Heckerling Musings 2009

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Introduction

The 43rd Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 12, 2009. I have summarized some of my observations for the week, as well as other observations from developments over the last several months. My goal is not to provide a general summary of the presentations; the summaries provided on the American Bar Association Real Property, Trust & Estate Law Section website (http://www.abanet.org/rppt/meetings_cle/heckerling) that is prepared by a number of reporters, coordinated by Joe Hodges, do an excellent job of that. This is merely a summary of observations of items that were particularly interesting to me. I generally have not included ideas that were summarized in the Heckerling Musings that I prepared for last year's Institute. I sometimes identify speakers, but often not. However, I take no credit for any of the outstanding ideas discussed at the Institute — I am merely relaying the ideas of others that were discussed during the week.

Much of the discussion at the Institute focused on planning issues in light of the recent market meltdown and financial scandals as well as planning in light of political uncertainties regarding possible future estate and gift tax legislation. There have not been major tax developments during the past year, and there was considerable discussion of a variety of non-tax issues as well. A variety of different sessions addressed retirement planning issues (including a number of sessions by the always outstanding Natalie Choate) but I have only summarized the session dealing with Roth IRAs (by Marcia Chadwick Holt), which contains very important information for clients with Roth 401(k) accounts.

1. Estate and Income Tax Legislation

a. $3.5 Million Exemption; 45% Rate. The Wall Street Journal on January 12, 2009 reported that estate tax legislation may be a high priority for Congress, and that we would likely see a permanent increase in the estate tax exemption to $3.5 million and a 45% rate. The Senate Finance Committee may begin addressing estate tax legislation in several weeks.

The position of then-Senator Obama and Senator McCain was summarized in "An Updated Analysis of 2008 Presidential Candidates' Tax Plans," Tax Policy Center (July 23, 2008). President Obama's position was to fix the estate tax law permanently in its 2009 form, with an exemption of $3.5 million and a top rate of 45%. Neither of the Presidential candidates officially supported restoring the state death tax credit, indexing the exemption to inflation, unifying the estate and gift tax system, or including a portability provision for the exemption between spouses, but both plans would repeal the carryover basis provisions. The proposal would be effective for 2010 and future years.

The Wall Street Journal report appears to confirm that the administration would like to move forward quickly on a $3.5 million exemption and 45% rate. A major question now is whether such legislation would just address the exemption and rate, or whether it would also address other estate tax issues (discussed below).

b. Permanent Relief May Be Possible With Relaxation of "Pay-Go" Rules. The Tax Policy Center's analysis of the Presidential candidates' tax proposals concluded that the estate tax provisions of the Obama plan ($3.5 million exemption and 45% rate) would reduce estate and income taxes about $284 billion over 10 years (2009-2018). A report dated January 28, 2009 by the Center on Budget and Policy Priorities indicates that a $3.5 million exemption and 45% rate would cost about *$609 billion* over the ten year period from *2012-2021* compared with what would transpire under current law. Under the Obama plan, 8,000 estates would be taxable in 2011 (or about 0.3% of decedents). The $284 billion or $609 billion cost over the various "ten-year windows" (which are often important in scoring the cost of tax legislation) seems daunting in face of the "pay-as-you-go" (or "pay-go") position of the House of Representatives over the last several years that tax legislation must be revenue neutral or be offset by other spending cuts. This is true particularly in light of the fact that other tax relief measures (such as relief from the alternative minimum tax) seem to have a higher priority than estate tax relief. However, in light of the current national economic crisis and the need to stimulate the economy, the "pay-go" rules are gone and this might be a window for "permanent" estate tax relief without immediate revenue raisers to offset the revenue loss.

c. Other Estate and Gift Tax Legislative Changes? Rumors are circulating wildly about other possible changes (that might come in a later tax package if a straightforward permanent $3.5 million exemption and 45% rate is passed in the near future, as suggested in the Wall Street Journal article).

(i) GST Qualified Severance. The qualified severance rules enacted in 2001 are scheduled to sunset in 2011. Extending the severance rules is very important and is not controversial, but the extension has not been addressed in most of the various estate tax proposals over the last several years.

(ii) Portability. Portability of exemptions between spouses simplifies planning. Many clients may not need bypass trusts or re-titling of assets to avoid wasting a spouse's available exemption. It would simplify planning needed to utilize fully the first decedent-spouse's $3.5 million exemption in states that have decoupled and would impose a state death tax on fully funding a bypass trust with the federal exemption amount. (However, the portability provision in the PETRA proposed legislation several years ago did not include portability of the GST exemption.) The portability concept seems to have legs in Congress — but this will be a revenue issue. There is a significant income tax cost associated with portability because the assets that might otherwise be left into a bypass trust could instead be left to the surviving spouse and receive a step-up in basis at the deaths of both spouses.

(iii) Gift Tax Exemption. If the gift tax and estate tax exemptions are recoupled, that would be a big change to planners' practices and would unleash a lot of planning. However, there does not seem to be a groundswell of support for reunification, and it is likely that the gift exemption will remain at $1 million.

(iv) Elimination of the Deduction for State Death Taxes. Some have suggested eliminating this deduction, but it has not received a great deal of attention.

