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

Report #5

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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First an errata - the Reports that are included in Report #4 were all for sessions that took place Tuesday afternoon, not Tuesday morning. We apologize for any confusion this may have caused.

Next, from the Seminar Director: The Heckerling Institute will be held January 8 through 12, 2007 in Orlando, Florida at the World Center Marriott and thereafter for 2008 and 2009. After 3 years, the Institute will determine whether to continue at that location or go elsewhere. The hotel has 2000 rooms.
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This Report contains coverage of the Wednesday morning **Programs on Partnership Interests and the Q&A Session**.

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The Beauty and the Beast: Partnership Interests in Your Estate or Trust Administration Wednesday Morning, 1/11/06
Presenter: Carol A. Cantrell

Reporter: Merry Balson Esq.

Partnerships are the beast in any trust and estate administration, particularly those that do not distribute all of their income. Prudent investor rules and principal and income statutes significantly impact fiduciary duties.

Mandatory Basis Adjustment Rules

The American Jobs Creation Act of 2004 created 3 new mandatory basis adjustment rules that can trap unwary family limited partnerships (FLPs)(see pg. 22 for a full discussion). First, a new Sec. 704(c)(1)(C) now provides that built-in losses on assets contributed to a partnership after October 22, 2004 can only be used by the contributing partner (prior law allowed built-in losses to be used by the donor and donee). The solution to this problem is not to contribute built-in loss property to a partnership.

Second, after October 22, 2004, partnerships are required to adjust the basis of its other assets under Sec. 734(b) when a distribution of cash or property results in a taxable loss to the partner or the partner receives a stepped-up basis in the property greater than $250,000. The most common application of this new rule is when the partnership makes distributions of low basis property to a high basis partner. Thus, if you are cashing out an estate with low basis property, the partnership has to make a negative basis adjustment if the liquidating partner gets a basis step-up. The solution is to make a Sec. 754 election, so that when the property is distributed it is no longer low basis property.

Third, Sec. 743 now provides that when a partner dies (or transfers a partial interest) after October 22, 2004, and the adjusted basis of assets exceeds the fair market value by more than $250,000 on the date of death (or transfer), the partnership will be forced to make a Sec. 754 election and step-down the inside basis of those partnership assets with respect to decedent to the discounted (not market) value of the assets. Ms. Cantrell's advice to deal with this problem is to get a better investment advisor, so that you are not stuck with losses in the partnership when you die.

Ms. Cantrell did not discuss the "mixing bowl rules" but the outline covers this in detail.

Investment Management Issues

Ms. Cantrell discussed investment considerations at length. The trustee's fiduciary duties under the Uniform Prudent Investor Act, including the duty to diversify, duty to monitor the portfolio, duty of loyalty to the trust beneficiaries, and duty of impartiality, make it difficult for the trustee to hold an FLP interest as its sole asset. The fiduciary has what equates to a duty to delegate if the fiduciary is unable to meet the prudent investor rule duties (e.g., if the trustee is not skilled in investing). If the trustee relies on an agent hired by the FLP to make all investment decisions, the trustee has not really fulfilled his duties. The trustee is fully liable for decisions by the FLP investment advisor even though that advisor is investing for all partners, and not necessarily for the sole benefit of the trust beneficiaries. The IRS will allow the trust to deduct fees where the trustee carries out investment duties himself (even if he is negligent in doing so), but where the trustee delegates those duties to the FLP's investment advisor, the IRS does not allow a full deduction for the investment management fees.

Section 67 applies a 2% haircut from miscellaneous itemized deductions.
However, Sec. 67(e)(1) provides an exception for trusts and estates. Under Sec. 67(e)(1), the 2% haircut does not apply to "administration expenses"
of trusts and estates that ". . . would not have been incurred if the property were not held in such trust or estate..." While investment management fees are administrative costs, the second prong of the exception under Sec. 67(e)(1) is that those costs must have been incurred because they were held in "such trust or estate." The IRS' position is that the expenses must be "unique" to trusts to be fully deductible, and because individuals commonly incur investment advisory fees, those fees will be subject to the 2% rule. Trustees argue that they would not have incurred the investment management fees but for the trustee's prudent investor duties. The Courts and commentators are split on this issue (See Mellon Bank N.A. v. U.S., 265 F3d 1275 (Fed. Cir. 2001) (holding investment management fees paid to a third party are subject to the 2% rule); O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993) (holding fees paid by an unskilled trustee were fully deductible because those fees are required as part of the trustee's fiduciary duties under the prudent person standard); and, Scott v. U.S., 328 F.3d 132 (4th Cir. 2003) (holding fees are subject to the 2% rule)).

