev. Rul. 2004-64.

Keith's article reviews the advantages, uses and areas of concern with IDGTs, and recommends that the suitability of the client for implementation of an IDGT be weighed carefully. Several open legal issues exist with this estate tax strategy that will receive additional attention as a result of this ruling.

Because of the length of Keith's report, we've posted it directly to our LISI site rather than sending it to you. It's waiting for you as Estate Planning Newsletter # 768 at http//www.leimbergservices.com (Just log in and look under Recent Entries).

Ed Also due to the length of this report, we are only including a part of it here. For the full report, go to the LISI Web site and subscribe to this service.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #768

Date 17-Jan-05
From Steve Leimberg's Estate Planning Newsletter
Subject Rev. Rul. 2004-64 - IRS Powerboosts Intentionally Defective Grantor Trusts

LISI Commentator Keith Schiller is the shareholder of the Schiller Law Group, a Professional Law Corporation, of Orinda, California . We'd like to thank Carol Raimondo , CPA, Torrance, CA, and April Green , CPA, Carmel, CA for their review of this special LISI commentary.

Keith notes that, while Intentionally Defective Grantor Trusts (IDGTs) are not for the faint of heart, they received a significant estate, gift and income tax boost when the Service issued Rev. Rul. 2004-64. (See commentaries by Larry Katzenstein in Estate Planning Newsletter # 697 , Bob Keebler in Employee Benefits and Retirement Planning Newsletter # 258, Steve Akers in Estate Planning Newsletter # 738, and David Shaftel in Estate Planning Newsletter # 7452 at http//www.leimbergservices.com)

Not only is the grantor's payment of income tax on income generated by the IDGT not an additional gift, but the payment of that tax by the grantor will not cause IRC Section 2036 inclusion of the IDGT in the grantor's estate provided the grantor is required to pay the income tax. Section 2036 inclusion results if the trust must pay the income tax. Estate tax caution is advised if a trustee (independent) would have discretion to pay the income tax.

EXECUTIVE SUMMARY

This article reviews the advantages, uses and areas of concern with IDGTs, and recommends that the suitability of the client for implementation of an IDGT be weighed carefully. Several open legal issues exist with this estate tax strategy that will receive additional attention as a result of this ruling.

REV. RUL. 2004-64 – WHAT IT SAYS, WHAT IT MEANS

In what may be the most significant non-legislated estate tax savings development in recent years for the most wealthy, the IRS supported a double boost for intentionally defective grantor trusts ("IDGTs") when it issued Rev. Rul. 2004-64, 2004-27 I.R.B. 7. This ruling overrides several prior private letter rulings of a conflicting nature and outcome. (PLRs 9109001, 9444033 (a GRAT); 9504021, 9416009, 9413045 and 9352004).

First, the Service ruled payment of income tax by the grantor that arises from the trust's income is not a gift by the grantor.

Second, the Service provided a roadmap on how to avoid inclusion in the gross estate of the grantor for estate tax purposes under Code Section 2036 relative to whether or not the trust cannot, may, or must reimburse the grantor for tax arising from income generated by the trust. In a nutshell, grantors of a properly-structured IDGT are encouraged to pay the income tax arising from the trust and may achieve significant gift tax savings and income shifting for the benefit of their children, grandchildren, or other loved ones.

The Service concluded that no portion of the IDGT will be included in the gross estate of the grantor under Section 2036 if the grantor must pay the income tax of the IDGT without reimbursement from the trust.

PROHIBIT MANDATORY REIMBURSEMENT

However, a retained interest and gross estate inclusion will arise under Section 2036 if the trust must reimburse the grantor for the income tax liability that the grantor incurs. Mandatory payment obligations could arise under the terms of the trust or state law.

The IDGT, therefore, should expressly prohibit such payments while it is an intentionally defective grantor trust, if this approach to avoiding Section- 2036 inclusion is preferred. Finally, gross estate inclusion may arise if the independent trustee has discretion to reimburse the grantor for income taxes and there was a pre-existing agreement to reimburse. This third prong encourages a fact and circumstances analysis on a case-by-case basis.

Each of the examples in the ruling assumed the use of an independent trustee. Even with an independent trustee, many clients may find the approach under which the trustee has discretion to reimburse the grantor for income taxes arising on income received by the trust to be too risky an approach given the large estate tax savings potential with an IDGT. As noted below, other alternatives exist if the grantor cannot afford to continually pay tax on income he or she is not receiving.

THE CONCEPT IN THE REAL WORLD

We begin with the best… an illustrated benefit of this ruling with the application of several rules discussed in this article before reviewing the purpose, background, and general positives and areas of concern with IDGTs.

The following is a realistic example that should not pierce the envelope of estate, gift or income tax principles

IlustrationT owns rental real estate with a fair market value of $10 million without debt. T creates six IDGTs in October, 2004, one for the benefit each of his two children and four grandchildren. The property has a net operating income of $900,000 per year and generates $850,000 in cash flow, after reserves.

T sells a 5% undivided interest in the real estate to each IDGT. Assuming that a 20% fractional interest discount applies to each 5% share, each share carries a $400,000 sales price ($10 million x 5% = $500,000 x .8= $400,000).

Each note is interest only for 9 years (maximum mid-term rate) with the balloon payment at the end of the term and is secured by a deed of trust. (The beneficiaries might guarantee the loans or the grantor may gift some funds to establish a trust equity. See, discussion, infra.)

Applying the 3.62% AFR to each 5% share generates an annual interest payment of $14,480 on the $400,000 sales price while the 5% interest in the property yields $42,500 in cash flow on taxable income of $45,000.

Depending upon whether or not T resides in a state with state income tax, T will pay income tax at a rate between 35-44% on the $45,000 of taxable income, removing an additional $18,000 (at an approximate, average-effective rate of 40%) from T's estate.

This creates a $46,020 wealth shift for each trust, or $276,120 from all six the trusts, and does so without a taxable gift. Of this annual wealth-transfer savings, $108,000 arises from the income tax treatment favored by the new ruling.

If T survives 10 years from the establishment of the IDGT, over $2.76 million, plus the growth on the transferred interest in the real property, will have been removed from T's gross estate.

If estate tax is repealed, the IDGT will also have diverted $2.76 million of cash flow to loved ones who are likely in lower income tax brackets. For additional estate-tax protection, T should file a gift tax return in the year of the sale, reporting no gift while making adequate disclosure of the transfer.

WHERE DOES THE MONEY TO PAY THE INCOME TAX COME FROM?

Some clients may ask, "What if I cannot afford to pay the income tax on income that I am not receiving?" There are several plausible responses

(1) Include a provision in the trust authorizing a termination of the defective trust character of the trust and bring the trust under general fiduciary income tax principles so that the trust will thereafter pay its own income tax.
(2) Grant an independent trustee discretion to reimburse the grantor for income taxes and hope that the IRS will not be successful in its likely argument that a pre-arranged deal exists or was evident from a pattern of conduct under Section 2036.

(3) Advise the client that these trusts are best suited for individuals who have so much income and wealth that the potential for payment of income tax is not a concern. (In this respect, an IDGT is like dating Uma Thurman or

George Clooney. If you lack confidence, don't seek the date.)

(4) Rather than creating an IDGT, wait until a parent dies and make a direct sale by the surviving parent to the loved ones when the gifted property has received a step-up in basis. This will minimize or eliminate the need for an IDGT from the standpoint of recognition avoidance on sale because there is little or no gain. The trust could then be structured as a standard trust. This strategy benefits the younger generation when the cash flow on the asset sold is greater than the payment required on the promissory note, while enabling the grantor/seller to not have to pay income tax on income that others receive.

IDGTs thread the eye of the needle… the gap between the potential benefit of wealth and income shifting to loved ones with a power that is broad enough to achieve the desired tax result, without running afoul of the gross estate rules that would doom the trust to inclusion in the decedent's estate under Code Sections 2036 or 2038. Estate planners must assess the suitability of their client for this level of planning.

PURPOSE AND BACKGROUND OF IDGTs

An IDGT is generally designed to remove its assets from the gross estate of the grantor for estate tax purposes while having its income taxed to the grantor (i.e., a grantor trust). The trust is "defective" because grantor income tax rules apply to the trust yet the trust is outside of the grantor's estate for estate tax purposes.

As discussed below, the law distinguishes between defects that apply to income and those that apply to corpus transactions (such as sales or other capital gain events). If the trust is defective only as to its income, the grantor will be income taxed on the income, but gains on sales or exchanges or other events of a principal nature will be taxed to the trust under normal fiduciary income tax rules. Such a trust would not be fully defective.

IDGTs have long been popular in the following planning contexts(1) life insurance trust; (2) wealth shifting and other benefits not available, or available to a lesser extent, with a Grantor Retained Annuity Trust ("GRAT"); (3) avoidance of the Estate Tax Inclusion Period ("ETIP") rules when the trust has skip persons as beneficiaries; (4) an entity to which the grantor can sell an asset with the ability to avoid the current recognition of gain; (5) ownership of S Corporation stock; (6) pass-through of tax incidents with partnerships; (7) deduction of interest and property taxes; and (8) net operating losses on the grantor's income tax return rather than on the trust's Form 1041.

Rev. Rul. 2004-64 provides significant planning security for planners and their clients in the handling of the income tax payment while providing additional estate and gift tax savings in the process.

SUITABILITY TESTING NECESSARY

IDGTs provide a general risk to clients because they are not blessed by any statute. They owe their existence to IRS rulings and case law. As a result, they may be eliminated by an act of Congress or a change in IRS position. As a consequence, they are not for clients who are risk adverse regarding estate planning.

