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When Things Don't Go As Expected
3 Case Studies

Presented By:
Philip B. Feldman
Coblentz, Patch, Duffy & Bass, LLP
San Francisco, CA

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When Things Don't Go As Expected
3 Case Studies

I. The Overgrown UTMA Account
II. Life Insurance That Has Outlived Its Useful Life
III. The QPRT That Seemed Like a Good Idea at the Time . . . .

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I. The Overgrown UTMA Account.

Example: 1990 – parents and GP contribute
$50,000 in annual exclusion gifts to
Baby's UTMA Account. Invested in
5,000 shares of AAPL Stock (FMV ± $10/share)

2007 – AAPL stock FMV $850,000.

Baby is now a senior in high school, with a triple major. . .. sex, drugs and rock & roll.

Client seeks your advice.

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Initial Observations

Avoid UTMA planning.
- Prefer flexibility of irrevocable trust
- Better income tax planning

Early attention to over funded UTMA avoids later problems

Good lay-person summary:

Protecting Children From Their Money,
Deborah L. Jacobs, NY Times, March 18, 2008

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Options

1. Do Nothing

    - Distributable at age 18 or 21
    - Financial institutions will not take instructions from custodian, may distribute directly to beneficiary
    - Creditor, divorce, spendthrift exposure
    - Only remedy - persuade beneficiary to create self-settled trust

2. Spend Down

    - Start early
    - Avoid parental support obligations or benefits for any other persons
    - Private school tuition, travel, extracurricular activities, automobile and insurance, etc. probably ok
    - Can not do much to reduce large UTMA balance

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3. Preemptive Investments

    - 529 Plans (subject to state law max.)
    - IRA (subject to income limits)
    - Life insurance
    - FLP/FLLC

4. Preemptive Transfers

    - 2503(c) Trust
    - Irrevocable Trust with withdrawal right at age 18/21
    - Irrevocable Trust with ratification obtained at age 18/21
    - Positive or Negative Persuasion Techniques
      Bribery; Disinheritance threat

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II. Life Insurance That Has Outgrown Its Useful Life.

Example: Matriarch age 85; ILIT owns $7M face value UL policy; $1M CSV; $220,000 annual premium.

Initially purchased to cover estate tax on illiquid assets (real property, closely held stock); presently ample liquidity; funding annual premiums is a challenge.

Client seeks your advise.

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Preliminary Observations

Considerations any time LI is involved in a client plan.

1. Avoid Ownership By Insured.
   - ILIT
   - Beneficiary ownership
   - 3-year rule (§2035)/TFV rules on transfer

2. ILIT Compliance.
   - Withdrawal notifications
   - Flow of premiums
   - Titling of policy and trust accounts

3. Policy Review.
   - In-force policy illustrations
   - Multiple assumptions for premiums, dividends

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Needs Assessment

Q1 Why did your client originally buy it?
- Family Income/Asset Protection
- Estate Tax Funding
- Illiquid Estate Assets
- Business Purposes (key person, buy/sell, loan security, etc.)

Q2 Have these needs changed? Any other life insurance needs?

Q3 If life insurance is needed, is the current policy/premium structure appropriate? If not, restructure, exchange, or replace.
- Reduce D.B., Policy Loans, etc.
- New Products (e.g., NLG); 1035 Exchange
- Premium Financing (related or 3rd party loans)
- Private Equity Split Dollar

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Investment Analysis

Q3 If policy not needed, is it a good investment?

- Compare current CSV (or life settlement value) plus future premiums with alternative investments.
- Variables: CSV or sale price (after costs/tax), mortality, investment return, tax consequences.
- Need to run multiple projections, and determine cross-over point (i.e., the longer the insured lives the investment results improve and insurance results decline).
- Consider hedging – retain some insurance (in case of untimely death) and sell balance for investment (in case of long life).

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Pro and Cons of Life Settlement

Cons

- Someone owns life insurance on your life.
- Their investment return is dependent on your demise.
- They generally can resell your policy without consent or knowledge.
- Creepy, mysterious, invasive process.
- Lack of transparency in pricing and commissions.
- Paperwork truly miserable, voluminous and time consuming. Allow 6 months to complete process.

Pro

- You can get paid more (possibly substantially more) for your policy than CSV.

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Application To Example

Needs assessment – insurance no longer needed; ample liquidity for estate tax

Investment Analysis – compare insurance to alternate investments

Assumptions:

- mortality 1, 5, 10, 15, 20 years
  age (86) (90) (95) (100) (105)
- investment return – 6% after tax
- premiums - $220,000 annually
- est. sale price - $2M
- income tax on sale - $0

Cross-over point – in year 8 the PV of [DB – additional premiums] is less than PV of sale price compounded at 6%

Thus – if Matriarch expected to live past age 93, sale works better. But, if she predeceases, LI works better.

However, all variables could change, and, other insurance products could cost less.

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III. The QPRT that Seemed Like A Good Idea At The Time. . . .

1999 – Clients have net worth of $6M
House FMV $1M / AB $300,000
Est. Tax ± $2.1M

10 yr. QPRTs implemented
$325,000 exemption applied
Estate tax savings $500,000+

2008 – Net worth $7M
House FMV $2M
Est. Tax 0 (assuming $3.5M exemptions)

Client no longer wants QPRT.

Client seeks your advise (and is not happy).

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Multiple Choice Question

- Why do clients not want their QPRTs?
  - (a) They no longer have estate tax exposure
  - (b) They want step-up in basis for house (potentially worth over $750K in income tax savings)
  - (c) They do not want their children to own their house, or to pay them rent
  - (d) They do not want to pay you any more money to set up a lease, or help document the continuing arrangement
  - (e) They are aging, crabby and impatient
  - (f) All of the above!

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Options

1. Continue As Planned
   - –QPRT Term Ends
   - –Clients Remain In House
   - –Rent:
     - Clients pay rent and Trust pays expenses
       - Rental income taxable to Trust (unless grantor trust)
       - Rental expenses deductible by Trust
       - No deduction to client
       - Depreciation?
       - Related party loss limitations?

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Options (cont'd.)

Clients Pay Expenses In Lieu Of Rent
- Probably implied rental income and rental deduction
- If expense less than FRV, may be gift from children
- May qualify for annual exclusion?

Clients Reside in House Rent Free
- Deemed gift from children for failure to enforce trust
- Imputed rental income and deductions

At Death
- House to children
- No step up

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Options (cont'd.)

2. Do Nothing
   - QPRT Term Ends
   - No rental arrangement documented
   - Client pays expenses and treats as personal residence
   - Possible imputed rental arrangement with rental income, deemed gifts, rental deduction to Trust
   - Constructive trust (State law)
   - §2036 retained interest (Fed. tax law)
     - Possible inclusion in estate
     - Resulting step-up
     - May lose gift tax previously paid
     - But, also possible completed gift with deemed gifts from children back to parents for failure to enforce trust.

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Options (cont'd.)

3. Buy Back House?
   - Trust prohibits (1997 Reg.)
   - So buy back is breach of Trust
   - What if Trust reformed and or amended under state law (e.g. Sec. 15403, 15404, 15409 of CA Probate Code)?
   - Gain on sale, taxed to Client (unless unrecognized under grantor trust rules)
   - Deemed gift by children? If sale at FMV?

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