(v) Limitation of Crummey Power. The Joint Committee Report on dealing with the "tax gap" from several years ago suggested the possibility of tightening the rules on Crummey trusts.

(vi) Elimination of Discounts for Family Entities. There have been various proposals to restrict discounts for interests in family entities (discussed in Item 2 below in more detail).

(vii) 10% Remainder Requirement for GRATs. There have been rumors that the Joint Committee on Taxation or some on the Senate Finance Committee have floated the idea of tightening the rules for GRATs, including the possibility of imposing a 10% remainder requirement or possibly imposing regulations with a remainder interest imitation (despite the absence of a remainder requirement in the statute). (Similar rumors have been floating around for at least several years.) That would require making a significant gift when GRATs are created, which would significantly reduce their desirability. This is an area where the rumor mill is working overtime, and it is hard to determine how likely this is. Many at the Institute believe that this will not be enacted.

d. Possible Income Tax Increases.

(i) Wages and Bonuses — Current Situation. There is a 35% maximum income tax rate on earned income. The FICA tax is 12.4% (6.2% employer and 6.2% employee) up to a $102,000 wage ceiling for 2008. The Medicare tax rate is 2.9% (1.45% employer and 1.45% employee) with no wage ceiling.

Itemized inductions are phased out at higher incomes. At one time, the cut back was limited to 80% maximum. In 2008 and 2009, the cutback is just one third of the cutback previously.

(ii) Possible Change for Wages and Bonuses.

- Ordinary income tax rate over $250,000 — increase to 39.5%.
- Employment taxes; there are proposals to increase employment taxes over $250,000 by amounts from 2% up to the 6.25% rate that now applies. (Apparently those amounts would be doubled for self-employed individuals that pay both the employee and employer share.)
- Itemized deductions; there are proposals to completely reinstate the phase out of itemized deductions if the taxpayer's income is over $250,000.

For employees, the maximum combined income tax and employment tax rate for amounts over $250,000, could increase from the current 36.45% (35% +1.45%) to 49.15% (39.5%+6.2% +1.45%). For self-employed individuals, it appears that the combined rate could increase to 54.8% (39.5% +12.4% +2.9%). These are huge potential rate increases.

(iii) Capital Gains and Dividends. The 15% rate on capital gains and dividends is scheduled to expire after 2010. There was some fear that a Democratic Congress and President might move up the timing of the rate increase. Many clients paid large dividends last year, assuming that the 15% rate on dividends would be repealed for this year, and would return to being taxed as ordinary income.

(Would a capital gains rate increase present a huge problem for our clients in 2009? Dennis Belcher quips, “I have one client with a capital gain in 2008.”)

(iv) Delay in Tax Increases. In light of the economic crisis and the fear of further dampening the economic recovery with tax increases, Democratic proposals for rolling back the Bush tax cuts may not be implemented; they may be allowed to expire on their own in 2011.

2. Elimination of Valuation Discounts for Family Entities

Proposals to eliminate “family discounts” have been around for years. The Clinton administration made proposals to disallow valuation discounts for “non-business assets” (other than reasonable working capital) in 1999, 2000, and 2001.

a. Joint Committee on Taxation 2005 Suggestion. In January 2005, the Joint Committee on Taxation’s report on “Options to Improve Tax Compliance” suggested a proposal that would remove lack of control discounts by applying a transferor aggregation rule (valuing the interest as a pro rata portion of what the transferor owned before a transfer) and a transferee aggregation rule (valuing the transferred interest as a pro rata portion of the transferred interest plus what the transferee owned before the transfer). For example, if a person owned an 80% interest in a family entity and gave a 40% interest, the value would be 40/80 or one-half of the value of the 80% interest (under the transferor aggregation rule). If the person later gave or bequeathed his or her remaining 40% interest to the same donee, that interest would be valued at one-half of the 80% interest owned by the transferee after the transfer (under the transferee aggregation rule). In addition, a look-thru rule to value "marketable assets" that composed at least 1/3 of an entity's assets without a discount. The look-thru rule would eliminate both a marketability and minority discount for transfers with respect to "marketable assets" inside family entities.

b. Proposal in H.R. 436. H.R. 436 was filed by Representative Pomeroy (D-ND) on January 9, 2009 and has been referred to the House Ways and Means Committee. It adopts a permanent $3.5 million estate tax exemption, a 45% rate (with a 5% surcharge for taxable estates between $10 million and $41 million), and imposes restrictions on valuation discounts for interests in entities that are not "actively traded." The changes would apply to transfers after December 31, 2009.

Before getting carried away with the impact of this bill, keep in mind that it is only one of many tax bills (and it has no co-sponsors unlike many other bills that have multiple sponsors) that have been and will be filed in this Congressional session. (Mickey Davis points out that H.R. 25 ["To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States"] has 39 co-sponsors in addition to John Linder (R-Ga) who filed it.