Moreover, IDGTs are more suited for the most wealthy of clients (i.e., those who can afford to make an irrevocable gift or sale and, generally, pay the income tax on income they are not receiving).

From my experience, IDGTs, outside of the life insurance trust context, tend not to be attractive or suitable for clients with estates under $15 million. In addition, IDGT planning necessitates that the client to make an estate planning investment that will be considerably greater than is typical of basic estate planning, living trusts, and GRATs.

While IDGTs rely on their existence from case law and rulings, Rev. Rul. 2004-64 reflects a trend that supports such planning. IDGTs also received an implied boost from the 2001 Tax Act. That Act amended Code § 2511(c) to read as follows after December 31, 2009

"(c) Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." (Emphasis added.)

This section was enacted as a protection against the use of trusts as a means of avoiding income tax, by requiring grantor trust treatment. It reflects a recognition of defective trusts, albeit after the year 2009, as a legitimate tax-planning tool. Following the enactment of the 2001 Tax Act, the author spoke with Elizabeth Paris of the Senate Finance Committee Staff regarding the above language and was informed that it could be read as implied support for IDGTs.

HOW TO MAKE A TRUST DEFECTIVE

Defective trusts can be treated as grantor trusts as to income or gains/losses on sales and exchange, or as to both ordinary income and sales or exchanges. (See, generally BNA Folio 858-2nd, Grantor Trusts Sections 671-679, Section XIII) The Service will no longer rule on whether or not a trust is defective. (Rev. Proc. 96 3, Section 5.21, 1997 1 I.R.B. 84.)

The following is brief list of powers that may make a trust defective, as to income and/or gains/losses

1. Premium Payment Power.

Code §677(a)(3) provides that the grantor is taxable as the owner of any trust or trust portion as to which the grantor or a non-adverse person (or both) may apply trust income to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. On the other hand, this power to pay the premiums and/or the actual payment of premiums does not of itself result in the inclusion of the proceeds in the insured grantor's gross estate. (See, PLRs 8118051 and 8126047.) NOTEAs discussed below, this power alone would likely not be sufficient to cause the trust as a whole to be treated as a grantor trust.

PLR 8126047 allows the entire trust, both as to income and principal to be treated as a grantor trust when the trustee may pay the premiums on the policy of insurance on the grantor's life first from the net income of the trust and then from the principal. The trust also provided that if these amounts are insufficient to pay the premiums, the trustee will notify the grantor and the grantor may make additional contributions to the trust. In addition, the trustee could borrow against the insurance policies and apply the loan to pay the premiums due.

Decades-old cases construing pre-Code §677 law concluded that only that portion of the trust with respect to which the income was actually needed to pay premiums would be treated as a grantor trust, not all of the income of the trust even if all of the income could be used for that purpose. (Iversen v. Comr., 3 T.C. 756 (1944); Weil v. Comr., 3 T.C. 579 (1944), acq., 1944 C.B. 29.) This older approach was not discussed or followed in PLR 8118051, under which the trust document recognized that net income may exist in excess of the amount used to pay life insurance premiums. That private ruling also treated the entire trust as a grantor trust even though the trust only referenced the use of income to pay premiums.

Warning With the caveat noted, an irrevocable life insurance trust under which income and principal may be used to pay premiums should be treated a fully defective. However, this power may not be sufficiently broad if the trust does not include life insurance.

2. Nonadverse Trustee's Sprinkling Power

Code §674 provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
The grantor should be careful not to directly or indirectly control the decisions of the trustee (or run the risk of inclusion under Code §2036 or §2038). For this reason, caution would limit this power to income. However, this would allow the net trust income, but not gains, to be income taxed to the grantor. PLR 8103074 treated the entire trust as a grantor trust under this nonadverse sprinkling power. That ruling also treated the trust as a grantor trust under the premium application noted in approach 1, above.

3. Nonadverse Trustee's Power to Add Beneficiaries

Under Code §674(b)(5) and (6), a grantor is treated as the owner of the trust for income tax purposes if a nonadverse trustee has the power to add persons other than after born or after adopted children as trust beneficiaries, in addition to having discretion to distribute trust income and principal. These powers would appear to make the entire trust defective as to income and sales events.

In PLR 200030018, the grantor included a power to add charitable beneficiaries exercisable by an independent trustee to qualify a charitable remainder trust as an S corporation shareholder. Grantors should consider their comfort zone with allowing a third party to add beneficiaries to the trust. Assuming no control or pre-existing agreement between the grantor and the non-adverse trustee regarding the exercise or non-exercise of the power, the power under this exception should not cause estate tax inclusion while allowing the trust as a whole to qualify as a grantor trust for income tax purposes. This approach has been considered the safest in the course of avoiding estate tax inclusion while having the entire trust treated as defective. (See Louis Mezzullo, Installment Sales to Grantor Trusts, ABA Tax Section, Mid-Year, 2000, San Diego, Ca.)

4. Payment of Trust Income to the Grantor's Spouse

Code §677(a)(1) imposes grantor status if a non-adverse trustee may pay trust income to (or expend it for the benefit of) the grantor's spouse. Under this approach, the grantor trust status should end on the death of the spouse. (See PLR9321050.)
Caution should also be added that the payment to a spouse can discharge a support obligation of the grantor. The trust would need to exclude such use. However, consider if community property is being used whether such an exclusion(1) would be lawful, (2) would violate fiduciary duties of the grantor, and (3) would cause the spouse to be treated as the transferor as to one-half, in any event. This defect would likely run to the income of the trust, not its capital gain events.

5. Payment of Discretionary Income to the Grantor or the Grantor's Spouse

Code §677(a)(1) directs grantor trust treatment in the event a non-adverse trustee may pay all of the trust income to the grantor, whether or not payments are actually made. While this power alone would not compel estate tax inclusion under Code §§2036 or 2038, a substantial risk is run of an adverse conclusion on this issue, whether as a result of implied agreement, or the rights of the grantor's creditors. (See Rev. Rul. 76 103, 1976 1 C.B. 293.) In addition, this defect would likely run to the income of the trust, not its capital gain events.

6. Right to Substitute Assets

Code §675(4) imposes grantor status in the event there exists the retention of the right, exercisable in a non-fiduciary capacity, to reacquire trust assets by substituting assets of equivalent value. This power, along with the power of a non-adverse trustee to add beneficiaries (approach 3), may be the least risky approach to achieve grantor-trust status without estate tax inclusion with a non-life insurance trust. If a life insurance policy is a part of the trust assets, caution must be inserted to prevent the grantor from acquiring the policy. This could give the grantor an incident of ownership. The allowance for the "grantor" to acquire the policy should be limited to another grantor trust.

This approach also raises issues as to whether or not the power to substitute assets is held in a non-fiduciary capacity. If the grantor is the trustee, special attention must be paid to avoiding fiduciary duties imposed or implied by state law. (See California Probate Code Sec. 16081) . Rev. Rul. 2004-64 further alerts practitioners to duties imposed by state law in view of its reference as to whether or not the fiduciary has a state-law duty to reimburse the grantor for income taxes relative to Section 2036 inclusion.

In Jordahl Est. v. Comr., (65 T.C. 92 (1975), acq., 1977 1 C.B. 1.) the court determined that estate tax inclusion did not arise when the grantor, in a fiduciary capacity (trustee), had the power to substitute assets of equal value, and that this power was not an incident of ownership. Jordahl was considered and this rule favorably applied in PLR 9413045, wherein the Service ruled that no estate tax inclusion would result merely because of the retention of a right to substitute assets at equal value.

SPECIAL POPULARITY WITH LIFE INSURANCE TRUSTS

While IDGTs may be used in a variety of settings, they have received extensive use with life insurance trusts. This has resulted, in part, to avoid the transfer for value rule under Code §101(a)(1) in the event that the policy must be transferred. The irrevocability of an IDGT is drawback. While amendments may be possible with a court order, or flexibility infused with a trust protector, a variety of unknowns can develop though the years, when beneficiaries mature or regress to immaturity. Can the trustee of an irrevocable life insurance trust transfer the life insurance to another trust without incurring the adverse effects of the transfer for value rule? Yes, if the transferring trust is "defective." (Swanson v. Comr. 75-02 USTC Par.9528 (8th Cir. 1975).

INSTALLMENT SALES BETWEEN A GRANTOR AND A DEFECTIVE TRUST

As indicated in the initial illustration in this article, an IDGT may be used to transfer growth and/or cash flow to loved ones. In this respect, it can be compared to a Grantor Retained Annuity Trust (GRAT). The GRAT provides cash flow to the trust remainder beneficiaries when the cash flow exceeds the annuity payment. The IDGT functions similarly, comparing the investment cash flow to the note payment.

Under this strategy, a sale is made by the grantor (or a GRAT) to the IDGT resulting in no recognition of gain while the trust is in grantor-trust status. (Rev. Rul. 85-13, 1985-1 C.B. 184; PLR 9535026.) The grantor would hold only a promissory note. As part of this planning, a GRAT may also be used. In that situation, the GRAT would receive the promissory note. However, the GRAT would remain subject to GRAT rules and the other implications of a GRAT discussed below.

If a GRAT is used in conjunction with an IDGT, the grantor would contribute growth or high income assets to the GRAT and the GRAT would then sell to the IDGT. Otherwise, the grantor would directly sell the growth or high income assets to the IDGT .

PLR 9535026 provides an excellent roadmap for use of the installment sale, including the use of a long-term balloon payment note, and interest at the applicable federal rate.

