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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