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

Report #7

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 Wednesday afternoon **Special Sessions #1 and #2 Programs on Grantor Trusts and Total Return Trusts**

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The 7 Habits of Highly Effective Grantor Trusts Wednesday Afternoon Special Session 1-C, 1/11/06
Presenters: Samuel A. Donaldson and M. Read Moore

Reporter: Barbara Dalvano Esq.

This special session is a continuation of the general session program presented by Samuel Donaldson on Tuesday morning on Grantor Trust rules. The materials consist of a table/grid with a listing of a number of powers that parties, including grantors, may hold and during the session, the presenters will discuss whether such powers create grantor trust status for income tax purposes and/or result in the trust property being included in the grantor's gross estate for estate tax purposes.

If the goal is to make a wholly grantor trust, it is important to have the right powers included in the instrument. In an era when the federal transfer tax regime is uncertain and clients don't want to make taxable gifts, together with the positive development in Rev. Rul. 2004-64 (grantor's payment of income taxes on income of the grantor trust does not result in taxable gift), forming a grantor trust is a favored estate planning technique and is a good way to make tax free gifts. Also, due to the lower income tax rates on qualified dividends, the income tax aspects of grantor trusts are less painful than were such trusts in the past.

First Power: Power of grantor to revoke the trust exercisable with the consent of the remainder beneficiary. This does not create a grantor trust because the remainder beneficiary is an adverse party. The section 676 regulations make clear that if the consent of an adverse party is required, no grantor trust status exists. The statute does not specifically provide for this result, so it took the promulgation of regulations to get this result. Holding this power will trigger gross estate inclusion per section 2038. Pursuant to regulations section 20.2038-1(a)(2), you need the consent of all beneficiaries that have vested and contingent interests in the trust to avoid gross estate inclusion under section 2038 for this power.

Second Power: Grantor's spouse has the inter vivos power to allocate the remainder among the grantor's children. This does create grantor trust status under section 674(a) as a power to control beneficial enjoyment – section 672(e) says that for income tax purposes, any power held by the grantor's spouse is deemed to be held by the grantor, so this power does result in grantor trust status. What if the instrument limited the grantor spouse's power by some reasonable standard - the result will not make the trust a grantor trust because regulations section 1.674(a)-1(b)(3) says that if the trust has an ascertainable standard limitation on the power, it is not a sufficient power to make the trust a grantor trust. If the power relates to a power to allocate income only, this is no longer a grantor trust per regulations section 1.674(b)(1) as it is not a significant power for grantor trust purposes. Does this power cause gross estate inclusion? No, no inclusion because the power is not held by the grantor who is the transferor unless grantor lives in a community property state that says something different. Section 672(e)(1) provides the spousal attribution rule only for income tax purposes. The regulations under section 2038 – 20.2038-1(a)(3) specifically say this.

So, this power would be good for structuring an "intentional defective grantor trust" (an "IDIT") but note that giving this power may be some practical non-tax issues that make its use unacceptable. For example, the grantor may not want his or her spouse to have this power.

Third Power: Grantor's spouse has a testamentary power to allocate the remainder among the grantor's children. Does this create grantor trust status? This does not create grantor trust per section 674(b)(3) and also does not create gross estate inclusion. But check rules as to accumulated income – it may be that if the trust has accumulated income and grantor had a testamentary power as to the accumulated income, then grantor trust status might be created.

Fourth power: Grantor has power to add charitable beneficiaries to the trust? This power does create grantor trust status. This is a pretty vanilla example under section 674(a). Does this cause gross estate inclusion? Yes, it does cause inclusion. This is why the power must be held by a non-adverse party (rather than the grantor) to avoid gross estate inclusion; there is no imputation back to the grantor of a non-adverse person holding this power for federal estate tax purposes.

Fifth Power: Unrelated party (neither trustee, beneficiary, grantor, adverse party or a person related to any of the above) has power to add beneficiaries to the trust. This will create grantor trust status where someone has absolutely no interest in the trust; they are defined under statute as a non-adverse party. Literally, could open up the white pages and pick someone from the white pages and draft the trust instrument giving them the power because there is nothing in the statute that says you cannot do this and even may not need to tell the power holder that they have the power, but under the "smell" test, this may be a bit over the line and Mr.
Donaldson suggests that you would need to inform the person that they have this power. Gross estate inclusion does not result. Note that holding this power could possibly create a problem for the unrelated party if they could name themselves as additional beneficiary of the trust, so limit the class of beneficiaries that can be added to charities so that the power is not a general power of appointment; could also add an ascertainable standard or some other restriction that would not result in the power holder having a general power of appointment.