ADVANTAGES OF AN IDGT OVER A GRAT

The most immediate choice facing client who desire to implement some form of retained-benefit plan, is whether to utilize a GRAT or an IDGT. The IDGT provides several benefits that can exceed those offered by a GRAT

1. The return to the grantor is based on the applicable federal rate, which is lower than the Section 7520 rate required for a GRAT. (Reg. § 25.2702-2(b)(2) . Moreover, a note bearing interest at the AFR does not create a taxable gift. (Frazee v. Comr. 98 T.C. 554 (1992).) For example, October, 2004, mid-term AFR rate with annual payments was 3.62% while the §7520 rate was 4.4%.

2. A GRAT requires payments that are annuitized, not merely interest only. (Reg. § 25.2702-2(a)(5). This accelerates the return to the grantor over that of an IDGT and puts more money back into his/her estate.

3. A GRAT cannot use a promissory note for the payment of an annuity while the IDGT uses a note to establish the obligation. (Reg. § 25.2702-3(d)(5)). However, even with an IDGT, the tax case may be better served if the trust has some equity in the sale and it is not wholly financed.

While there is no direct case law on this point, concern has been raised that the lack of equity may reflect a thinly capitalized trust which will result in a deemed retained interest by the grantor-seller. (Hesch & Manning, "Beyond the Basic FreezeFurther Uses of Deferred Payment Sales and Avoiding the Meltdown," 34th Annual Philip E. Heckerling Inst. on Est. Plan. ch. 15 (2000); Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 J. Tax'n 152 (Mar. 2000)).

By point of analogy, the purchase of split-interests in trusts of general partnership interests were upheld or found to be retained interests depending upon whether or not the remainderman had independent equity to satisfy the obligation independent of the earnings from the investment. (PLR 9515039) While the cash-flow from the property may be sufficient to sustain the note payment as evidence of its bona fides, the more cautious donor may wish to gift some cash to the trust to fund equity or obtain a beneficiary-guaranty of the liability.

4. The estate tax inclusion period (ETIP) rules do not apply for an IDGT but do apply for a GRAT. (Reg. § 26.2632-1(c)(1).)

5. If the grantor does not survive the retained period with a GRAT, estate tax results to the grantor, which include growth in the value of assets while they were held in the GRAT. The note from an IDGT will ordinarily be included at its fair market value in the estate of the grantor, which would exclude the post-sale appreciation on the asset transferred to the trust in exchange for the note.

ADVANTAGES OF A GRAT OVER AN IDGT

On the other hand
1. a GRAT is blessed by Code Section 2702 and regulations, (Reg. § 25.2702-(3)). whereas an IDGT relies on rulings, which can be revoked, and the interpretation of court cases. (Rev. Ruls. 85-13 and 77-402; Madorin v. Comr., 84 T.C. 667 (1985)).

2. A GRAT is cleaner in its creation because of its regulatory support and presence of fewer areas of legal and accounting interpretation.

The 2004 ruling at the commencement of this article sends a hopeful signal for the future of IDGTs. However, significant review by Congress and the IRS should be anticipated in view of the increased attention that IDGTs are receiving and the variety of issues raised in this article.

The grantor should also be alerted to the fact that in the event gain becomes recognized as a result of the cessation of grantor-trust status, or otherwise, and a sale exists between the grantor and a trust established by the grantor-- and the asset sold is property subject to depreciation, that the gain recognized is ordinary, not capital gain. (Code § 1239).

<<SNIP>>

SUMMARY

The Service has widened the door for the use of IDGTs with its recent ruling, which will likely spawn more interest and use of defective trusts. The issues and uncertainties presented herein and suggested in the materials cited suggest that practitioners and their clients carefully consider the suitability for this strategy. It offers significant tax savings, and its benefits can outlast the repeal of estate tax.

HOPE THIS HELPS YOU HELP OTHERS!

Keith Schiller

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #19 (Wednesday, Cont'd)

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

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This Report contains coverage of the Wednesday morning General Sessions on GST and Questions and Answers and the afternoon Special Sessions on the Practical Issues of Valuing Closely-Held Interests and Funding Trusts with Retirement Assets

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We're Sorry, Your GSTT and Gift Tax Exemptions Have Been Temporarily Disconnected. Please Check the Numbers and Plan Again.
Wednesday Morning, 1/12/05
Presenter: Ellen K. Harrison Esq.

Reporter: Jeffry L. Weiler Esq.

The presentation covered generation skipping transfer tax planning. The gift tax exemption remains fixed at $1,000,000 while the GST exemption follows the increase in the applicable credit amount - $1,500,000 for 2005, $2,000,000 for 2006, 2007, and 2008, $3,500,000 for 2009,. 0 for 2011, and $1,000,000 for 2012, The tax rate follows the estate tax rate. This is 47% for 2005 and 55% for 2012. The credit for gifts is mandatory and must be applied to taxable gifts. It can not be saved for future use.

Use of GST exemption and GST transfers could be deferred until 2010 if there will be repeal. However, if repeal does not occur, postponing the GST transfer could increase the cost of the tax.

The outline summarizes the GST rules.

Application of GST exemption to lifetime transfers was covered. A timely allocation is effective as of the date of the transfer. Requirements for gift tax returns were set forth in the outline and included reporting for transfers to trusts. A late election may be used to eliminate GST exposure for a trust with an inclusion ratio more than zero. To have a late election, the automatic application of the GST exemption must be avoided. A late election may be appropriate if the value of the trust assets subject to GST have decreased. A late election may be made any time on or before the estate tax return is filed. To make a late election will require filing two Forms 709, one timely to elect out of automatic application of the GST exemption and a later return to apply the exemption.

If a late election to a trust is made for the same year that a timely allocation is made to the same trust, a complex computation arises. The fraction is to be redetermined under Reg Sect . 26.2642-4.

In regard to ETIPs, an election to apply exemption may be made before the close of the ETIP but it does not become effective until the close of the ETIP. The amount of exemption to have a zero inclusion ration is determined at the end of the ETIP. No gift is made at the close of the ETIP. This results in use of GST exemption at the close of the ETIP but no additional -application of the gift tax exemption.

A transfer to a skip person will produce a GST tax unless the GST exemption is available to offset the value transferred. The IRC assumes that persons do not want to pay GST and there is an automatic application of GST exemption to such transfers. If a person does not want the automatic application of exemption to apply, then the person must elect out of the automatic application of GST exemption. The rule applies to gift to trusts.
It is unwise to rely on the automatic exemption rules for gifts to trusts.
The automatic exemption rules could result in some exemption being wasted and may not result in an allocation to a trust where an allocation is appropriate (Crummey trusts with hanging powers).

Prop Regs were issued on July 13, 2004 for electing out of the automatic allocation – Prop Reg Sect 26.2632-1(b)(2). In regard to ETIPs, the election out is made at the end of the ETIP and it is unclear if the election out can be made in the year of the gift. To election out, there must be a statement attached to the return AND a box checked. Warning:
check the box.

EGTRRA provides for 9100 relief for late elections. IRS responded by issuing Notice 2001-50. On August 2, 2004 Rev Proc 2004-46 was issued to provide a simplified procedure for obtaining an extension of time to make a GST election. Rev Proc 2004-47 deals with a late reverse QTIP election.

IRC Sect. 2632 (d) permits a retroactive election where there has been an unnatural order of death. It is to be made on a timely filed gift tax return for the year of the non skip person's death.

The power to allocate GST exemption to a trust affects the beneficial enjoyment. The speaker states that the trust instrument should require the trustee to hold in a separate trust property entirely exempt from GST.

Where there is transfer tax concern about a beneficiary of the trust acting in a fiduciary position with the power to take certain action, use of an independent trust protector was recommended to take tax sensitive action. In Will, executor should be directed to apply exemption (or independent person could be appointed by executor if there is concern about the exercise being transfer tax sensitive). A grantor's power to allocate GST exemption to the trust and have the beneficial enjoyment altered causes concern. If the dispositive provisions of the exempt and non exempt trusts are the same, then the issue should not exist. Giving the trustee discretion to adjust trust shares for GST allocation rather than requiring it would eliminate the grantor's power to affect beneficial enjoyment.

Techniques for minimizing GST tax without incurring a gift tax were discussed.

One technique is funding a lifetime reverse QTIP. There can be no partial QTIP election with this approach. Spousal ETIP rules do not apply – Reg 26.2632-1(2)(ii)(C). There is no addition when the estate tax attributable to the QTIP trust is paid from another source. This permits preserving the exempt QTIP property. The QTIP will be grantor trust during the grantor's lifetime under Sect 677. To have capital gain taxable to the grantor, the trustee could be given the power to invade principal for the spouse. If grantor dies before the spouse, grantor trust status is lost unless action is taken. The trust assets could be invested in an S Corp with a trust QSST election which results in the surviving spouse QTIP beneficiary being tax under Sect 678 (e) without changing the identity of the transferor for GST purposes.

Qualified severances were reviewed. The outline enumerates 6 requirements for a qualified severance. A qualified severance can be helpful at the end of a ETIP. Under Sect 645 a trust and an estate are combined and the separate share rule does not apply.

The ETIP rules preclude applying exemption to GRATs and QPRTs. The speaker suggest that remainder beneficiaries could sell for fmv their remainder interests to skip persons (sale of remainder interest by child to grandchild). However, the IRS may challenge this approach.

Annual exclusion rules and Crummey trust were discussed. The lapse of the withdrawal right may not be a taxable gift but it is still a generation skipping transfer unless certain requirements are met. It may be appropriate for the donor to allocate GST exemption to the gift. Cascading Crummey powers were explained. This technique shifts the transferor down a generation when there is a lapse of the Crummey power.

The gift splitting rules under Sect 2513 for gift tax differ from the gift splitting rules under Sect 2652 (a) for GST. Under gift tax rules, there can not be gift splitting for gifts to a spouse. With respect to gifts to a trust, it may be possible if the spouse's interest may be severed from other interest. Under the GST rules, one half of the gift is deemed to be by the spouse regardless of an interest of the other spouse.