H.R. 436 has three major provisions restricting valuation discounts. (1) Nonbusiness assets (not used in the active conduct of a trade or business) in any entity that is not actively traded would be valued at a pro rata portion of the full value of those assets, with an exception for real estate in which the transferor "materially participates" and for reasonably required working capital needs. (2) Look-thru rules would ignore "tiered discounts" for nonbusiness assets consisting of a 10-percent (presumably or greater) interest in another entity. (3) Look thru rules would disallow any minority discount for transfers of interests in a family controlled entity (using the very broad attribution rules of §2032A(e)(2), which counts interests held by an [1] ancestor, [2] spouse, [3] lineal descendants of the individual, of the individual's spouse, or of a parent of the individual, and [4] the spouse of any individual described in [3] immediately above). Marketability discounts for the business portion of family entities would still be allowed (except for the portion represented by nonbusiness assets, as discussed above).

c. Revenue Impact. Jonathan Blattmachr has been told that a broad family discount restriction would save between $5 and $6 billion a year.

3. Retroactive Tax Legislation

A fear among estate planners is that changes (such as elimination of discounts in some circumstances) might be imposed retroactively. (Even if they are not imposed retroactively, tax legislation attacking perceived abuses is sometimes enacted with an effective date of when it is passed by the House Ways and Means Committee, and there is always at least a one day lag before planners become aware of such legislation.) How can planners plan in light of that uncertainty? Dennis Belcher asks, "Because Congress can make changes retroactive, do I have to rush out and do it last year?" The panelists thought that retroactive estate tax legislation this year is not likely, but planners should alert clients that retroactive change is possible. Rates are sometime retroactively changed, but generally when rates are changed during the year, they are effective from the date of enactment.

a. <u>Validity of Retroactive Tax Legislation</u>. Supreme Court cases have upheld the validity of retroactive tax legislation, but none has involved a specific rule that has been in the law a long time (such as GRATs, the definition of fair market value, etc.). However, back to the 1920s, the taxpayers won on the retroactive effect of the gift tax, but that involved the creation of a whole new tax. <u>U.S. v. Hemme</u>, S. Ct. 2071 (1985) case upheld the retroactive application of what is now §2010(b). In addition, <u>U.S. v. Carlton</u>, 512 U.S. 26 (1994) upheld the validity of retroactive legislation regarding an estate tax deduction that was allowed at one time under one of the various provisions of §2057 for the sale of stock to ESOPs (adding that the stock had to be owned by the decedent at the date of death).

b. <u>Planning in Light of the Possibility of Retroactive Tax Changes (or Changes That Were Unknown to the Planner at the Time of a Transfer)</u>. The possibility of retroactive changes does not mean that planners must stop doing transfer planning in uncertain areas — but just plan to be able to get out of the transfer if there are substantial adverse consequences. Planning possibilities include the following.

(i) <u>Disclaimer</u>. A disclaimer of an outright gift generally means that the property returns to the donor — as long as there have been no acts of acceptance. A way to make a completed gift but avoid the acceptance issue is to make the gift to a trust. There could be a delivery to the trust, but provide in the trust agreement that if the beneficiary renounces his interest in the trust, the property would pass back to the donor. Make sure that no distributions were made out of the trust before the end of the nine-month disclaimer period. Also, the trust should authorize the trustee to disclaim and provide that the trustee has no liability if it disclaims. The same could apply to the disclaimer of a remainder interest in a GRAT.

(ii) <u>Rescission</u>. A Third Circuit 1999 unpublished opinion, <u>Neil v. U.S</u>. (which was published in Tax Notes) addressed the tax effect of a rescission allowed under Pennsylvania law in the case of a unilateral mistake where there was no consideration. The issue is whether there was a unilateral mistake if the law subsequently was changed retroactively. The case involved old section 2036(c), and the donor kept a retained power to comply with a Notice about the old section 2036(c). The section was later repealed retroactively. The taxpayer had the local probate court approve a rescission of the retained power based on unilateral mistake. The IRS challenged that the rescission was not binding for tax purposes and lost. The case said further that an actual rescission was not even needed, because the gift was not complete because it could have been rescinded under Pennsylvania law.

(iii) <u>Defined Value Clause</u>. Using a defined value clause has the effect of adjusting values based on retroactive law changes (for example that might disallow valuation discounts.)

(iv) <u>Contingent Gifts</u>. Consider making gifts contingent on the fact that laws that now allow discounts remain effective as of the date of the gift. That does not make the gift incomplete because the condition is outside the control of the donor. However, if the law does change, the gift would be reversed.

4. Expatriation Legislation; HEART Act

The Heroes Earnings Assistance and Relief Tax Act of 2008 (referred to as the "HEART" Act), includes generally (1) a special income tax "mark to market" rule when someone expatriates after June 17, 2008, and (2) a new succession tax on anyone who receives a gift or bequest from someone who expatriates after June 17, 2008. (There are special rules and exceptions to these rules, some of which are summarized below.) Some of the provisions of the HEART Act potentially affect clients in many planners' practices even for planners that do not typically represent foreign individuals.

a. Application to "Covered Expatriates". The new provisions apply to a "covered expatriate," who is a U.S. citizen who relinquishes citizenship and any long term resident (i.e., a lawful permanent resident or green card holder for eight out the 15 years prior to expatriation) who terminates U.S. residency if the individual meets one of three categories. (Those categories are that the individual (1) has an average income tax liability for the last five years over $139,000 [indexed for inflation], (2) has a net worth of $2 million or more [not indexed], or (3) fails to certify that he or she has complied with all U.S. tax obligations for the prior five years.) There are several exceptions to who constitutes a covered expatriate.