Can power holder be a corporation? Mr. Donaldson has not seen any example of this, but strikes him that it should work.

Sixth Power: Grantor may vote the shares of closely-held stock transferred to the trust. Does this make it a grantor trust? It is a grantor trust as to the stock only and not other assets that may be held in the trust. We need to be careful as section 675(4)(a) provides the combined voting power held by the grantor and the trust should be significant – if the combined voting power held by the grantor and the trust is significant, then it is a grantor trust. The regulations give no guidance on what combined voting power of the grantor and trust constitutes a “significant” amount and could be a small threshold. For gross estate inclusion, there is more definitive guidance on “significant” - if a grantor retains 20% or more of stock vote per section 2036(b), it will cause gross estate inclusion. Don’t play game of designing a vote that relates to less than 20% voting power of the entity (to avoid gross estate inclusion) but more than minimal amount to try to achieve grantor trust status.

Seventh Power: Grantor may sprinkle trust income among a designated class of beneficiaries, not including the grantor. Creates grantor trust and gross estate inclusion per section 2036(a)(2).

Eighth Power: What if three trustees (including grantor and two independent trustees) who act by majority vote, who can sprinkle trust income among a designated class of beneficiaries not including the grantor.
Here, under section 674(d), the grantor’s presence is enough to taint for all, so it will be a grantor trust. The consent of independent people does not preclude grantor trust status. Only the consent of an adverse party would render it a non-grantor trust. What about for gross estate? This causes inclusion per section 2036; regulations section 20.2036-1(b)(3)(i) says that it does not matter if other people, with or without grantor, have the power, gross estate tax inclusion results.

Ninth power: Grantor may cause the trust to make unsecured loans to grantor, but only if the grantor pays interest in an amount necessary to avoid the application of any imputed interest rules. Section 675(2) says a wholly grantor trust is created. Does it create gross estate inclusion? No, section 2036 should not apply. Grantor should pay at least adequate interest and maybe more to make sure trustee feels comfortable to make the unsecured loans so that trustee is not considered to violate fiduciary duties to the beneficiaries. Also, charging high interest on the loan might be a way to pump in more money to the trust without gift tax consequences. Mr. Moore has used this power and indicated that when the value of the loan is appraised, the valuation shows that there is a basis to have higher rate on the loan than the AFR and that no income tax consequences on receipt of interest and no gift tax, but Mr. Moore cautions to avoid being greedy and charging exorbitant rate of interest.

Discussion of Hypothetical Fact Patterns

The session then turned to a review of a few hypothetical examples applying the grantor trust principles. The first fact pattern involves grantor swapping assets of equivalent value for the trust assets.

Facts: The grantor created an IDIT to which she sold nonvoting interests in an LLC that owns rental property. At the time of sale, the LLC interests were worth $1M and grantor’s basis in the LLC interests was $300,000. The independent, non-adverse trustee gave the grantor a promissory note of $1M requiring payment of annual interest at AFR rate. The note was paid off during the grantor’s lifetime and at the time the note was paid, the LLC interests are worth $2M. (The payment of the note does not change the status of the trust as a grantor trust). The grantor has the power to reacquire trust assets by substituting assets of equivalent value. The grantor believes she will live only for another 2 years. She owns other assets directly as follows: life insurance with $5M face and FMV of $1M and AB of $800,000; United Airlines stock with FMV of $1M and AB of $1.4M; personal residence of $1M and AB of $650,000 and one share of Google stock with FMV of $1M and AB of $250,000.

Issue: Should the grantor exercise the swap power and if so, what assets should be swapped in exchange for the LLC interests?

Discussion: Grantor may want some or all of the LLC interests back because they have a low tax basis and grantor would want to put high basis assets into the IDIT so that when the grantor dies within 2 years, the low basis assets she gets back get a basis step up under section 1014.

Should the grantor swap the life insurance policy? Look to see if section 2035 applies – in this case the 3 year rule is not triggered because per section 2035(d) the swap would be for full and adequate consideration. So, $1M life insurance for $1M LLC interests will not trigger section 2035. Here, grantor can get the life insurance out of her estate for no tax consequence. But for income tax purposes, would this trigger section 101 transfer for value rule to make some portion of the life insurance death benefit subject to income taxes? No, for income taxes, there no sale or transfer due to Rev. Rul. 85-13 which essentially would provide that there was no transfer of the life insurance policy because the trust is a grantor trust. There could be gift tax issues – the issue is the proper valuation of the LLC interests that are exchanged by the trust for the life insurance policy. The valuation issues make the swap difficult. Also, due to the ability to swap the life insurance, does the grantor have incidents of ownership in the life insurance policy under section 2042? Jordahl case would say no section 2042 issues present and the Jordahl case involved a swap of life insurance in an ILIT. So, some lawyers just rely on the Jordahl case that this swap works. Others say Jordahl case can't be relied upon because the swap power in Jordahl case was held by the trustee and not the grantor. So, want to be careful with regard to the life insurance policy on the section 2042 issues and do due diligence given the lack of consensus on the section 2042 issue.