Adoption rules are found in Prop Reg 26.2651-2. A person adopted before age 18 can qualify as a child for GST purposes. To avoid certain legal obligations of having the person concerned a child, the adoption could be timed to occur shortly before the person becomes 18.

Ways to avoid a GST transfer were provided: payment of tuition and health care expenses, making trust owned personal use assets (such as a residence) available for use.

The phase out and restoration of GST causes complications. The generation move down rule application is uncertain.

Conclusion: allow broad amendment power to an independent trust to person solving future problems.

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Question and Answer Session
Wednesday Morning, 1/12/05
Presenters:
Jonathan G. Blattmachr Esq.("Jonathan") Steve R. Akers Esq. ("Steve") Pam H. Schneider Esq. ("Pam") Catherine V. Hughes Esq. ("Cathy" from Treas Dept.).

Reporter: Jeffry L. Weiler Esq.

Cathy: Has no prediction on repeal. The Pres. Appointed the panel to make recommendations for tax reform. The report is due ASAP and not later than July, 2005. Legislative developments:2004 income tax deduction for Jan 2005 gifts for Tsunami relief, 15% tax on qualified dividends, Sect 529 changes in beneficiary at lower generations, 9100 relief for QDOT's tied to Sect 2032 9100 relief.

Jonathan: rent free use of trust property by beneficiary should not be income. Cash loan to beneficiaries are uncertain since there is no authority for treating them as income tax free (Sect 1274 and 7872 can apply). Claims on installment sale to an intentionally defective grantor trust, there should be no taxable income on death citing Frane case. Also, he claims there will be a basis step up based on a careful reading of Sect 1014 (b). Right to reacquire trust property in Sect 675 (4)(C) could be read to apply only to grantor and not to a third party. He believes it should apply to a third party also. However watch out for

inclusion in gross estate where grantor can reacquire life insurance and voting stock in a closely held corporation. In regard to reacquisition and inclusion in the gross estate, Sect 675 requires the right to be in a non fiduciary policy.
The case relied on for no inclusion, Jordahl involved a fiduciary power. To avoid high state taxes suggests: change domicile, put assets into low tax state, use S Corp. To avoid additional state estate tax use a QTIP. To avoid state estate tax, convert assets to tangible property (gold, silver) and move assets out of high tax state.

Bruce: FLP/LLC cases. To bullet proof, have donor transfer G/P interest to spouse so donor has no rights at death. To avoid 2035 three year rule, have transfer be a fmv sale. Amend partnership agreement to take away restrictive rights (increase value of interests) and have donor's child cash out child's interest (to shift value to child). Liquidate partnership to avoid 2036(a)(2) but application of 2035 is uncertain. Some say Judge Cohen in Strangi just is wrong.

Jonathan: Could get partnership/llc case into CA 5 (Tex and La) for better precedents by having one of the co executors in Tex or La. even if the decedent is domicile outside CA 5.

Pam: Cir 230 and the team approach to estate planning causes problems. One exception to application of rules is reliance on the opinion of others.
However, use of this exception will involve practical problems. Use of vacation property by grandchild and application of GST rules – no authority. Could state in trust agreement that the child can use the residence and the grandchild would tag along.

Cathy: Basis step up is available at death even if no estate tax return is required to be filed. Merely filing a non required return will not assure basis step up. Jonathan: get an appraisal to substantiate fmv at death.

Jonathan: Walton and GRATs. Have greater of annuity or fiduciary accounting income paid to estate if grantor dies.

Jonathan: Getting capital gain into DNI when state law and the trust are silent. Regs permit an invasion of corpus and trustee to deem it to carry out capital gain. Kathy: election under Reg is by asset class and not by individual assets.

Jonathan: Attempting to reduce estate tax at death of surviving spouse with QTIP. Sale of assets will be taxable to QTIP if built in gain. Having QTIP invest in FLP: Steve – concern with trustee's fiduciary duty to manage and invest properly, and concern with IRC Section 2519 gift of remainder.

Steve: Should be decision from court of appeals any day. To fix value suggests formula disclaimer or use of GRAT with formula value.

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Special Sessions I-B and II–B - Valuation of Closely Held InterestsPractical Issues Wednesday Afternoon, 1/12/05
Presenters:
John W. Porter Esq. ("John")
Alex W. Howard ("Alex") of Howard, Frazier, Barker Elliottl, Inc.

Reporter: Jeffry L. Weiler Esq.

Alex discussed appraisal items and John covered other areas.

IRS is putting three cases, McCord, Lappol, and Peracchio into a matrix, seeing where your case fits, and telling you what the discount will be. You must distinguish your case from these three cases and reject IRS matrix approach. IRS is ignoring cases that are favorable to taxpayer when focusing only on these three cases – see Dailey with 40% - 50% discount.

John: IRS appraiser was successful in convincing the Tax Court to slice and dice entity assets in McCord to get a low discount. There are flaws in the IRS appraiser's study.

John: In valuation testimony, the credibility of the expert witness is critical. Look at: credentials, testimony history in prior cases, experience with the type of asset involved, quality of past written reports. At trial the expert's report goes in on direct without testimony and then the IRS cross examines. The report must be good!

John: Consider asking appraiser who appraiser would not want to be against him, then have these person review the appraisal report and provide a critique of it. This prevents the IRS from using these persons.

John: Noble case. Problem with co authors of an appraisal report. Both co authors may be required to testify. Also, expert testifying must be able to vouch for everything in the written report.

John: Marketability discounts have been allow by the Tax Court in the 21% to 25% range in recent cases.

Alex: Key to value is rate of return and cash flow.

John: IRS says no tiered discounts citing Royal Martin but in this case the Tax Court allowed a 75% discount and the incremental discount under the tiered approach would be relatively small.

Alex: Corporations with built in gain. Negotiating point: if the is a liquidation approach must consider taxes payable. In business deals, much negotiation over the tax burden, basis step up for future depreciation, etc.

John: S Corps and tax effecting. Gross case and Adams Case. These case did not tax effect income. Alex: thinks government witness was correct. Need to look at market driven realities but IRS manual states should be tax effecting for flow through entities.

Alex: In real world it makes a difference to whom the S Corp is being sold – a corp strategic buyer or an individual. John: For tax valuations, can not consider the nature of a specific buyer.

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Special Session I-C - Funding Trusts in the Crossfire of Conflicting Estate, Tax, Income Tax and ERISA Laws Wednesday Afternoon, January 12, 2005
Presenter: Prof. Christopher R. Hoyt

Reporter: Jeffry L. Weiler, Esq.

Professor Hoyt began the afternoon Special Session with a review of the types of retirement plans:

Section 401(a), Section 408 IRA's, and Sections
403 (b) and 457(b) for charities and government employees. He observed that at death the retirement plan death benefits are subject to the worst tax
treatment- combined estate and income taxes up to 80% leaving only 20% for beneficiaries. For income tax deferral, he noted the availability of a non-deductible IRA if taxpayer can qualify – not covered by a plan at work, and limited adjusted gross income. However, as noted below he does not recommend use of a non deductible IRA. He strongly recommended use of a Roth IRA for favorable income tax treatment – after 5 years distributions are income tax exempt if – used for first home (max $10,000), after age 59 ½, or to a successor beneficiary after account owner's death. Deductible IRA can be transferred to Roth IRA if AGI for the year is $100,000 or less.
Amount transferred is included in income for the year of transfer but is exempt from the early withdrawal tax. No payments allocable to the transferred amounts can be qualified distributions unless they are made more than 5 years after the transfer. The conversion from a regular IRA to a Roth IRA can reduce estate taxes – assets are used to pay the income tax liability on the transfer which reduces the assets subject to estate tax, plus the heirs will receive income tax exempt income.

Schedules were presented in the outline that compared the savings for retirement with no IRA, deductible IRA, non deductible IRA, or Roth IRA.
The income tax free compounding inside the IRA provided much more funds for retirement than conventional savings. He does not recommend use of a non deductible IRA. It converts what would qualify for capital gain to ordinary income. A Roth IRA is a great technique for a low income taxpayer such as a college student who will be in a higher tax bracket later.

The rules for minimum required distributions ("MRD") were reviewed. The
2002 rules permit naming a charity as a beneficiary of an account without adverse income tax consequences as long as the charity is cashed out before 9/30 of the year following death of the account owner. A common strategy is to withdraw only the smallest amount necessary to avoid the 50% penalty.
The calculation of the required lifetime distributions has been simplified through use of a uniform lifetime distribution table in the regs. People will be dying with large account balances due to the new table.

The rules for required distributions after death were reviewed. The objective is to have a designed beneficiary (which qualifies for income tax deferral of assets in the retirement plan account of the decedent). If any beneficiaries do not qualify, they must be "cashed out" by Sept 30 of the year following the year of death of the account owner. Ways to eliminate a non qualifying beneficiary in addition to cashing out the beneficiary include disclaimer and establish a separate account for different beneficiaries so that qualify beneficiaries will not be adversely impacted by non qualifying beneficiaries.

In regard to a charity as a beneficiary of retirement plan death benefits, he observed that the payment could be to a donor advised fund so that family members could have some participation. The beneficiary designation form can specify how payments will be made to the beneficiary. A customized IRA could be used for special provisions not found in the standard forms – such as a spendthrift clause.

A chart was provided in the outline indicating the MRD rules for the type of beneficiary, death before required beginning date, and death after required beginning date. He suggested establishing separate accounts after the account owner's death to permit more favorable income tax treatment. If a surviving spouse is the beneficiary; he observes that a rollover to an IRA of the surviving spouse normally provides the best income tax results. A surviving spouse can leave assets in the decedent's IRA and elect to have it treated as a rollover IRA.

