**Heckerling Institute 2006**
Reports from the event, as posted to the ABA-PTL List Serve

# Report #11

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

As we have done in January for the last nine years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 40th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 9-13, 2006 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida. A complete listing of the proceedings and speakers is available on the Institute's Web site. The URL for that site is http//www.law.miami.edu/heckerling.

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This Report contains coverage of some of the Thursday afternoon Special Sessions #4 on **the Trust Law and Order Mock Trial Demonstration, Partnerships in Estate and Trust Administration, Charitable Options in Business Succession Planning, and Estate Planning Without Taxes.**

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Trust Law and Order: A Mock Trial Demonstration Ripped From The Headlines Thursday afternoon Special Sessions III-A and (cont.) IV-A, 1/12/06
Presenters: Terrence M. Franklin, Bruce S. Ross, Dominic J. Campisi, Robert N. Sacks and Steven K. Mignogna

Reporter: Joanne Hindel Esq.

Mock Trial Case Summary

Decedent, Daniel Deadinger was 75 years old on the date of his death, March 17, 2005. His assets are valued at $5 million.
He was survived by his wife of 49 years, Dolores and their only son, Sonny.
He was only married once and Sonny is his only child. He did have a lady friend, Anna Nickel, since 1990, until the date of his death.
While the decedent was an attorney, he never practiced law but was successful in the garment industry.

Although the decedent remained married to Dolores, he lived with Anna for the last ten years of his life. He had purchased an apartment in South State for Anna and lived there with her. His wife remained in their home in North State.

In 1999, he had a will drafted, at the urging of Anna, by an attorney friend of Anna's, Robert Johns.

The will provided that one-half of Daniel's assets would go to Anna and the balance would go to his wife and son.

In late 2004, after Dolores learned of the existence of this will, she insisted that her husband write a new will and leave everything to her and then to their son. Daniel typed a new will and signed it in her presence.
There were no witnesses to the second will.

After Daniel died, Dolores presented the 2004 will for probate. The clerk told her that the will did not meet the traditional formal requirements and that she would need to petition the probate judge to admit the will to probate. North State, where Dolores lived, had just adopted the UPC, which has a provision allowing a judge to admit a document as a will if he found that it was a "writing intended as a will."

When Anna learned of the 2004 will, she filed pleadings to oppose the probate of that will and asserted that:
1. the 1999 will was the last valid will
2. the 2004 will was invalid and the result of the undue influence
by Dolores
3. Daniel was domiciled in South State at the time of his death and
so any probate should be there

Dolores then asserted that:
1. the 1999 will was the product of Anna's undue influence
2. Daniel had been domiciled in North State not South State
3. The 2004 will was valid.

Neither state has elective share statutes.

The issues at trial are:

A. the domicile of Daniel at his death
B. the validity of the 1999 will and
C. the validity of the 2004 will

Trial testimony

The presenters questioned participants who were posing as the various parties and interested persons in the mock trial. They included the surviving spouse, Dolores, her son, Sonny, the decedent's accountant who had witnessed the 1999 will, the lady friend Anna Nickel and the drafting attorney of the first will, Robert Johns.

The participants did an excellent job of impersonating the characters involved in the action. They were both entertaining and iron clad in their roles.

The lawyers questioning them did a fine job of attempting to find evidence of undue influence by both the surviving spouse and the lady friend, the existence of a confidential relationship between both the attorney and the accountant and the decedent and the existence of any undue benefit by either the lady friend or the son.

The visiting judge presiding over the mock trial discussed the importance of the jurisdictional issue since North and South State had very different laws pertaining to admission of writings as wills. She also discussed the importance of determining domicile of the decedent and the presenters pointed out that the taxing authority's records might be of use in that regard.

Key issues highlighted by the trial

The presenters also discussed the key issue in proving undue influence was shifting the burden of proof. They also discussed the individual Declarations that had been signed by the parties prior to trial and how these could prove very useful during trial. They did note however, that in reality the Declarations would differ substantially in their recitation of the "facts" as seen by each party to the action.

While the outcome of the trial was not determined, the presentation raised interesting questions of proof and was very entertaining.

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Avoiding "Oops" With Partnerships in Your Estate or Trust Administration Thursday afternoon Special Session No. IV-B, 1/12/06
Presenters: M. Read Moore and Samuel A. Donaldson

Reporter: Gene Zuspann Esq.