United Airlines stock – should the grantor swap this built-in loss stock? There would be a step down in tax basis at death if the grantor held this stock until death so to avoid this step down and preserve the built in loss, could swap this stock for the LLC interests so that the trust obtains a carryover basis and the built-in loss is preserved for income tax purposes. If the grantor would otherwise plan to hold on to the built-in loss stock until the grantor's death, this may be a way to preserve the built-in loss stock assuming there is a power over principal exists for grantor trust status. If the IDIT trustee is independent, trustee will think about this carefully and trustee has a duty to make sure trustee is getting back equivalent value in what trustee is giving up. Trustee would be acquiring asset with a built-in loss and is essentially buying the ability to shelter future capital gain on other assets. This might be an interesting swap because of the additional tax benefit of using the built-in loss to shelter future capital gains in the trust (assuming the income tax law is not changed). Effectively this is a built-in loss premium assets that trustee might not need to pay a separate price for.

Principal Residence: Usually, grantor would use a QPRT (qualified personal residence trust). Here though, there is higher tax basis in the residence than in the LLC interests so grantor would be getting back LLC interests with greater capital gain exposure for income tax purposes. If the grantor of the trust occupies the home, and the home is subsequently sold, the built-in gain might go away per section 121. If rent is being paid to the grantor trust, the trust gets extra cash on a transfer tax and income tax free basis without the need to use a QPRT (which eliminates the concern about the grantor surviving the QPRT period; also a QPRT has to actually prevent this type of transaction). This could be like a zeroed out QPRT when the grantor makes this swap. This involves an appraisal and proper valuation. This is a way of achieving a freeze without using a QPRT. Also need to make sure appropriate rent is paid and get good valuation comparables. Here, would want to pay more rent than fair rental value for the use of the residence although should not go too overboard, but erring on high side may work well. Lawyers should exercise due diligence in reviewing all aspects of this possible transaction.

Can grantor buy the same stock as IDIT holds (assuming IDIT holds marketable securities) and then swap the new block of fresh basis stock with old basis stock that is held by the IDIT? Here, if grantor could buy stock, then grantor has cash and should really just swap the cash and IDIT could buy its own stock and it is a cleaner transaction.

Google stock: If idea is to preserve basis, LLC interests have less gain than Google stock, so why do this swap? Particularly if the Google stock will outperform the LLC interests – so, initially, thought is that would want date of death step up in tax basis for the Google stock that is believed will outpace the LLC interest growth. However, upon further reflection, the income tax capital gain rate might be 15% and state death tax rate for the grantor might be higher. So, death tax cost may be high to get a date of death tax basis step up for the Google stock, so if capital gain tax rate is only 15%, the rate difference as compared with the state death tax rate may make it worthwhile to swap the Google stock to avoid the state death tax; later, can generally come up with ways to deal with the income tax liability on the LLC interests that are exchanged out. So, if Google stock will really take off in value, it might be worth paying the income tax on capital gain rather than the state death tax if the grantor had retained the Google stock in the grantor's estate.

If grantor has cash that will not be invested in the short term, swapping cash might also be a good idea. If grantor does not like any of the strategies above due to concerns discussed, then grantor could borrow cash to conduct the swap and pay off the loan (or grantor's estate pay off the loan). Also, could swap in a promissory note of the grantor for the LLC interests (a "reverse IDIT installment sale") and the grantor agrees to pay principal and interest on her note to the IDIT in the future. Rev. Rul.
85-13 says there is no tax consequence in making the note. But, what if grantor dies and her note has not been paid off? From a federal estate tax perspective, perhaps there is not transfer tax consequence to this transaction, as the grantor may get a debt deduction for the promissory note obligation to offset the inclusion of the exchanged trust assets.

Cautionary note: If have an old trust that is GST exempt, be careful not do anything that would be considered as an exercise of a pre-1942 power.