Few estate planning attorneys have U.S. clients who will renounce citizenship. However, it is common to counsel permanent residents working for a U.S. company who have always intended to return to their homeland when they retire. Permanent residents do not have to do anything formal to relinquish their residence status; they can do so by just staying out of the country too long.

b. Exit Income Tax. Section 877A is an income tax provision, requiring a mark to market tax. A covered expatriate is deemed to have sold his or her property on the day before expatriation occurs. There are various exceptions, including (a) the first $600,000 of gain, (b) eligible deferred compensation agreements (for which the gain is recognized only as funds are paid out), but this exception does not apply to IRAs, and (c) Section 529 plans.

Interests in grantor trusts are subject to the mark-to-market tax. The mark-to-market tax does not apply to interests in non-grantor trusts at the time of expatriation, but there is a 30% withholding requirement on the trustee on the portion of any distribution that that would have been includible in the gross income of the expatriate if he or she continued to be subject to tax as a citizen or resident of the U.S. (Trustees of trusts around the world are very concerned that this may require that they find out if all trusts they are administering were created by U.S. expatriates; if so they may be subject to the 30% withholding requirement.) Furthermore, if a non-grantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property was sold to the expatriate at its fair market value.

Persons who expatriated before June 17, 2008 are subject to continued taxation under the former special tax regime in §877 for 10 years, but that will run out in 2018.

c. Succession Tax. Section 2801 is a transfer tax provision, imposing a transfer tax on the recipient who is a U.S. citizen or resident of a gift from a "covered expatriate" or a transfer directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death. Therefore, planners must ask every client if any "upstream" relative has expatriated on or after June 17, 2008. There are several exclusions from this tax: (1) property shown on a timely filed gift or estate tax return of the covered expatriate; (2) property for which a marital or charitable deduction would be allowed under §§2055, 2056, 2522, or 2523; and (3) annual exclusion gifts and other gifts exempt under §2503(b). (Observe, an expatriate loses all benefits of a unified credit; the recipient qualifies for the $13,000 annual exclusion, but gifts above that are subject to the transfer tax.) The tax is the highest marginal rate of tax specified for gifts or estates, respectively [currently 45%].

The statute says that for this purpose, the net worth and income tests are applied either at the time of expatriation or at the time of the gift or bequest. That would be amazing; someone who acquires a net worth of $2 million many years after expatriating could then become subject to the succession tax for gifts or bequests after that time. Treasury has said informally that was not intended and they will apply the net worth and income test only at the time of expatriation. Hopefully, they will formalize that position at some point in published guidance.

Observe that this will be a tax applied to transfers by many long term residents who would not have otherwise been subject to the U.S. estate tax. Many long-term residents may not be domiciled in the U.S. (and therefore would not be subject to the U.S. estate tax on their worldwide assets) if they have always intended to return to their home country. If they expatriate, they may be subject to a transfer tax that would not have been applied had they stayed in the U.S.

If the transfer is made to a domestic trust, the tax is due from the trust. (What if the bequest is made to a charitable remainder trust and taxes cannot be paid from the charitable remainder trust?) If a transfer is made to a foreign trust, the succession tax is not imposed in the year of transfer but is imposed on any distribution from the trust (whether from income or principal) attributable to such covered gift or bequest. However, a foreign trust can make an election to be treated as a domestic trust and pay the tax at the trust level. Otherwise, the foreign trust and beneficiary must act together; the portion of a distribution attributable to a covered gift must be reported by the distributee.

The recipient of a transfer from a covered expatriate must file a report and pay the tax, but if property received by a US resident is shown on a timely filed gift or estate tax return, then the recipient does not have a reporting requirement. This creates considerable confusion until the IRS issues guidance. (There have been rumors that there will be guidance from the IRS on this Act in the near future; Cathy Hughes has indicated that a lot of people are working on guidance and it is a priority.) The statute does not provide when the report must be filed. It must be reported after the receipt of the property, but is that the date of death or the date the bequest is funded? How will the recipient know, if the transfer has been shown on another person's gift or estate tax return (which may not be due until the same day the report would be due by the recipient)?

Observe that this is a more expensive tax than the gift tax, because this tax is a tax inclusive tax — the transferee must pay the tax after being subjected to a 45% tax on the gross amount transferred to the transferee.

d. <u>Practical Planning Considerations</u>.

(i) <u>Long Term Resident Exit Before Eight Years</u>. If the client is not yet a long term resident, consider leaving quickly. Once the person stays in the U.S. eight years, the client is subject to the exit tax and transfer tax for transfers to U.S. persons.

(ii) <u>Inadvertent Loss of Resident Status</u>. Persons will do not wish to be subject to the new exit tax and transfer tax must be very careful not to lose their long term resident status by staying out of the country too long.

