Report #19 (Wednesday, Cont'd)

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

==

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

===

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.

==
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.

==

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.

==

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.

GENERAL INFORMATION ABOUT INSTITUTE
Inquiries/Registration
Philip E. Heckerling Institute on Estate Planning University of Miami School of Law Center for Continuing Legal Education P.O. Box 248087 Coral Gables, FL 33124-8087
Telephone305-284-4762 / FAX305-284-6752
Web site www.law.miami.edu/heckerling
E-mail heckerling@law.miami.edu
==
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607

===