Ms. Cantrell was personally involved in the recently decided case of William K. Rudkin

Testamentary Trust v. Comm'r, 124 T.C. 19 (2005), appeal docketed, No. 05-5151 (2nd Cir. Sept. 26, 3005). In Rudkin, the trust was subject to the uniform prudent investor act (unlike the cases cited above), and based on the duty to diversify, and duty to delegate, the trustee (who was a CPA) hired a NY registered investment advisor, paid them a fee and deducted that fee in full on its return. The IRS audited the return and determined the fee was subject to the 2% rule. The trustee tried his own case and lost, and Ms. Cantrell became involved at that point. The case is currently on appeal to the 2nd Circuit and the American Banker's Association recently submitted an amicus brief in support of the trustee's position which focused on the fact that the prudent investor act requires the trustee to incur these fees. Ms. Cantrell discussed the legislative history of Sec. 67(e)(1) in some detail, and noted that the second prong of the Sec. 67(e)(1) test was not in the House or Senate version of the statute and was added in a conference session late in the process. Ms.
Cantrell stated that if the trustee takes an active role in investments, or is a party to the contract with an investment manager, the trust should be able to pass the test.

Fiduciary Income from Partnerships

There is some dispute over the meaning of Sec. 401 of the Uniform Principal and Income Act (UPAIA). The UPAIA describes the portion of distributions from an "entity" that will be allocated to income. Generally, cash distributions to a trustee are income, unless the distribution exceeds 20% of the gross assets of the entity in which case the distribution is allocated to principal. In Thomas v Elder, 21 Cal. Rptr. 3d 741 (Dec. 2,
2004) the Court wrestled with whether the distributions are allocated to principal when the shareholder actually receives 20% or more of the gross assets of the entity, or when the entity distributes 20% or more of its gross assets to all shareholders collectively. In Thomas the Court reviewed the statutory language and determined that where an S corporation distributed 50% of its gross assets to its shareholders, and a marital trust (holding only 16% of the shares) did not receive 20% or more of the gross assets, the trustees could not allocate that distribution to principal. Following this ruling, California immediately passed an amendment to their UPAIA statute inserting the words "money received by all owners collectively" to cure this problem. Note that every state other than Florida who has adopted Sec. 401 of UPAIA has the same language as the statute in the Thomas case.

Allocating Taxes on Partnership Income

When partnerships do not distribute all income there can be significant taxable income in the trust creating a number of problems. UPAIA Sec.
505(d) requires a trustee who holds an interest in a pass through entity to allocate taxes generated by the entity between income and principal based on the character of the receipts coming from that entity. Most entity distributions will be income, and the tax liability for those distributions will also be income. The trust must pay the tax liability on undistributed income from the entity before making a distribution to the beneficiary. An algebraic equation must be used to determine the amount distributable to the beneficiary and the amount the trust must retain to pay its tax on remaining taxable income from the entity. The formula for this calculation is set out on the bottom of page 70 of the outline.

Ms. Cantrell included several excellent flow charts addressing partnership tax issues as exhibits to her outline.

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Question & Answer Sesion
Wednesday Morning, 1/11/06
Presenters: Dennis I. Belcher [DIB], Prof. Jeffrey N. Pennell [JNP] and Carol A. Harrington [CAH]

Reporters: Jeff Weiler Esq. and Gene Zuspann Esq.

DB: Use of parallel GRAT's. Husband and wife establish identical GRAT's.
Term could be 2 year GRAT interest and 20 year revocable interest for spouse with revocation by grantor in Will. For use by person that wants to make a gift but needs funds and person has poor health. Problem areas: 1.
IRS maintains that the right to revoke is only for the initial term (here the 2 year GRAT term), and 2. Application of reciprocal trust doctrine.
Covey says that on 1 IRS is wrong and on 2 there should not be a problem.
However, advisors should arrive at their own conclusions. Authority to review is example 8 of final IRC Section 2702 regs. Taxable gift is made based on GRAT calculations. Play is that one of the parties will die during the term of the GRAT's.