(iii) <u>2009 May Be the Best Time to Expatriate</u>. For a client who wishes to return to his or her homeland at some point, 2009 may be the best time to expatriate while the 15% capital gains and dividend tax rate is still in effect. Furthermore, values are greatly depressed and the exit tax may considerably lower than in later years after the market has recovered.

(iv) <u>Liquidity Concerns</u>. Clients considering expatiation may be reluctant to do so because of liquidity concerns. However, there is an option of deferring the exit tax if there is adequate security, and that will be an attractive option for some people.

5. Minimum Distributions for Retirement Plans Not Necessary For 2009; Inherited IRA Rollovers

The Worker, Retiree, and Employer Recovery Act of 2008, passed in December 2008, makes various changes for retirement plans.

a. <u>Minimum Distributions Not Required for 2009</u>. There are no minimum required distributions for 2009. §401(a)(9). This applies to defined contribution plans (including 401(k) plans and profit-sharing plans) and IRAs (but not defined benefit plans).

For an employee who turns 70 ½ in 2009, the "required beginning date" is still 4/1/2010. A distribution would ordinarily be required for 2009, but for the first year (and the first year only) the distribution can be postponed to April 1, 2010. The distribution for 2009 would not be required.

If an employee turned 70 ½ in 2008, there was a required minimum distribution for 2008, but it could be postponed to April 2, 2009. However, because that distribution was actually required for 2008 and could just be postponed, it must still be paid by April 2, 2009 if the employee elected to postpone the 2008 initial distribution. While there may have been some confusion about this in the statute, the IRS clarified that this is the result in Notice 2009-9.

b. <u>Effect of 2009 Waiver of Distributions on Post-Death Distributions</u>. After the death of the plan participant, the required distributions depend on whether the participant died before his or her "required beginning date." If the participant dies before the required beginning date and if there is no "designated beneficiary," the plan benefits must be paid out within five years. However, under the WRERA legislation the five year period is determined "without regard to calendar year 2009." §401(a)(9)(H)(ii)(II). Effectively, the "five-year rule" becomes a "six-year rule" for beneficiaries who die in the years 2004-2009.

If the participant dies before the required beginning date and has a "designated beneficiary," or if the participant dies after the required beginning date, the payout can be made over the life expectancy of certain persons. The WRERA rule will not change the way the life expectancies are calculated; it just provides that any distributions that would otherwise have been required for 2009 will not have to be made.

c. Plans Required to Offer Inherited IRA Rollovers Beginning in 2010. The Pension Protection Act of 2006 permits a designated beneficiary to have qualified retirement plan benefits that he had inherited to be paid to an "inherited IRA" (an IRA opened after the participant's death in the name of the deceased participant payable to the beneficiary.) This is very helpful because it allows beneficiaries to use a life expectancy payout method even if the plan they inherited does not permit that form of distribution. Before this law change, only spouses were entitled to rollover plan benefits to an IRA. The IRS announced that plans were not required to offer this election to beneficiaries of deceased participants in Notice 2007-7, and many plans did not. WRERA mandates that plans must offer nonspousal rollovers to designated beneficiaries, beginning in 2010.

6. Priority Guidance Plan 2008-2009 Projects

There are six new items in the estate and gift tax area.

a. Uniform Basis Rules for Trusts. Some transactions that the IRS has seen are questionable. If the income beneficiary and remaindermen join in selling the entire trust to a third party, each gets a pro rata share of basis in the trust assets under §643. IRS is taking another look at those rules. They were enacted before §664 regarding charitable remainder trusts. The IRS is looking at whether the uniform basis rules should apply to split interest trusts.

b. Adjustments to CLT Sample Forms, §664. The CLUT forms issued in 2008 are a little different than the CLAT forms that were issued in 2007. The annotations to the new CLUT forms reference the ordering rules that were issued after CLAT forms were published. In addition, the IRS is considering whether to include a sample form using formula clauses in testamentary CLTs.

c. Graduated GRATS, §2036. Various comments about the §2036 regulations for GRATs asked how §2036 would apply to GRATs with graduated annuities. There were several suggestions, and the IRS has its own views. The IRS has been working on this issue with IRS actuaries, and a proposed regulation should be issued in the near future. "It is pretty far along."

The next two items in paragraphs (d) and (e) are outgrowths of the §2053 proposed regulations. (The IRS is close to finalizing the §2053 proposed regulations.) The next two items were mentioned in comments about the §2053 proposed regulations.

d. Protective Claims for Refund. More detail will be provided about the details for filing and protecting protective claims for refund. Many comments to the §2053 proposed regulations asked for more detail about how to make protective claims. One issue that may be addressed is whether the entire return can be considered, even though the statute of limitations has run on the return, as an offset against the protective claim.

e. Effect of Guaranties and Present Value Concepts. There will be new guidance regarding the effect of personal guaranties on §2053. One comment to the §2053 proposed regulations asked whether a guarantee would be treated as a contingent claim by a family member, where there is a presumption that the claim is not bona fide.

The project will also address when present value concepts should be applied to administration expenses and claims. Under current law, administrative expenses may be deducted fully, as of nine months after the date of death, even though the claim is not paid until years later. Under a present value approach, taxpayers might only be allowed to deduct the discounted value. When contingent claims are actually paid, there may be a superficial parity: the discounted value would be deducted, which would generate a tax refund, and interest would be allowed on the tax refund. If the interest on the refund is calculated at the same rate as the discount rate, there would be parity. However mismatches may occur — including that income tax would be paid on the interest.