This presentation analyzed some of the problems in exiting FLP's shortly after the death of the parent. This has been a topic that has appeared before at the Institute, but is always timely because of the degree of difficulty in managing a partnership in an estate, especially when the beneficiaries are not amicable.

Problem 1: What taxable year end should the estate use?
There are several good answers.
If the estate owns more than 50% of the partnership, then the estate should use a calendar year. This is to avoid the partnership having to change its year to match the estate's year.
If the estate does not own more than 50% of the partnership, then:
- For the benefit of the estate, a November year end defers the reporting of the income for 11 months. The calendar year partnership's K-1 will be reported on the estate's return for the year that includes the partnership year end. For a partnership ending 12/31/05, the income will be reported on the estate's 1041 ending 11/30/05.
- For the benefit of the partners, a January 31st year end will defer reporting for 11 months. An estate owning a partnership ending 12/31/05 will report the partnership income on its 1/31/06 return and the beneficiaries will then report the income from the estate K-1 (assuming a distribution of the income) on their 12/31/06 return.

Problem 2 analyzed whether the partnerships in the example would have to make the mandatory 754 election required by the Amer Jobs Creation Act of 2004. The three instances are when there is a contribution after 10/22/04 of built in loss property, there is a 734(b) distribution of low basis stock after 10/22/04 or under 743(a) when the FMV of the property is more than $250,000 higher than the partnership's basis in property.

This is a partnership by partnership analysis. It does not accumulate all of the partnerships to make the determination and some may have to make the
754 election and some may not.

Problem 3 discussed whether either of the partnerships should make a voluntary 754 election. In one case, the partnership had little basis because all of the assets had been depreciated out and the basis was the discounted basis of the decedent's interest in the partnership. Carol felt that there was no choice because of the savings in tax and the fact that all of the assets were being liquidated.

For the second partnership, there was little potential savings based upon the inside basis and the outside basis. However, she felt that he election could be beneficial if an audit changed the values on audit (which later happened in the fact situation).

Problem 4.
What is the impact of funding the trusts with the partnerships (essentially the only remaining asset in the estate). There could be gain if the instrument made a pecuniary devise and the partnership assets had appreciated. In this case, there is no sale or exchange because the trusts received a percentage of the residuary.

The partnerships must close their books. There is still a 754 election because the estate does not own more than 50% of the partnership.

Problems 5 and 6 involved the problems in cashing out one family from each partnership. The problems were complex for a number of reasons, but involved disproportionate distributions of assets and securities and triggered 704(c)(1)(b) and 737 because the partnerships were less than 7 years old. Carol illustrated the problems involved in the distributions under 704(c)(1)(B), 731 and 737. This included the surprising result that there is income to the remaining partner as well as the liquidating partner.

Problem 7
What is the duty under the Uniform Prudent Investor Act to diversify?
She pointed out that the duty to diversify is not mandatory and that the trustee must justify its decision. This is an issue to be considered in light of the facts and circumstances. The other problem is that the trustee may not have the ability to liquidate the partnership interest.

Problem 8
She had previously discussed the problems with several professional trustees and asked whether they would take these trusts on. The response from all queried was that they would run from this trust.

Problem 9 and 10
How does a trustee determine the accounting income? UPAIA section 401 holds that the cash distribution for an entity is the trust accounting income. This is true regardless of the fact that partnership may have substantially more income and the trust would owe tax. In the event that tax is owed by the trust, there must be an allocation of the tax between income and principal.

Problem 11
Can DNI include capital gains?

Carol believes that it can in three situations
- the instrument says that capital gains are included in trust income
- the capital gains are actually distributed or
- the trust always treats capital gains as trust income.

In this case the trustee cannot adjust under UPAIA 104 because she is also a beneficiary.

Problem 12
If the IRS adjusts the values on the 706, should the partnerships amend the returns.
Yes - this will be necessary for several reasons.
One to report corrected amounts to the beneficiaries and two to make adjustments to the 754 elections and reduce the gain or increase the deductions on the partnership's return.

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More on the Charitable Options in Business Succession Planning Thursday afternoon Special Session No. IV-D, 1/12/06
Presenters: Daniel L. Daniels and David T. Leibell

Reporter: Merry Balson Esq.