Facts: Grantor owns a small apartment building that generates substantial rental income. The building is worth $3M and has AB of $1M. Grantor is thinking of transferring the building to his kids. Grantor has other assets (about $10M) so grantor can afford to transfer the building to his kids, but grantor wants to retain cash flow from property. So, some folks have recommended a zeroed out GRAT vs. installments sale to IDIT. Lots of commentary on advantages of each, including GRATS more settled in the law and no need for seed gift and have re-valuation protection. With an IDIT, relative advantages are: lower interest rate, flexibility as to payments to grantor and no risk of estate tax inclusion (there is no annuity term that grantor has to survive).

Is there a preference? Mr. Moore has used GRATs more frequently – a
zeroed- out GRAT can be done a lot faster than an IDIT and valuation is less of an issue at the time of the creation of the GRAT. Also, lawyer can tell the client what the rules are with a GRAT and rules are not clear on income tax consequences if the grantor dies prior to the note being repaid in an IDIT transaction. GRATs also have other benefits – if the GRAT property declines in value, it just comes back to the grantor per the annuity payment. With an IDIT, if the property declines in value

and there is insufficient value to repay the note, the trust bears the downside in the value of the property purchased as the note is a recourse note. Technically, the presenters mused that perhaps the IDIT promissory note could be a non-recourse note, but the interest rate on the note would have to be higher and the freeze would not be as effective. Can you combine the GRAT with a GRAT sale to IDIT? Here is how this would
work: The hard to value property would be gifted to a GRAT (for the re-valuation protection) and the GRAT would then sell the property to the IDIT. Perhaps this combines benefit of both techniques – lawyers to review due diligence of this possible transaction.

Is there a preferred grantor trust power for the IDIT? Power to add charitable beneficiaries could be fine, but want to identify exactly who the non-adverse party is that holds the power and there is always a risk that the power would be exercised, so this power is less in control of the grantor. Power to borrow without adequate security is becoming more favored and Mr. Donaldson feels that this won't generate section 2036 exposure for the grantor. If this power is added to the trust instrument it creates a grantor trust and if it is not expressly permitted in the trust instrument, the grantor can do an actual borrowing to create grantor trust status. Mr. Moore thinks that there are other ways to get grantor trust status. The power to swap assets is the one that seems to be used most often and there is tremendous flexibility with this power to swap.

But, there may be other powers that work also. Per Mr. Moore, he looks for something that he can take right from the IRC that is comfortable and almost self-executing and this is having the spouse as beneficiary of the trust under section 677. Also, having a related or subordinate party who is subservient to the grantor act as a trustee of a discretionary trust (no ascertainable standard exists) who is not also a beneficiary of the trust. In a GRAT, Mr. Moore provides for the payment of all the income of the GRAT, in addition to the annuity, to the grantor; although you can only back out the present value of the annuity for gift tax purposes the payment of the additional income is beneficial for the grantor. Finally, most dangerous power is to make the trust a foreign trust under section 679. If the trust is a foreign trust and has at least one US beneficiary, trust will be a grantor trust. Can still administer the trust in US; just need someone in Canada to make it a foreign trust. This power is one that merits a separate workshop to explore further.

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The Prophylactic Approach to Total Return Trusts: Avoiding Unwanted Litigation Wednesday Afternoon Special Session II-A, 1/11/06
Presenters: Margaret E. W. Sager and Paul S. Lee

Reporter: Joanne Hindel Esq.

Margaret Sager started the presentation with the statement that the total return trust represents a paradigm shift and that the trust world has changed because of it. She stated that we do not yet have much developed case law in this area but that she anticipates it will develop as courts and beneficiaries start to realize that a trustee’s duty to invest for total return now exists under the UPIA, UPAIA and modern portfolio theory.

Margaret then reviewed how potential litigation involving total return trusts falls into three broad categories:

1. Transitional which arises from the initial decisions
to convert or exercise the power to adjust or not to convert or adjust.

2. Operational which arises as a result of the choice of
investments, asset allocation and valuation.
3. Estate planning which arises from the terms used in
wills and trusts regarding total return concepts.

Paul Lee discussed the three sets of rules that he believes provide a simple framework for evaluating and implementing total return trusts. These
are:

1. a determination of the appropriate investment
strategy for the trust, given the guidelines set out by the UPIA
2. the determination of an appropriate distribution
policy given the parameters of the UPAIA or the version adopted by the governing jurisdiction
3. and a determination of that portion of income taxes
to be paid either by the trust or the current beneficiary, given the parameters of the recently finalized Treasury Regulations.