The rules for having retirement plan death benefits paid to a trust were reviewed. If the rules are met for a look through of the trust for a qualifying designated beneficiary and there are multiple beneficiaries, the age of the oldest beneficiary is used for calculations of the MRD's. Several pages of the outline summarize private letter rulings that address problems of funding trust with retirement plan assets. Remote beneficiaries are considered. Having a charity remainder beneficiary is a problem. Potential solutions for problem contingent beneficiaries include using a conduit trust, and PLR 200235038 – adding a restriction that no retirement plan assets can go to a beneficiary older than the primary beneficiary. Also, retirement plan assets may be used for administrative expenses and taxes up to Sept 29 following the year of death of the account owner and on or after Sept 30 payments can be made only to designated beneficiaries. More liberal rulings were PLR 200432027 – 200432029.

There are situations when deferring distributions does not make sense. One is where a person has an inherited IRA and is a participant in a qualified plan through his employer. He uses his employment income to fully fund his
401(k) account and uses the IRA for living expenses. An investor with an inherited IRA and using income from bonds for living expenses wants to invest in growth stocks. The bonds are sold and invested in growth stocks (cutting back on income for living expenses) and withdrawals are taken from the IRA for living expenses.

If there a desire to have retirement plan death benefits paid to a charity upon death, have the payment directly from the retirement plan to the charity and not to the estate and then to the charity.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #20 (Thur. and Fri - Final)

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

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This Report contains coverage of the Thursday afternoon Special Session involving Implementing Total Return Trusts and the final Friday morning General Session entitled Wrapping It Up.

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SOME ANNOUNCEMENTS:

This will be our last Report for the 2005 Institute. While we were unable to cover and report on every session as we had hoped in the beginning due to the limitation on the number of reporters we could have and the fact that on both Wednesday and Thursday afternoons there was a Fundamentals session running all afternoon concurrently with 14 different break out Special Sessions, a review of the sessions that were covered and reported on by us indicates we were fairly successful in accomplishing our mission again this year. Also, we normally would have ended these Reports before now, but this year we had a four-day e-mail crash that put a real wrench in our usual distribution and publishing process.

At this time, as your Editor again this year, I want to take this occasion to publicly thank all seven of our reporters for a job well done, especially considering that all but two of them had never been reporters for us before. They were loyal and dedicated to the task at hand in spite of some of the later evening and early morning hours they had to put in so their reports could be prepared and submitted in a timely fashion. Maybe by next year the Fontainebleau hotel will have installed high speed lines in all the sleeping rooms, making our job all that much easier.

And now for the last of our Reports for 2005..................

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Special Session IV-F - Implementing Total Return Trusts: Solving Three Variable Problems When You're Bad at Math (Part of the financial planning program series) Thursday Afternoon, January 13, 2005 at Wyndham Hotel

Presenter: Paul S. Lee of Bernstein Investment Research & Management

Reporter: Jeffry L. Weiler Esq.

The decline in interest rates and dividend yields makes it difficult to provide sufficient income to current income beneficiaries when the Trustee is limited to distributing fiduciary accounting income. States have enacted legislation that allow fiduciaries to invest for the highest total return but not hurt the current beneficiary in the process. These trusts are referred to a "Total Return Trusts". Implementation of these trusts requires an understanding of modern portfolio theory as well as tax and trust law. This speaker's presentation defines Total Return Trusts, reviews legislation and regulations, quantifies the decision making process and provides guidelines and a methodology for drafting and implementing Total Return Trusts.

A Total Return standard for investment performance encourages investors to seek the highest overall return without being restricted by how that return is created. This type of investing creates a conflict in traditional trusts between the income and remainder beneficiaries. A Total Return Trust allows the fiduciary to invest for Total Return and permits an adjustment of the amount to be distributed to the current beneficiary without regard to whether the source of the distribution (dividends, interest, capital gain, etc).

Framework for implementation involves solving a three variable problem:
* What is the appropriate investment strategy for the trust?
* What should the appropriate distribution policy for the trust be?
* What portion of the income taxes should be paid by the trust and by the current beneficiary?
The outline reviews the investment strategy under the provisions of the Uniform Prudent Investor Act including the duties of the trustee and circumstances and conditions the trustee should consider in making investment decisions. The primary consideration of the fiduciary is finding the appropriate risk and return tradeoff given the objectives of the trust.
Diversification of the investments is required (unless the fiduciary is relieved of this obligation). The applicable circumstances must be considered.

Applicable state law may allow the fiduciary to make equitable adjustments between principal and income. In exercising the power, the fiduciary should consider the nature, purpose, and expected duration of the trust; intent of the settler; identify and circumstances of the beneficiaries; needs for liquidity, regularity of income and preservation and appreciation of capital; assets in the trust; actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; anticipated tax consequences of an adjustment.

States have adopted three versions of distributions polices: only equitable adjustment power; dual approach – equitable adjustment power and option to convert of a unitrust; only conversion to a unitrust.

US Treas Regs under 643 (b) deals with the computation of distributable net income. Generally capital gain is excluded from DNI and is taxable to the trust rather than to the beneficiary receiving distributions. However, exceptions are provided in the Regs.

The current financial planning tools are not limited to historical averages and take into account the alternative returns and as well as the random and unpredictable nature of the markets. It is called stochastic or probabilistic modeling – Monte Carlo modeling. Frequently 10,000 simulated markets are produced to study possible outcomes.

Distribution policies:

An annuity permits the current beneficiary to avoid downside risk of a falling market. The portfolio risk is shifted to the remainder beneficiary.
A unitrust approach allows the fiduciary to invest for total return and eliminate the conflict between the current beneficiary and the remainder beneficiary. Studies indicate a 4% unitrust has an equal probability of maintaining the initial distribution over 10 and 30 years with a 60/40 stock/bond portfolio. However, due to market volatility the unitrust amount will go up and down. Smoothing rules will make the unitrust payments more uniform (reduce volatility). This is accomplished by calculating the unitrust distribution using a three year average of assets value. Another distribution approach is the greater of an annuity and a unitrust which can be favorable to the current beneficiary. Another approach is a collared unitrust which has fixed minimums (floors) and maximum (ceiling).

In regard to taxation, the allocation of tax by the fiduciary does not affect the trust assets but does have an impact on what is received by the current beneficiary and the remainder beneficiary.

The fiduciary must follow a process concerning trust investment policy. The process protects the fiduciary and is more important that the investment performance. The outline includes a sample total return investment policy statement.

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Wrapping It Up - a case study
Friday Morning - The Finale
Presenter: Louis A. Mezzullo

Reporter: Eugene Zuspann Esq.

Lou offered up an extensive fact situation. It addressed many of the issues included in the institute this week. Many of the topics apply to the fact situation.

Parents (Harry and Wilma) have 4 children David, Son, married, has 4 children. Joan, married and has children from a prior marriage.
Missy - gay, living in San Fran and has a partner. Ed, married, no children. Harry has a very successful defense software business in VA. The company is an S-Corp. They have always lived in VA, except for 10 years working for a company in CA. They have 3 residences (total value $2,500,000) in joint tenancy. Each separate own $5mm in stocks and bonds valued. Harry owns the S-Corp valued at $75mm. He has guaranteed $30mm of debt for the corp. The business generates $15mm per year in net income.
They have rental real estate valued at $5mm held in joint tenancy. He has a $1mm 401(k) and they each have a $100k IRA. He has life insurance of $2mm with a cash value of $400k and Wilma(Mom) has $750k with cash value of $100k. David, Joan and Joan''s husband are active in the business. Ed is a doctor and his wife, Carol, is a lawyer. Missy is half owner of a restaurant in San Francisco. Harry does have charitable desires. Harry has come in for help planning his estate and providing for the employees of the business. The facts do not mention that Wilma came in with Harry.

Lou started by explaining his practice in this classes about assumptions outside of the fact situations. If necessary facts are missing, the students are expected to make other necessary assumptions to complete the analysis of the estate.

First, who is the client? You need to determine this at the outset. Harry needs to define the scope. If the family gets along and Harry wants to do planning for the children, then Lou would represent the family. However, if something comes up that the family does not agree during the representation, he may have to withdraw from the representation of the entire family. When an in-law is a lawyer, Lou has also found that the person is always looking over his shoulder and ''knows'' all about estate planning. Given this fact, he may not be willing to represent the family.

Lou set out some immediate considerations:

1. Determine potential conflicts and who is the client 2. QPRT''s 3. Liquidity 4. Restructuring issues for the corporation 5. Employee''s financial future 6. Asset protection Next, get a comprehensive list of all assets and liabilities and have the client verify its accuracy. This summary is necessary to do the plan and helps avoid problems later when other assets or liabilities are identified. He has an outline about repeal of the estate tax.