This special session was a continuation of the general session entitled "Planning for the Closely Held Business Owner: The Charitable Options" that was held on Thursday morning. The presenters tailored the session to covered some of the more fundamental information on charitable planning options after receiving questions following the general session presentation.

The presenters recognized that there a number of freezing and discount techniques that do not involve charitable giving, and that those options should be considered along with charitable options, particularly where clients are concerned about completely eliminating or significantly reducing estate taxes, interested in carrying on a legacy, and concerned about the potentially negative impact of wealth on their descendants.

The presenters generally reviewed the available charitable vehicles used in business planning, including private foundations, supporting organizations, and split interest charitable trusts, which were all discussed in the general session earlier today. They noted that private foundation status is the default status, and provides the family the greatest amount of control, but that the excise tax rules apply, and that the private foundation has a 5% minimum distribution requirement. The supporting organization, as a public charity, is not subject to the private foundation excise tax rules, and a business can be run from the supporting organization. However, they noted that the IRS has become very anti-supporting organization recently and it has become very difficult to obtain exempt status as a supporting organization. Efforts to reform these organizations legislatively, which in 2005 seemed inevitable, now appear to have lost momentum and will likely not move forward.
Moving on to split interest trusts, the presenters described the structure of charitable remainder trusts (CRTs) and explained the advantages of using a charitable remainder trust (CRT) to sell low basis assets, and using a NIMCRUT or FLIP CRUT for illiquid assets. The presenters then highlighted the features of charitable remainder lead trusts (CLTs), a technique that is good for hard to value assets.

The presenters noted that under Rev. Proc. 2005-64 [sic. 2004-64] (addressed in the outline on page 12-22) a waiver of spousal election rights is required to avoid disqualification of certain charitable trusts.
They also noted the 2003 change in the 4 tier system under Sec. 664 relating to payments of income

from a CRT, which is addressed in more detail on page 12-25 of the outline.

An overview of the tax issues relating to charitable giving followed. The issues discussed included: (1) excise taxes on entities, where the major concerns are the self dealing and excess business holdings rules; (2) unrelated business income tax (UBIT), which is often seen as the charity's issue, but can also cause unexpected recognition of income to the donor;
(3) the prearranged sale rules; (4) the "ascertainability" problem, which was discussed in the general session, and essentially requires the testamentary plan to be specific as to the terms of the charitable gift; and, (5) the charitable whipsaw, where a donor devises a portion of a business to a charity but given the discounts for minority interests, the value of the charitable deduction is less than the value of the business as a whole.

The presenters spend significant time on prearranged sale issues. Privately negotiated transactions always give rise to this issue. If there was an informal agreement or understanding between a CRT and grantor to sell the contributed property to a buyer prior to transferring the asset to the CRT, and that sale actually occurs, the IRS can look through the substance of the transaction and recharacterize the sale as a transaction between the grantor personally and the buyer. Basically, if the transaction is so far along that the donor can not back out of the sale, he or she will be personally responsible for gain on sale. The IRS is very sophisticated on this topic. The presenters commend to our reading an article in the March
2004 Trusts & Estates Magazine by Laura Peebles on selling business interests for additional information. The body of law on the prearranged sales issue is well established. The general redemption exception to the prearranged sales rule is stated in Palmer v. Comm'r, 62 T.C. 684 (1974), and the IRS approved the transaction in Rev. Rul. 78-197. Rauenhorst v.
Comm'r, 119 T.C. 157 (2002) also is a taxpayer friendly decision in this area. However, see Blake v. Comm'r, 697 F.2d 473 (2nd Cir. 1982) which held for the IRS where an informal agreement existed between the taxpayer and the charity to purchase taxpayer's yacht after the taxpayer redeemed stock he contributed to the charity.