Throughout the presentation, both speakers discussed their view of the twelve areas of potential transitional and operational litigation:

1. Disappointing trust investment performance
- The emphasis should be on a prudent process as that
may protect a trustee from liability
- How the trustee got there is probably more important
than where the trust ends up.

2. Imprudent delegation of investment authority
- Section 9 of the UPIA allows a trustee to delegate
investment authority but the delegation itself must be prudent.
- The trustee must exercise reasonable care, skill and
caution in selecting the agent, defining the terms of engagement and monitoring performance.

3. Disappointment after an adjustment or conversion
- As with any discretionary decision, the process is
paramount
- It is critical for the trustee to engage in a
thought process and make a considered decision, even if the result of that process is to take no action and make no change.

4. Failure to inform or notify beneficiaries of their
rights and failure to ascertain the needs of the various beneficiaries
- The UPAIA requires a trustee to consider many
factors including circumstances of the beneficiaries when considering whether to adjust or convert.
- UPIA requires the trustee to consider other
resources of the beneficiary when making investment decisions for the trust.
- The presenters discussed the McNeil v. Bennett, 792
A.2d 190, decision where the court held that a trustee must communicate essential facts, such as the existence of the basic terms of the trust.

5. The lawyer's obligation to inform clients of the new unitrust and power to adjust options
- A critical determination is whether the client is active or dormant.
- The most likely plaintiff in a malpractice action arising from estate planning or representation of a fiduciary is a beneficiary

6. A change of circumstances after the exercise of discretion to convert to a unitrust
- Generally, statutes allow a permanent revision of the trust so that the income beneficiary will receive a fixed percentage of the fair market value of the trust each year. Conversion to a unitrust, once accomplished, is a permanent change to the trust.

7. Liability of the trustee for damages incurred by a beneficiary as a result of the tax effects of a conversion to a total return trust
- The part of the Final Regulations which leaves the most discretion in trustees, and therefore the area where disputes are most likely to arise, pertain to the allocation of capital gain to DNI

8. Effective defenses to a beneficiary suit for breach of fiduciary duty
- Consideration should be given to the standard of care, burdens of proof, exculpatory provisions, standing and privity and applicable statutes of limitations periods
- Most courts will respect exculpatory clauses and retention provisions in documents as long as there are no significant changes in the market

9. Removal of a trustee for failing to adjust or convert when the beneficiary wants it
- Neither the UPIA or the UPAIA provide for removal of the trustee as a remedy
- The presenters discussed the case of In the Matter of Jacob Heller, 800 N.Y.S.2d 207, in which the appellate court upheld the trustees decision to convert a trust to a unitrust even though the trustees were remainder beneficiaries and the conversion benefited them and was to the detriment of the current beneficiary.

10. Available damages if a trustee fails to adjust income or principal or fails to convert to a unitrust
- UPAIA 105 limits damages to an adjustment between principal and income unless the beneficiaries cannot be placed in the position they would have been absent the abuse of discretion.
- Generally no surcharge against the trustee is available.

11. The calculation of damages if the trustee is determined to have imprudently invested
- The UPIA does not contain a limitation on damages.
- Courts however, are starting to look at market place comparisons to determine damages
- The presenters reviewed the case of In re Estate of

Scharlach, 809 A.2d 376 in which a fund under management by a guardian had not lost value however the court found damages for the profit that should have accrued due to the fiduciary's failure to exercise due care.
- By contrast, they also discussed the case of
Suntrust Bank v. Merritt, 612 S.E.2d 818, in which the court held that the trustee did not breach their fiduciary duty when all they had done was preserve and protect the trust corpus but not protect it against inflation.

12. Calculation of commissions if the trustee has adjusted
income or a trust has been converted
- Fee arrangements should be re-examined once a trust
is converted to a unitrust or once the trustee starts exercising the power to adjust.

The presenters then reviewed aspects of sample litigation scenarios by discussing the effect of a trustee's inertia when the trustee is not even aware of the ability to adjust or convert a portfolio, counsel's inertia in doing nothing to alert a client trustee of options under the UPIA and UPAIA, the potential liability of a trustee who makes a conversion of a trust to a unitrust but then does not adjust the investment allocation and the potential liability of the trustee who makes a conversion to a 4% unitrust and then the market shifts to low income and growth.

The presenters were very thorough in their review of both the concept of total return trusts and the potential liability trustees face due to the adoption of the UPIA and UPAIA. Their written materials are also excellent and a valuable resource to any practicing trustee.

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News From The Exhibit Hall
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None for now so we can get this report out tonight.

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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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