JP: Getting a valuation discount for a built in gain is going to be difficult. Courts will not consider the built in gain if projected payment of tax is too far in the future.

CH: Grantor trusts. IRC Section 674 (4) and reacquiring property in a non fiduciary capacity. Jordahl decision involved a fiduciary capacity situation. IRS will not rule in this area. Is there a problem with this approach? CH's view, from a legal perspective, there should not be an inclusion in gross estate problem. As to suggestion that the power should be given to someone other than the grantor, CH is concerned. The phrase "any person" in the statute and "reacquire" does not fit, "other person"
can not "reacquire" an asset that the other person did not put into the trust.

JP: Comments on Grantor trusts. IRC Section 675 power to buy assets at fmv can not trigger IRC Section 2036. Should multiple approaches be used to get grantor trust status? Note that different grantor trust provisions cause different inclusion in income. Some include ordinary income and some include capital gain. See "portion" rules in regs for IRC Section 671. Note the rules use a Distributable Net Income model - can not get losses out of trust in excess of gains in JP's view without citing authority for this view. Another approach to grantor trust status that is good today is grantor borrowing from the trust.

DB: Corporate insider and impact of SEC 16 (b) rules on GRAT's and CRT's.
Problem is with stock in publicly held corporation going to insider under right to reacquire or a principal distribution for payment of annuity.
Suggests use power for insider other than the right to reacquire. Also, do not use insider as trustee of GRAT or CRT.

JP: Application reciprocal trust doctrine (Est of Grace) outside of IRC Section 2036 area. One suggestion that doctrine can be avoided merely by having a cap on distribution to one spouse in one of two husband and wife reciprocal irrevocable life insurance trusts does not in JP's view work. More difference are needed. Levy decision and a PLR (citation not
provided) state having a non general power of appointment in one of the trusts and not the other is sufficient to avoid the doctrine.

Panel: Doctrine can apply outside of IRC Section 2036 like applying concerning IRC Section 2042 (life insurance). To avoid IRC Section 2042, if spouses are trustees, have them resign as trustees and disclaim benefits. (Speakers did not mention application of IRC Section 2035).

CH: Family limited partnerships, future planning, existing partnerships.
Suggests respect governing instrument rules, avoid donor's unilateral right to liquidate. Try to avoid being an IRS target and avoid audit. Have donor give up general partnership interest (or manager of LLC). Give up 100% of control and do not keep a minority interest. It is OK for donor to be involved with investment decisions - IRC Section 2036 should not be applicable to involvement with investment decisions. The problem is the IRS and the courts are applying a "smell test". Ownership of limited partnership interests and right to vote on liquidation is a stretch for IRC Section 2036 application but IRS agent could raise the issue. Better to get rid of all interests - general and limited.

DB: Agrees with CH concerning getting rid of control. If there are financial assets in the FLP, want to avoid control as general partner at death. Putting interests into an irrevocable trust with an independent trust, and retaining a power of appointment to avoid a current gift is an approach that could be used to get rid of control. Less worried about entities with active real estate or operating business. Read the cases and you will see a difference between treatment of entities with financial assets and entities with business assets. The "bar" is getting higher each year for taxpayers. There always is risk involved.

JP: IRC Section 2043 and application to FLP's (Reporter: warning this is real bad news!). If taxpayer loses on FLP IRC Section 2036, estate may not be back to square one and may be in much worse shape. JP has provided the following information to IRS agents at classes that he has presented. He notes that the IRS has not pursued this issue to date. He speculates that the results are so bad for the taxpayer that the IRS may be concerned that a court will back off on the IRC Section 2036 arguement to avoid having the taxpayer subject to the application of IRC Section 2043. This involves the relationship between the purge and credit rule in IRC Section 2001 (b) where an asset is brought back into the gross estate and the previous gift of the assets is eliminated from the estate tax calculation. Assume IRC Section 2036 applies. First the asset owned at the date of death is included in the gross estate under IRC Section 2033. Then under IRC Section 2036, the transfer of assets is brought into the gross estate due to retained control or enjoyment. There is a double inclusion of assets in the gross estate unless there is an adjustment. IRC Section 2043 provides an adjustment but it does not work correctly for the taxpayer. The value of the adjustment, or offset, is based on the value at the time of transfer.
The taxpayer's benefit is based on the value of assets at the time of transfer. If the assets brought back into the gross estate have appreciated since the time of the original transfer the "offeset" is only the original value. If there is death shortly after the original transfer, with little appreciation is assets, the impact should not be too bad. However, in older FLP where time has elapsed and the value of assets has appreciated, the estate will get hit hard. Solution: get rid of FLP so no IRC Section 2033 inclusion at death.