The presenters then discussed testamentary planning strategies. The morning session covered the following strategies: (1) simple bequest of business interests to a foundation, (2) bequest of a business interest to a foundation followed by a redemption, and (3) bequest to a foundation coupled with an option in the family to purchase the interest from the estate prior. The presenters discussed strategy (3) above in depth. When using this option, the presenters recommend recapitalizing the business into voting and nonvoting shares, so the donor can bequeath the nonvoting portion to the foundation, and the voting portion to the family. The family would then use the general redemption exception to redeem the nonvoting shares from the foundation. However, this strategy could implicate the charitable deduction whipsaw (see Ahmanson Foundation v. U.S., 764 F.2d 761 (9th Cir. 1981). The solution to this problem would be to have the owner gift the voting shares to the children pre-death, or use the estate administration exception instead of the redemption exemption. The bequest coupled with an option strategy will not constitute self-dealing if the transaction is for fair market value, the court approves the transaction, and the transaction is completed during a reasonable period of estate administration. Additionally, the IRS has approved a disqualified person's use of a note to fund the purchase. The risk in using a note is that the terms must be fair (AFR may not be available), court approval is not guaranteed, payments under the note must be timely made, and all payments on the note must inure to the benefit of the foundation.

A fourth strategy discussed is a bequest of the business interest to a CLAT (rather than foundation) coupled with an option by the family to purchase the business interest while it is in the estate. This strategy has similar benefits and risks strategy (3) above, with the additional benefit that the family can be the remaindermen of the CLAT. If the interest rate on the note is higher than the 7520 rate, the family could receive significant benefits. Advisors need to run the numbers to determine the appropriate term of the note, term of CLAT and annuity payment from the CLAT to fully utilize this strategy to meet the client's goals. Drafting with flexibility is key. The CLAT can be drafted to ensure that the term is long enough to produce an estate tax charitable deduction equal to the value of the assets passing to the trust. Consider giving the trustee the power to choose among CLATs with varying payout rates (see PLR 9631021 where similar strategy was approved). Note that a default provision should be included which sets the rate in the event the trustee does not make the selection within 9 months of the date of death. Also consider giving the trustee the flexibility to increase the term of the note to match the cash flow from the business and provide security to the noteholder. Consider personal guarantees if necessary to support valuation of the note, and consider structuring the trust to avoid application of GST tax, provide property management and creditor protection. This strategy is sometimes referred to as the "note CLAT."

Finally, the presenters discussed lifetime planning strategies. This too was discussed in the general session. Typically, lifetime planning involves using a CRT to accomplish sales to third parties. An asset by asset analysis is often necessary here to determine the tax issues.

C corporation stock. Excess business holdings are an issue when using CLTs and foundations. Self dealing issues exist for CRTs, CLTs, and foundations if the sale is to a disqualified person. However, an excellent business planning strategy for the mid-sized family C corporation is the wholly charitable stock bailout technique (discussed on pg. 52 of the outline) which uses the redemption exceptions to the prearranged sale and self-dealing tax to redeem shares contributed to a lifetime CRT for cash.
UBIT is not generally a problem, but under Sec. 512 (b)(13) if a charitable entity owns more than 50% of C corporation, interest, annuity, royalties and rent (but not dividends) paid from the corporation to the charity is UBIT. Additionally, if the CRT is unable to sell the stock of the business and is forced to sell the assets instead, Sec. 337(d) will tax the sale as a deemed liquidation inside the CRT, with a tax on the sale at the corporate level. Finally, when planning for ESOP qualified replacement property, the donor can transfer the low basis, low yield replacement property to a CRT, recognize no gain and receive a much higher yield.

S corporation stock. Foundations, supporting organizations and CLTs can be S corporation shareholders, but all income and gain is taxable under the UBIT rules. CLTs must make the ESBT election, or the trust must be structured as a grantor trust to be a qualified shareholder, and neither are good options. CRTs are not permissible S corporation shareholders, but the S corporation can be a CRT grantor. The benefits are that there will be no recognition of built-in gain on the transfer of appreciated property to the CRT, so long as the corporation, rather than the shareholders are the trust beneficiaries. As mentioned above, the Sec. 337(d) liquidation tax may be an issue. Other limitations with this strategy are that the trust term cannot exceed 20 years, and deductions will be limited to basis when the corporation funds the CRT.

Partnerships and LLCs. Partnership and LLCs have the same self dealing, excess business holdings and prearranged sale issues as corporations.
Additionally, advisors must look to the underlying investments of the FLP or LLC to determine whether there are debt financed issues or whether there is an active trade or business that could result in UBIT.