Furthermore, the present value concepts may be addressed for all administration expenses (including attorneys fees, Tax Court litigation expenses, etc.), not just contingent claims. Tax litigators often tell clients that the IRS pays 80% of their litigation expenses in the Tax Court (including the estate tax refund from the additional administration expense deduction and interest on the refund). This project may change their result. Cathy Hughes said "that is a fair reading of what we might be looking at."

Graegin Notes. Current law permits deducting the full amount of interest paid on Graegin notes, even though the interest is paid years after the date of death. Graegin notes might also be on the radar screen. Cathy Hughes: "They certainly are in the scope of what we are looking at."

f. Updating Mortality Tables, §7520. The mortality tables will be updated to reflect the 2000 census. The tables must be revised every 10 years to reflect updated census data.

g. Additional Guidance Coming Under 2704. The IRS Priority Business Plan for the last six years has included "Guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership" (first appearing in the 2003-2004 Priority Guidance Plan). This probably relates to the statutory authority to issue regulations regarding the effect of a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." I.R.C. § 2704(b)(4). Cathy Hughes, with the Treasury Department, has indicated that these new regulations will be out soon and that this regulation project is "at the top of the list." (However, even though the drafting of the regulations may be essentially completed, senior people in the Treasury Department who must sign off on regulations are focusing on the economic stimulus plan, and the issuance of regulation projects could be delayed for some time.) These regulations will be a HUGE DEAL when they are issued. They could potentially substantially restrict FLP discounts.

7. Freeze on New and Pending Regulations

In a memo to the heads of executive departments and federal agencies (Federal Register, 1/26/09, Volume 74, Number 15, page 4435), Chief of Staff Rahm Emanuel stated that unless related to an emergency situation or other urgent circumstances, no proposed or final regulation should be sent to the Office of the Federal Register (OFR) for publication until it has been reviewed and approved by a department or agency head appointed or designated by the President after noon on 1/20/09. Furthermore, proposed or final regulations that have not been published in the Federal Register should be withdrawn from the OFR so they can be reviewed and approved, and the recipient should consider extending for 60 days the effective date of regulations that have been published in the Federal Register but not yet taken effect "for the purpose of reviewing questions of law and policy raised by those regulations."

A regulation project of major importance to estate planners is the guidance on §2704 that has been under study for the last six years. See Item 6.g above. This Treasury memo, as well as reports indicating that senior persons in Treasury are tied up with economic stimulus issues, suggest that estate and gift tax regulations may be placed on the back burner for some extended period of time.

8. Planning In Light of Increased Federal Estate Tax Exemption

There are important non-tax considerations in whether to fully fund a bypass trust at the first spouse's death, now that the federal exemption has increased to $3.5 million. A $3.5 million bypass trust may not be desirable in family situations where the estate is not significantly larger than the $3.5 million amount. The surviving spouse might not like having almost the entire estate pass into a bypass trust, and most clients put a priority on providing for the surviving spouse. Alternative include the following. (1) Fully fund the bypass trust and add provisions to the trust clarifying that no distributions may be made to the client's children unless the trustee is assured that the surviving spouse's needs can be met, that the spouse has a "5 or 5" annual withdrawal power, and that the spouse has a testamentary limited power of appointment (affording him or her leverage over complaining children). (2) Leave the estate to the spouse and provide that disclaimed assets pass into a bypass trust having the spouse as a potential beneficiary. (3) Rely on a partial QTIP election with the unelected amount passing (under a "Clayton provision") to a bypass trust with the surviving spouse and other persons as potential discretionary beneficiaries. (In that case, the executor who makes the QTIP election should not be a beneficiary.)

9. Planning In Light of Valuation Drops During Estate Administration

If the estate drops dramatically before the marital bequest and exemption bequest are satisfied, the drop in value may deplete the bypass trust. For example, if there is a pecuniary martial bequest with funding based on date of distribution values, any decrease in the value of estate assets will reduce the amount passing to the bypass trust — the marital bequest would still receive the full amount of the pecuniary bequest based on estate tax values. (On the other hand if values increase during the administration, the increased value would pass to the residuary bypass trust under the approach of using a pecuniary formula marital bequest.)

a. Double Pecuniary Formula Clauses: Approach to Capture All Upside for Non-Marital Share or GST Exempt Bequests While Limiting Downside Risks. The formula clauses may be structured to capture all of the upside for the non-marital share while limiting losses charged against the non-marital share. The approach is to split the bequest to the non-marital share between a pecuniary and a residuary bequest. For example, assume wife dies with an estate of $6 million. Her will might have a series of three bequests:

   (i) Pecuniary bequest to husband of an amount equal to the smallest amount necessary to reduce the estate tax to zero;

   (ii) Pecuniary bequest to the bypass trust of an amount equal to say 90% of the remaining estate; and

   (iii) Residue passing to the bypass trust.