What would attorneys continue to do if the estate tax is repealed?
1 plan for disposition of the clients assets at the client''s death 2. Asset protection planning 3. Planning for disability 4. Business succession planning 5. Planning for marital and other situations 6. Charitable giving 7. Life insurance planning 8. Fiduciary litigation 9. Planning to cope with carry-over basis. Lou feels this will be more complex than planning for the GST tax.
10. Retirement planning
11. Planning for the state death taxes where applicable 12. Planning to avoid gift taxes. The gift tax it will still be applicable for lifetime gifts over $1mm
13 Planning for business for non-tax objectives 14. Planning for children, spendthrift planning 15. Planning for clients with property in more than one state 16. Planning for clients with contacts in more that than one country 17. Planning for non-residents 18. Planning for reinstatement of death taxes; still may want dynasty trusts I missed two more - Lou''s list had 20 items

Only 4 issues would no longer be applicable 1. No planning for the estate tax 2. No using marital deduction planning 3. No planning for charitable gifts for federal estate taxes 4. No gifts at death to avoid death taxes

He discussed the various alternatives to the changes in the estate tax. How will the law change? Will there be a complete repeal? When? Will the repeal be immediate (this would be the easiest) or will it phased in?
Instead of complete repeal, will the exemption just be frozen or increased to some fixed amount? We may also see some reforms that we do not want to see? e.g. Crummey powers

He also raised other non-tax issues and questions that would be relevant after a complete repeal: We will still need to consider one or more trusts for the benefit of the children because one spouse may not need or want to give the other spouse full control of all of the assets. Steve Oshins and Jonathan Blattmachr both stated that almost everything should be left in trust.

Some preliminary ideas on planning the estate for Harry and Wilma 1. Create voting and non-voting stock (90% non-voting and 10% voting). He assumes the premium on the voting stock makes it worth $10mm. Using the
§§2701 subtraction rule, the non-voting stock is worth $65mm.
2. The company is operating company. He concluded that if the appraiser gives a total discount for the minority interest and lack of control, ""I would get another appraiser.""

A. Give one-half of the non-voting stock to Wilma
B. Sell $18mm of non-voting stock to a grantor trust for each of the children involved in the business. This represents $36mm and a 50% discount. (The reporter must have missed because this is not going to total $75mm)
C. Lou would do this without an estate tax because it is good planning for the family and also for the gift tax.
D. Transfer balance of non-voting stock to a zero-ed out GRAT. Use some small gift with a formula clause. Use a 10 year GRAT because he thinks it would work. E. Now have 2 grantor trusts and a GRAT.

3. Transfer marketable securities to a zero-ed out CLAT. The beneficiaries are the other two children.
4. Have children with the interests in the CLAT sell to a GRAT for the benefit of the children. Make sure there is a non-skip person with an interest in the CLAT so that when the term of the CLAT or the GRAT ends, there will not have a taxable termination. You will have to file a gift tax return to start

the statute of limitations on the inclusion ratio.
5. FLP - read the Monday materials discussing the 2036(a) issue.
Lou then discussed the applicability of a number of other programs to this estate plan:

A. You may wish to consider the use of the Inheritor''s Trust if Harry and Wilma''s parents are going to be leaving assets to them. This is for both estate tax protection and for creditor protection if the software company goes down the drain. The trust would be a discretionary trust. He does not agree with Steve Oshins that the UTC good faith standard may cause a problem. Lou believes the good faith standard applied before the UTC.
B. He discussed the issues raised by several other programs - Chris Hoyt using retirement plan assets in Charitable remainder trusts, Mitchell Gans on deference, Dennis Belcher on liquidity and 6166.
C. May want to structure borrowing for any estate tax using a fixed payment arrangement so that the interest is deductible.
D. Could use Carlyn McCaffrey''s idea to buy a call from the GRAT. This makes a whole lot of sense. Make sure that the remaining payments that must go to the spouse so you are not back with the Walton problem. There should not be a merger with the remaining payments gong to the same place as the remaining assets.
E. He discussed most of the other sessions and the possibility of each topic affecting this estate.

THE END......................

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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Report #20A (Bonus Supplement)

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

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This is a Bonus Supplement to Report #20 since another report from the Friday morning session on Money Laundering that was sent to us yesterday did not reach us until after Report #20 had been sent out. In addition, Steve Leimberg of the LISI Newsletter Service has been kind enough to give us permission to publish excepts from the Heckerling 2005 Helpful Hints Memo by Steve Akers of Bessemer Trust Company that is being published in full on the LISI Service today at http://www.leimbergservices.com
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Are You Going to Have to Tell the Government About Your Client?
Friday Morning, 1/14/05
Presenter: Henry Christensen III, Esq.

Reporter: Shelly D. Merritt, Esq.

Mr. Christensen's presentation focused on the rules that many countries have adopted in an effort to combat international money laundering and how these rules may apply to attorneys.

The Financial Action Task Force on Money Laundering ("FATF") is an inter-governmental body which sets standards and develops and promotes policies to combat money laundering and terrorist financing. It currently has 33 members, including among others, the United States, Mexico, the United Kingdom, and the European Commission. The FATF has no legislative or executive authority, but simply makes recommendations for its members to adopt or not adopt as they see fit. The FATF's most important work product is its "Forty Recommendations to Combat Money Laundering." The Forty Recommendations consist of (1) amendments to legal systems to criminalize money laundering, (2) actions to be taken by financial institutions and other businesses and professions to prevent money laundering and terrorist financing, (3) institutional and other measures necessary to combat money laundering, and (4) steps to take for international cooperation.

(1) Changes to Legal Systems. The purpose of the first three Recommendations is to criminalize money laundering in all countries, both members and non-members of the FATF.

(2) Measures to be Taken by Financial Institutions and Others to Prevent Money Laundering. These involve 22 Recommendations dealing with steps to be taken by financial institutions and others, such as lawyers and other intermediaries and gatekeepers, to detect and prevent money laundering. Under these Recommendations, financial institutions are required to undertake customer due diligence measures, including verification of the identity of their customers when opening new business relationships or when undertaking large transactions. In addition, the financial institution is required to know the purpose of a transaction in which it is being asked to participate, and to refuse to participate in a transaction whose purpose the institution does not understand.

Recommendation 12 now applies some of these rules to, among others, lawyers, notaries, other independent legal professionals and accountants when they prepare for or carry out transactions for their clients concerning certain activities such as (i) buying and selling real estate, (ii) organization of contributions for the creation, operation or management of companies, and (iii) the creation, operation or management of legal persons or arrangements, and buying and selling of business entities. These provisions will also apply to most trustees, registered agents, and other professionals engaged in the financial markets.

In addition, Recommendations 13 and 14, which deal with the reporting of suspicious transactions and compliance with the rules, apply to lawyers, notaries, other independent legal professionals and accountants when, on behalf of or for a client, they engage in a financial transactions in relation to the activities described in Recommendation 12 above.

(3) Other Measures to Deter Money Laundering and Terrorist Financing. Recommendations 17 through 20 present a variety of foundation legal provisions to fight money laundering.

(4) Steps to Take for International Cooperation. Recommendations 26 through 32 deal with law enforcement, including the establishment by each country of a financial intelligence unit with which suspicious activity reports are to be filed, selecting which government agencies are to have enforcement authority, and assuring that they have all requisite authority.

It is important to note that none of the Recommendations have been adopted yet in the United States. However, they have been adopted in the European Union and in the United Kingdom. As a result, law firms with offices in countries that have adopted the Recommendations are subject to these rules. Where the Recommendations have been adopted, lawyers will need to obtain third party verification of identifying data on a client as well as knowing what the purpose is of a client transaction with which the lawyer is involved. The rules do not require lawyers to report on suspicious activities of clients if the lawyer is acting only as a lawyer. If the lawyer does more, such as acts as a financial intermediary, the lawyer will be subject to these rules.

The International Money Laundering Abatement and Anti-Terrorist Financing Act under the PATRIOT Act of 2001. Under this section of the PATRIOT Act, the Secretary of Treasury is authorized to designate specific non-U.S. jurisdictions, classes of transactions, financial institutions or types of accounts, as being of "primary money laundering concern" and to require U.S. domestic financial institutions and regulatory agencies to take one or more of five types of special measures. The Act also provides for due diligence requirements for correspondent and private banking accounts, certain foreign banks with correspondence accounts, a prohibition on correspondent accounts with "shell" banks, and maintenance of records relating to correspondent accounts with foreign financial institutions. A key issue is how the Act should apply to persons engaged in the real estate industry since Section 5312(a)(2) of Title 31 of the U.S. Code defining financial institutions, includes "persons involved in real estate closings and settlements." Comments have been filed by the ABA Real Property Section, the Florida State Bar Association Real Property Section, and others in the real estate industry. No action has been taken yet to determine how the Act should apply in this case.

Regulations that are being adopted under 31 U.S.C. Section 5318(h) require every financial institution to have internal policies and rules to combat money laundering. The statute and regulations provide for four minimum requirements: (1) the institution must develop internal policies, procedures and controls to combat money laundering; (2) the institution must designate a compliance officer who has charge of the institution's anti-money laundering efforts; (3) the institution must have an ongoing employee training program to combat money laundering; and (4) the institution must establish an independent audit function to test anti-money laundering programs. With respect to the real estate industry, there is not yet consensus as to who these rules will apply to. For example, will they apply to lenders, title companies, building inspectors, environmental consultants, and lawyers? Treasury has advised that it does not intend any regulations to apply to lawyers unless they "touch money." The question is what does "touch money" mean?

The Act requires that regulations be adopted by Treasury setting forth the minimum standards for financial institutions and their customers regarding the identity of the customer that will apply in connection with the opening of an account at a financial institution. One question is who are the "account parties" for a trust? Mr. Christensen concludes that unless the trust is a grantor trust, the account party of a trust should be the trustee since the trustee owns the trust assets and has the authority to dispose of the assets.

While there are no direct provisions of the USA PATRIOT Act which apply expressly to lawyers, where a lawyer is acting other than as a lawyer, some provisions of the Act are likely to apply. Outside of the PATRIOT Act, Lawyers are required to file Forms 8300 if they receive a transfer on behalf of a client of currency in excess of $10,000. In addition, they are also subject to the Trading with the Enemy Act, the Internations Emergency Economic Powers Act, and various special acts which impose sanctions on trading with certain countries, and persons who are residents in those countries.