DB: Look at value of inside assets relative to basis of inside assets before making an IRC Section 754/743 election. If value is below basis, do not make election since is will result in a step down in basis. Consider revocation of IRC Section 754 election.

CH: Generation-skipping transfer tax matters. Normal legal adoption of a minor person results in relationship like blood line lineal descendant (rather than analysis of generation placement based on age differential). Comparing exposure to generation-skipping transfer tax to estate tax will probably show that the generation- skipping transfer tax is lower even after consideration of state generation-skipping tax. Trusts last for a long time and tax laws will be different many years from now. Exposure to generation-skipping tax (if it still exists) with a limited power to a trust beneficiary may be better than giving the beneficiary a general power of appointment and having the assets exposed to creditors of the child.

JP: Planning for persons in decoupled states. Like use of partial QTIP election and may be a Clayton technique. Feels this is better than a disclaimer approach.

CH: In using a Clayton flip, use an independent executor to make the election. Could require that the executor follows the instruction of an independent trustee and trustee can appoint an independent trustee for this purpose. This approach eliminates probate court involvement in the process.
CH agrees with Ron Aucutt that the power to make tax elections should not be a basis for applying IRC Section 2036 and property rights should be determined after tax elections have been made. However, CH suggests avoiding the risk even though IRS has not raised this issue.

DB: Avoid drafting Wills for persons outside of your state. May not be unauthorized practice of law but the new complexity from state death tax could cause malpractice exposure.

CH: For generation-skipping transfer tax planning, likes to use separate trusts and spells out the split with a direction to sever the trust.

CH: In marital deduction formulae, reference to state death tax "credit"
should be changed to "deduction".

JP: Selection of fiduciary. For QPRT, could be child, spouse and during the initial term only even the settlor. If trustee is beneficiary, a HEMS ascertainable standard is needed. Watch obligation of support and do not permit trustee to make distributions that fulfills the trustee's obligation of support (such as support of a child of trustee where the child is a trust beneficiary). Ascertainable standard will not save the obligation of support problem.

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News From The Exhibit Hall
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Wealth Transfer Planning ["Interactive Legal Systems" <info@ILSDocs.com>]

They are working Brentmark to integrate their Estate Planning Tools and NumberCrucher programs with WTP. Phase I will be completed in January and shipped to WTP users as no charge then.

Subscribers must be using the 2006 version of the Brentmark programs. They will also have an automatic updating service by February. New features include an extensive no-contest option for wills and revocable trusts and completely updated planning memos. Lastly, they have added a SNT to their forms library.

BNA Estate and Gift Tax [www.bna.com]

Their calculation program now has state calculations for decoupled states included in it. This program is very popular for its's spreadsheet look and feel and how easy it is to do three-column what-if comparisons for a given set of facts for a married couple, including with an instant reverse order of deaths calculation feature. BNA also has a feature that comes with a subscription to its Tax Management EGT Portfolios whereby the user can gain instant on-line access to the portfolios, Code and regulations.

Lexis/Nexis [www.hotdocs.com and www.lexisnexis.com]

No word on any pending upgrades to their current line of HotDocs products, which are HotDocs 2005 and HotDocs 6.1 and 6.2. Maybe the folks over at Wealth Transfer Planning or WealthCounsel know something we don't know. Lexis does have a flat rate Tax Library that allows a user to ahve access to all the primary sources, administrative materials from the IRS, and state administrative codes, as well as dozens of secondary sources. The cost for a single user is 225 per month.

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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