   If the applicable exclusion amount is $3.5 million, the effect based on a date of death value of $6.0 million is to leave $2.5 million outright to the husband, $3.15 million to the bypass trust under the second pecuniary bequest (i.e. 90%% of $3.5 million), leaving a residue of $350,000 also to the bypass trust. Only that $350,000 amount has to bear the full brunt of future declines in value during the estate administration. Any additional decline in value would be apportioned equally between the husband's share and the nonmarital share. However, the residuary bypass trust share would be entitled to all increases in values during estate administration.

   An alternate approach for the second pecuniary bequest (described above) would be a pecuniary bequest of the remaining estate less a specified dollar amount, say $250,000.

This would mean that the bypass trust would bear all of the first $250,000 of deprecation but only a pro rata amount of depreciation after that.

This approach can also be used to limit the downside exposure of GST exemption bequests. For example, a will could use the following series of bequests:

(i) Pecuniary formula bequest amount equal to 90% of the decedent's GST exemption to a dynasty trust;

(ii) All of the estate in excess of the decedent's GST exemption to trusts for children; and

(iii) Residue to the dynasty trust.

The effect would be that the residuary gift to the dynasty trust will have a date of death value equal to 10% of the decedent's GST exemption. The residuary bequest to the dynasty trust would receive 100% of gains, but the 90% of the GST exemption bequest will be the last to suffer losses. (The executor would have to follow the funding rules of Reg. §26.2642-2(b).)

b. Alternate Valuation Date Election to Shift Market Decline to Marital Share. If a pecuniary marital bequest with date of death funding is used, declines in value during the first six months after the date of death would fall entirely on the residuary bypass trust. If a fractional share bequest is used, the bypass trust would be reduced by a pro rata part of the loss. In each of those cases, depleting the bypass trust could be avoided by making the alternate valuation date election, so that the formulas would operate to leave the full exemption amount to the bypass trust as of that six-month valuation date.

There are two requirements to qualify for the alternate valuation date election; the gross estate must decline as a result of making the election and the combined estate and GST taxes must decline as a result of making the election. Under the typical formula clauses, the estate tax is reduced to zero, so there would be no decline in estate taxes as a result of making the election. That can be solved by having the spouse make a disclaimer of the marital bequest or by having the executor make a less than full QTIP election if the marital bequest passes to a QTIP trust.

If there is no state death tax, this can be accomplished by disclaiming or "unelecting" QTIP treatment as to an amount slightly in excess of the decedent's remaining federal exemption amount. This is further complicated if the decedent dies in a state having a state estate tax. Because of lower state exemptions, and because there is a federal deduction for state death taxes, disclaiming or leaving unelected an amount equal to the federal exemption may still result in a sufficient federal deduction attributable to the high state death taxes so that no federal estate tax is payable. The planner must "push the pencil" to calculate the amount of disclaimer or unelected QTIP necessary to produce a small federal tax, which would be reduced slightly as a result of making the alternate valuation date election.

Pam Schneider strongly prefers the partial QTIP approach over the disclaimer approach. (1) It is not as prone to error, because it just requires making a 99% (or less) partial QTIP election (assuming there is no state death tax and federal state death tax deduction to worry about). (2) The disclaimer must be made within 9 months whereas 15 months is allowed to decide whether to make the partial QTIP election (if a 6-month extension of the estate tax due date is requested). (3) Under the disclaimer approach, the surviving spouse cannot have a testamentary power of appointment over the disclaimed assets, but that restriction does not apply to a partial QTIP election. However, if the QTIP approach is used, an independent party should be the executor who makes the QTIP election, not someone who would benefit by becoming a beneficiary of the unelected portion of the QTIP if a partial election is made.

If the alternate valuation date election is used to avoid depleting the bypass trust, the trust should be funded soon after the six-month valuation date to assure that further decreases in value do not deplete the bypass trust. Furthermore, the executor must not make sales or dispositions before the six-month valuation date that would peg the value of those sold/distributed assets to the date of sale/distribution.

Observe that the overall impact is that making the alternate valuation date election may preserve the full amount passing to the bypass trust, which can result in substantial estate tax savings on the additional amount left in the bypass trust (and future income and appreciation from that additional value) when the surviving spouse dies in the future. This potential 45% savings comes at the cost of losing the step up in basis on the difference between the date of death and six-month values, which might result in a more immediate capital gains cost (or loss of some capital loss carryover) when the asset is sold. The issue is a 45% savings in the future (dependent on future estate tax laws, whether the spouse has an estate large enough to be subject to estate tax in any event, etc.) vs. a 15% potentially much more immediate income tax savings (on future sales).

c. <u>Alternate Valuation Date Election to Lower Tax If Estate is Paying Estate Tax</u>. If the estate is paying estate tax, effectively the beneficiary gets the benefit of 100% of the appreciation after the date of death but only has to bear 55% of losses for the first six months because of the possibility of making the alternate valuation date election if values decline. After that, the estate receives and bears 100% of appreciation and depreciation.

d. <u>Effect of Alternate Valuation Date Election on IRAs</u>.