Real estate. The biggest problem in using real estate to fund CRT is the mortgaged property problem. The gift of mortgaged property is treated as a bargain sale rules, may cause the CRT to have UBIT when it sells the property and receives income, which may cause the CRT to be treated as a grantor trust and lose its exemption, and if the exemption is lost in the year of the sale the grantor will be taxable on the gain. If the grantor remains personally liable on the mortgage or has guaranteed the mortgage, the CRT will be a grantor trust and will also be disqualified. There are also self-dealing issues that arise when a mortgage exists. The presenters recommend that advisors get rid of the mortgage before funding the CRT.
Finally, the presenters mentioned that gifts of undivided interests in real estate to charity are probably permissible and should not be not a problem under the self dealing rules (see PLRs on this).

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Coke without Sugar; Coffee without Caffeine; Estate Planning without Taxes:
We Do Live In Interesting Times
Thursday afternoon Special Session No. IV-E, 1/12/06
Presenter: Mark B. Edwards

Reporter: Paul Hood Esq.

We do live in interesting times, Edwards began. He dealt with three questions.

1. Who will be our clients in the future, and what will they want?

Edwards believes that most clients will not be driven by estate tax considerations, so estate tax repeal/reform will be an impact driving our first question (Force No. 1). Force No. 2-the financial world is different and will remain down. Force No. 3-Aging of the baby boomers (most dominant force in society). Force No. 4-Anxiety. Clients will be extraordinarily risk averse. Clients are living longer. Capital will be appreciated not appreciating because it will be so difficult to create. He then discussed increasing important capacity issues.

2. How are we going to control our assets in order to enjoy our longevity?

Durable powers of attorney and revocable trusts. Edwards believes that planner will be spending more time fashioning and coordinating revocable trusts and durable powers of attorney. Gifting will be focused/targeted on grandchildren and will not be primarily tax-driven, e.g., a non-marital deduction trust donation, "upstream" generational gifting, annuitizing, etc.

3. How can their money be managed/controlled in light of their longevity so that they won't outlive it?

Edwards explained the concept of "rentiers" (people who live on a finite pool of money) and how economics of ebbs and flows in the market affects them. He reemphasized that little time has been spent on how to spend money as we have spent our time in either the accumulation or conservation phases. Edwards underscored the benefits of utilizing the unitrust concept to solve the problem of the squeezed rentier.

All in all, it was a wonderful presentation. Edwards is a quality, entertaining speaker, and kudos to the Heckerling Institute Advisory Board for getting him to present on such an outside-of-the-box subject.

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News From The Exhibit Hall
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Lawgic [www.lawgic.com]

Building on our earlier coverage of this document assembly product, the company representatives wanted us to know that their big addition in 2005 was the release in May of 2005 of the New York Wills & Trusts edition of the popular Lawgic software. This was made possible with the able assistance and co-authorship of New York attorney Carlyn McCaffrey. In fact, at Carlyn's urging the "federal' portions of all of the estate planning forms in the Lawgic system were revised and fine-tuned with the cooperation and supervision of Rick Stockton of Holland & Knight who oversees the Lawgic line of wills and trusts software programs.

Hot Off The Presses - Apple Goes Intel

In case you missed it earlier this week, Apple made a hugh surprise announcement on the 10th that they are releasing an Intel-based iMac and a similarly based laptop called the MacBook Pro. This is a real shift in Apple's development plans, and this announcement caught all the analysts off guard. To check this out further, go to Macworld at C/NET Digital Dispatch [www.cnet.com]. To go along with this news, for all of your iPod owners, there will not be a new iPod right now. Instead, for a mere $50, you can get a little device that adds an FM tuner to the Apple music player (how nice).

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Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Bruce Stone of Goldman, Felcoski & Stone, PA in Coral Gables, Florida (a member of the Institute's Advisory Committee), Herb Braverman of Walter & Haverfield, LLP in Cleveland, Ohio, Jeff Weiler of Benesch, Friedlander, Coplan & Aronoff, LLP in Cleveland, Ohio, Merry Balson of Wade, Ash, Woods, Hill & Farley in Denver, Colorado, Barbara Dalvano of Isaacson & Rosenbaum, PC in Denver, Colorado, Paul Hood of Dickenson, Peatman & Fogarty in Napa, CA, and Joanne Hindel of Fifth Third Bank in 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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