It should be noted, that other countries who are members of FATF have adopted similar rules (i.e. the European Union, United Kingdom, and Canada). If the law firm has offices in these countries, it may be subject to some of these rules.

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Leimberg LISI Newsletter Service
Heckerling 2005: Helpful Hints
By Steve R. Akers, Managing Director and Associate Fiduciary Counsel, Bessemer Trust Company

NOTE: Portions edited out for purposes of this Report are denoted by <<SNIP>>.

The 39th Annual Philip E. Heckerling Institute on Estate Planning the week of January 10, 2005 was outstanding. Some of my observations from the week are summarized below. I attribute all the good ideas to other speakers at the conferenceand I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. The summary includes some substantive items that I found interesting and includes a wide variety of interesting and creative planning strategies.

In addition, a more detailed summary of rough notes of some of the presentations is available in a separate document. This more detailed summary also includes some observations from private informal conversations that I had with others throughout the week. Unfortunately, the “rough notes” document is rather long. But if you are interested, you can get much of the benefit of my week at Heckerling by reviewing this document.

1. Prospects of Estate Tax Repeal. Right after the election, administration officials informally said the estate tax would be repealed, and indeed complete repeal might be moved up to 2007. At the least, the repeal would be extended to 2014, and with 5 years of no estate tax, the estate and gift tax division of the IRS would effectively be dismantled and
it would be difficult to reinstate it. However, there are more recent
indications that the estate tax might not be repealed. Current “polls”
indicate that 59 senators (not the 60 required to overcome a Byrd amendment

vote) are in favor of permanent repeal of the estate tax.

2. Using Substitution Power Under Code § 675(4)(C) as a Grantor Trust Trigger.

a. Advantage of Giving Substitution Power to Grantor's Spouse. (1) Avoids an argument by the IRS that the trust assets are includible in the grantor's gross estate under 2036-2038 as a result of the grantor having a substitution power. (2) A substitution power held by third parties raises the question of whether the IRS might at some time argue that it does not qualify as a right to RE-acquire assets, because powers held by the grantor's spouse are treated as also being held by the grantor for purposes of the grantor trust rules. (However, various PLRs [such as PLR 2004 34 012] have approved third party substitution powers as causing grantor trust treatment.)

b. Potential 2036 Inclusion. In a recent ruling request, the grantor had a substitution power in a non-fiduciary capacity under an irrevocable trust agreement. The IRS refused to issue a ruling that the substitution power would not cause inclusion of the trust assets in the grantor's estate under §2036 unless the parties agreed and a court reformed the trust to provide that the substitution power could only be exercised in a fiduciary capacity. (Of course, the substitution power would then no longer trigger the grantor trust rules for income tax purposes.) This is not a situation where the IRS took the position in an actual audit or in litigation that a substitution power in a non-fiduciary capacity triggered section 2036. However, it is a recent example where the IRS refused to give the blessing of a PLR, and might suggest some rethinking by the IRS about this issue.

c. Crummey Withdrawal Powers in Grantor Trusts; Grantor Trust Provisions vs. Section 678 Power. Despite arguments from the literal statutory language (the exception in section 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. However, this issue was raised in the PLR request described above, and the IRS said informally that this issue was "in a state of flux." If it is really important that a trust be a wholly grantor trust as to the grantor, do not use a Crummey withdrawal power.

3. Use Grantor Trusts for Split Purchase Transactions.<<SNIP>>

4. Sale to Grantor Trust.<<SNIP>>

5. Grantor Trust Selling Call Option to Grantor or Grantor's Spouse.<<SNIP>>

6. Grantor Trust Treatment for Grantor's Spouse Following Grantor's Death.<<SNIP>>

7. Miscellaneous FLP Issues.

a. Allegation by IRS that Anticipated Estate Taxes Must be Considered to Avoid §2036. The Bassler case was tried in TX before Judge Thornton. The decedent contributed $35m to the FLP and kept $6m for living expenses. IRS argued that she needed to retain assets to live on AND to pay estate taxes in order to avoid § 2036(a)(1). The IRS wanted to introduce into evidence a cash flow summary including estate taxes (which the court did not allow to be introduced into evidence). (The case was settled after trial.)

b. Section 2036(a)(2) Not Being Argued Where Decedent Only Retained Limited Partnership Interest. In disturbing language, Judge Cohen in the Strangi case intimated that even the right to vote on liquidation as a limited partner would be a retained right to designate under §2036(a)(2), because the limited partner can vote "in conjunction with" others to liquidate. However, the IRS is not alleging in audits that retaining a small limited partnership interest triggers §2036(a)(2).

8. Income Tax Issues Regarding FLPs.

a. Mandated §754 Election. The 2004 Jobs Creation Act provides that the §754 election is mandated at the death of a partner if the partnership holds assets with a built-in loss of over $250,000 (i.e., if the partnership's adjusted basis in the partnership property exceeds the property's fair market value by more than $250,000), unless the partnership is an "electing investment partnership" (examples would be venture capital funds or fund of funds in which 95% of the investments are made in cash pursuant to a private offering). This is NOT triggered by the step down of a deceased partner's basis in his or her partnership interest as a result of valuation discounts.

b. Basis Transfer Upon Transferring Interest in FLP. If a partner transfers part of his or her entire interest, only a part of his or her basis is transferredbased on the fair market values of the partnership interests, not liquidation values. So if a parent transfers a 20% interest to a child, with discounts, less than 20% of parents' basis passes to the child.

c. Income Tax Effects of Liquidation.

(1) If Sell Assets and Distribute Cash. If the partnership sells assets, the gain passes through to partners. If there is built-in gain at the time of contribution, the built-in gain from specific assets must be allocated to contributing partners (or their successors), then there is a distribution of cash. If the distribution of cash to a partner exceeds the outside basis of that partner, the excess is capital gain.

(2) If In Kind Distribution of Assets.

(i) Distribute Asset to Another Partner Within 7 YearsGain to Contributing Partner. If a partner contributes built-in gain or loss property, and within 7 yrs the partnership distributes the asset to another partner, the contributing partner must recognize the gain or loss.
§704(c)(1)(b). For purposes of this rule, a successor in interest inherits this potential liability. So if H gives a partnership interest to his son, the son picks up liability for gain under this section if the asset is later distributed from the partnership to some other partner. If an asset is going to be distributed to someone other than the contributing partner (or his successor in interest), generally wait 7 years before the distribution.

(ii) Distribute Different Asset to Contributing Partner Within 7
YearsContributing Partner Recognizes Built-In Gain. If a partner
contributes built-in gain assets, and the partnership within 7 yrs distributes any non-cash property back to the partner other than the contributed asset, then the contributing partner realizes the built-in gain
on the contributed asset. §737. This is a disguised sale rule. The
contributing partner is treated as effectively selling the originally contributed property. There is also a contributing partner exception to this rule--if the built-in gain asset goes back to contributing partner. However, there is not an explicit successor in interest rule like there is under § 704(c)(1)(b).

(3) Distribution of Marketable Securities. A distribution of marketable securities is treated as a

distribution of cash. §731(c). A seven-year wait does not help with this rule. There are several exceptions to this rule, including (i) a contributing partner exception (there is no explicit application of this exception to successors in interest), and an investment partnership exception.

(4) Avoid 7-Year Rules By Using Grantor Trusts. The complicated 7-year rules can be avoided entirely if all partners in the FLP are the grantor and grantor trusts.

9. Circular 230.

a. Overview. The circular announces requirements designed to attack tax shelters. The proposed notice referred explicitly to tax shelters, but the final regulations do not refer to tax shelter opinions, but rather to "covered opinions," and there is concern that some of the requirements may apply to standard written communications between tax advisors and clients.
There are "best practices" that are applicable to all advisors. While the "best practices" are not mandatory, it is likely that the plaintiff in any malpractice action would point to any failures of a practitioner to meet the best practices. There are mandatory strict standards for "covered opinions." Sanctions include censure or disbarment from practicing before the IRS.

b. Written Advice. The standards apply to "written advice" which includes email. Written advice is not limited to formal legal opinions, but includes any writings.

c. Covered Opinions. The strict standards apply to "covered opinions." This is a precisely defined term that includes "written advice"
concerning one or more federal tax issues arising from:
(1) a listed transaction [these are tax shelter transactions that the IRS has previously identified];
(2) any plan or arrangement where avoidance or evasion of any tax is a principal purpose; [It seems likely that day to day advice by estate planning practitioners may not be included in this category, because there are typically principal purposes other than just tax avoidance.]
(3) any plan or arrangement where avoidance or evasion of tax is a significant purpose, if the written advice is, among other things, a "reliance opinion," which is written advice that concludes at a confidence level of at least more likely than not that one or more significant federal tax issues would be resolved in the taxpayer's favor. The writing will not be treated as a "reliance opinion" if it has bold face disclaimer in a font larger than any other font in the advice, at the beginning of the advice, that it was not written to be used and cannot be used for the purpose of avoiding penalties.

Observation: It would seem that many written communications between tax advisors and estate planning clients may satisfy the "significant purpose"
test because one of the significant purposes of the transactions is to be as tax efficient as possible. However, written communications would not seem to come within the "reliance opinion" category if they do not give a "more likely than not" prediction on the likelihood of success on tax issues. Even if the advice does include a "more likely than not" confidence level of prevailing on tax issues, the advice will still avoid being classified as a reliance opinion if a bold faced, large font disclaimer is placed at the beginning of the advice. (However, the client then could not rely on the communication to establish good faith or reasonableness for the purpose of avoiding tax penalties.)

Conclusion: Unless the written advice comes within the "principal purpose"
category or comes with the "reliance opinion" category by including a "more likely than not" prediction of success on tax issues, many written communications with estate planning clients apparently will not be "covered opinions."

d. Requirements for Covered Opinions. If a written advice is a “covered opinion” as defined above, there are various strict requirements that the writing must meet. One of those requirements is that the written advice evaluate all significant federal tax issues and reach a conclusion, supported by the facts and the law, as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue. If the tax advisor is not giving a formal opinion letter, the advisor probably will not want to include an exhaustive analysis of all significant tax issues in many informal client communications. If not, it would be important to avoid having the advice classified as a “covered opinion.”

e. General Standards for Written Advice That is Not A Covered Opinion. (Observe, this applies to ALL written advice.) A practitioner cannot provide written advice if he (1) bases it on unreasonable factual or legal assumptions; (2) unreasonably relies on representations of the taxpayer or others; (3) fails to consider relevant facts; or (4) takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. [Accordingly, written communications should never refer to “audit lottery” or settlement types of considerations.] Broad circumstances will be considered in determining whether a practitioner has failed to comply with these requirements.

10. Inclusion of Capital Gains in DNI. The definition of income regulations provide that an allocation of capital gains to DNI will be respected if the allocation is allowed either under the governing instrument OR state law. If the trustee has the authority under the instrument to make discretionary distributions of corpus to the beneficiary, the trustee can deem a distribution to be out of capital gains and therefore be included in DNI. However, the election must be “consistent.” Therefore, the first time the issue arises, the trustee will make an election that is probably binding for all similar later distributions. The election need not be consistent for different “classes”
of assets. It is not clear whether this means that different elections can be made for a distribution of Exxon stock vs. IBM stock. However, the regulations do not address what “classes” means, and that may refer to big differences in classes, such as stock vs. real estate.

11. GRAT Planning Issues.<<SNIP>>

12. Fiduciary Investment/Liability Issues.<<SNIP>>

13. Spendthrift Protection Issues for Trust Beneficiaries.

There is a distinction between a beneficiary’s creditor’s ability to reach trust assets based on whether the trust is a discretionary trust or a support trust.

For a “discretionary trust,” the trustee has absolute discretion over distributions. The beneficiaries have no property right in the trust because they cannot enforce a standard for distributions. The cases have generally recognized 100% protection against the beneficiary’s creditors for discretionary trusts, even if the trust does not have a spendthrift clause.

A “support trust” has a standard for distributions--often health, education, support, or maintenance. Creditors of beneficiaries of support trusts can step into their shoesand request a court to order a distribution of assets (pursuant to the standard) to pay their debts, if the trust does not have a spendthrift trust. But if the trust has a spendthrift clause, the trust is protected against most creditors.

There are several categories of “exception creditors” that can reach assets in “support trusts” even if there is a spendthrift clause. Most states recognize three: (1) Alimony or child support claimants; (2)

Necessary services such as medical service claimants; and (3) Claims by the United States or a state for moneys owed (such as a tax lien). There is a 4th exception that is recognized in the Uniform Trust Code but is not recognized in most statesfor services or materials that preserve the beneficiary's interest in the trust.

14. Trust Created By Client's Parents.<<SNIP>>

15. Creditor Effects of FLP or LLC; Charging Order vs. Foreclosure Remedy.<<SNIP>>

16. Tenancy by the Entireties Property Not Protected Against Federal Tax Claims. <<SNIP>>

17. Graegin Notes. <<SNIP>>

18. Section 6166 Issues.<<SNIP>>

19. GST Planning Issues

a. Automatic GST Exemption Allocation. If there is any question whatsoever as to whether a trust is a "GST trust" under the automatic allocation rules, a return should be filed in the first year of a transfer involving that trust and make a clear election as to whether to have automatic allocation apply. Then, there is no worry as to whether the trust is a "GST Trust" to which the automatic allocation rules apply inadvertently.

b. Mere Power to Allocate GST Exemption to Future Transfer to a Trust May Conceivably Cause Estate Inclusion of the Trust Assets. The mere power to allocate GST exemption to future transfers to a trust could conceivably cause the grantor to have a §2036(a)(2) power over the trust. If a trust provides different terms for exempt and non-exempt trusts created under the instrument, the donor's power to later allocate GST exemption (and thereby shift assets from the non-exempt to the exempt trust) may be deemed to be a power to control disposition that causes estate inclusion. One solution is to have identical dispositive provisions in the non-exempt and exempt trusts, and give an independent third party the flexibility to create different dispositive provisions. For example, the exempt and non-exempt trusts could both be lifetime trusts, and an independent party could have the power to provide that the non-exempt trust would terminate at an earlier time.

A similar problem can arise with an executor-beneficiary's power to allocate GST exemption. If the beneficiary is the executor of the estate and has the power to allocate GST exemption, and if the allocation causes more or less assets to be subject to a general power of appointment, the executor's power could conceivably result in the executor having a general power of appointment. One solution: Mandate how GST exemption must be allocated. Allow the executor to appoint an "independent" executor that would have expanded authority to deviate from the "mandatory" allocation provisions.

c. Utilizing GST Exemption Without Making a GiftReverse Lifetime QTIP and GRATs. These are various ways to utilize the difference between the GST exemption and the $1.0m gift exemption. These include using a lifetime reverse QTIP trust (which would permit allocation of the donor's GST exemption without making a taxable gift), and GRATs.

If a lifetime reverse QTIP trust is used, make sure that any estate taxes at the surviving spouse's death are paid from another source. Also, if the spouse dies first, the spouse can appoint the assets to a trust for the client's benefit (an example in the regs makes that clear). A problem is how to make the trust a grantor trust as to the surviving spouse after the donor spouse's death. One possible strategy would be to contribute the trust assets to an S corporation and make the QSST election. All Sub S income will be taxed to the spouse under the QSST rules. (Observe, this is a way generally to cause a trust to be a grantor trust as to a beneficiary of the trust.)

d. Strategic Decision To Use a Non-Qualified Severance in Order to Delay Taxable Terminations. Non-qualified severances can be used as a planning strategy. For example, assume a trust is in existence for all descendants for two years, then divides into separate shares for issue per stirpes. That is all treated as one trust unless there is a qualified severance, so there is no taxable termination until all of the children have died. If the settlor had created separate trusts for each child at the outset, a taxable termination would occur for each trust when the child-beneficiary of that trust died.

e. GST Effects of Split Gifts. There are different split gift rules for gift and GST tax purposes. For gift tax purposes, gifts to a spouse, including gifts in trust, cannot be gift split (although a trust with an interest of the spouse that is ascertainable in value can be severed, permitting the remaining trust interests to be gift split.) For GST purposes, however, the gift is split 50-50. So if the spouse is a beneficiary as to 99% of the trust, then for gift purposes, the donor may only gift split as to 1%, but for GST tax purposes, the spouse is treated as the donor as to ½. For GST purposes, is it clear that each spouse is treated as the transferor of ½ of the assets under a split gift.

f. Section 529 Plans. If a Section 529 plan is originally designated for the donor's child, and the beneficiary is later changed to another person, the child (not the original donor) is treated as the transferor making a gift to the grandchild.

g. Ways to Benefit Grandchildren Currently Without Making a Taxable Distribution. Sometimes the client really want to benefit skip persons currentlywithout making a taxable distribution. Examples of ways to do that include:
(1) Distribution to school for tuition or to medical provider;
(2) Trust acquires a personal use asset in which skip person resides free of rent;
(3) Appoint a skip person as a co-trustee and pay compensation;
(4) Make distributions to skip persons out of another trust that does not cause GST tax, and make compensating distributions to child- level beneficiary from the non-exempt trust;
(5) Add the spouse of the deceased child as a discretionary beneficiary and make a distribution to the spouse who would provide benefits for grandchildren;
(6) Invest in enterprises of a skip person;
(7) Low interest loans to a skip person;
(8) Give the flexibility to permit terminating adjustments to take into account disproportionate distributions among siblings, so there will be no pressure to limit distributions to child-level beneficiaries to amounts that can be made available to skip beneficiaries without incurring GST tax.

h. Granting General Power of Appointment to Child to Avoid GST Tax. One method of delaying a GST transfer is to cause assets to be in the estate of the child-level beneficiary. However, with decoupled state estate taxes, giving a child a general power of appointment will often will be more costly than just subjecting the assets to the GST tax.

20. Planning With Disclaimers to Give Beneficiary Possibility of Utilizing Charitable Income Tax Deduction.<<SNIP>>

21. Planning For a Fair Distribution Policy and Investment Allocations.<<SNIP>>

22. Selling Life Insurance Policy.<<SNIP>>

23. Planning Strategies From Case Study Involving Closely-Held Business.<<SNIP>>

24. Rethink Always Using Ascertainable Standards. Planners often use health, education, support and maintenance standards for distributions, even if the beneficiaries are not the trustees. However, using an ascertainable standard makes the assets more vulnerable to creditors claims of the beneficiaries. If child is not going to be the trustee, seriously consider not using an ascertainable standard.

25. Numbers of Estate Tax Returns. The IRS, Statistics of Income Division, October 2004 report shows how few estate tax returns are filed each year for large estates. For estates between $5.0 to 10.0 million, there were only 3,732 returns filed in 2003 throughout the entire country. Of those, only 902 included interests in limited partnerships,
1,048 included closely held stock, and 708 included “other noncorporate business assets.”

For estates between $10 to 20 million, there were 1,293 total estate tax returns filed in 2003. Of those, 444 included limited partnership interests, 485 included closely held stock, and 359 included other noncorporate business assets.

(Charts including the numbers of estate tax returns with breakdowns by categories of assets and deductions can be located at the IRS website [www.irs.gov], at the tab for Tax Stats, under the heading for the Year 2003.)

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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