(i) <u>Effect of Changing Title</u>. Does changing the title on the IRA to the name of the beneficiary peg the alternate valuation date value to the date of such distribution as a "sale or disposition" of the asset? While distributing estate assets from the estate to a beneficiary is treated as a disposition that pegs the valuation on that date, re-titling assets to an IRA beneficiary should be like re-titling assets that were in a joint account with right of survivorship to the surviving joint tenant after the decedent's death, which is not treated as a "disposition" under the alternate valuation date rules. Rev. Rul. 59-213.

(ii) <u>Effect of Sales of Assets Inside the IRA</u>. It is unclear whether the IRA is valued as a single unit or whether sales of individual assets inside the IRA may be treated as a disposition, pegging the alternate valuation value to the date of sale as to those particular assets. There is an excellent discussion of this issue in the January 10, 2009 Leimberg Information Services, Inc. Newsletter.

10. Planning In Light of State Estate Taxes

a. <u>Whether to Fully Fund the Bypass Trust At the Cost of Additional State Taxes</u>. In state that have "decoupled" from just basing their tax on the federal state death tax credit and that apply an independent state estate tax, usually with a lower exemption amount than the federal $3.5 million exemption, substantial state taxes may be imposed if the full $3.5 million exemption amount is left to a bypass trust. For example, in some states, fully funding the bypass trust now costs $229,200 of state tax. There are now 22 states that have an exemption amount that is substantially lower than the federal exemption.

The preferred approach is to give the surviving spouse a choice; from a client relations standpoint, this "feels" better to the spouse if the spouse sees it as a future tax savings opportunity rather than the imposition of an current state death (due to "poor draftsmanship") that could have been avoided. If the spouse thinks that his or her estate will continue to grow and will be subject to a 45% (or higher) estate tax in the future, the spouse may be delighted to pay an additional state tax currently (say at a 9% rate) to avoid the additional federal tax later. The flexibility can be achieved by using a disclaimer or partial QTIP approach, much like discussed above for the alternate valuation date election decision.

If the spouse disclaims or if the executor makes a partial QTIP election in a manner that fully funds the bypass trust (or unelected portion of the QTIP trust) with the full federal exemption amount, what trust should bear the expense of paying the additional <u>state</u> death tax? It is deductible for federal estate tax purposes, so no additional federal estate tax will be incurred by reason of charging it to the marital share. However, some states may take the position that charging the additional state tax against the marital share further increases the state death tax. In those states, consider charging the added state tax against the bypass trust. Furthermore, any federal estate taxes should continue to be allocated against the non-marital share (even though no federal taxes are anticipated). A recent New Jersey case took the position a clause allocating federal taxes against the marital share would increase the state taxes from about $229,000 to about $500,000, even though no federal estate taxes were actually payable, because they calculated the federal estate tax as the amount of federal tax that would have been imposed if the law had not changed in 2000.

b. <u>QTIP Trusts in Smaller Estates</u>. Smaller estates, that do not have to file a federal estate tax return because they are under $3.5 million, present an issue as to whether the QTIP election can be made for state QTIP purposes. In those states where that is unclear, for smaller estates under the federal exemption limit use an outright bequest to the surviving spouse or a bequest to a general power of appointment trust rather than a bequest to a QTIP trust.

Another unclear issue is whether smaller estates (that do not have to file a federal estate tax return) can make the alternate valuation date election.

c. <u>Real Estate</u>. If the client resides in a state without state estate taxes but owns real estate in a state that has a state estate tax, consider contributing the real estate to an LLC. Most LLC statutes say that an interest in an LLC is a personal property interest (which would be subject to tax in the state of domicile rather than the state of situs of the real estate). That is not always clear with respect to real estate owned in partnerships.

On the flip side, if the individual resides in a "high tax" state and owns real estate in a "low tax" state, do not put the real estate in an LLC, or it could increase the state estate tax in the state of domicile.

As an aside, if an LLC is used in New York, observe that single member LLCs might present problems in New York, and some planners recommend having at least two members for New York LLCs. Furthermore, a recent Advisory Opinion issued by the New York State Department of Taxation and Finance (TSB-A-08(1)M) takes the position that New York real estate in an S corporation or in a single member LLC that is treated as a corporation for federal income tax purposes will be treated as an intangible that is not subject to New York estate tax for a non-resident, but only if the entity's purpose is the equivalent of a business activity or is followed by the carrying on of a business by the entity. (Presumably, it would have applied the same business purpose test to a multi-member LLC.)

11. Deathbed Gift Planning

Most states with an independent state estate tax do not have state gift taxes, and deathbed gifts in those states could save substantial state estate taxes. For deathbed gift planning to work, (1) the client must have cash or high basis assets so that he or she would not be making gifts of highly appreciated assets resulting in loss of the step-up in basis, and (2) there must be a mechanism for making the gift on short notice, because the timing of death is often unpredictable. One approach is to use a power of attorney, but death could occur over a weekend when it would be impossible to make a transfer from accounts at financial institutions that are closed during the weekend. Carlyn McCaffrey suggests using a revocable trust, and giving the person who would otherwise be named in a power of attorney the authority to terminate the client's revocation power. The person would only need to sign a simple instrument terminating the revocation power (either completely or as to specified assets) in order to complete the gift from the client.

12. Decanting Issues

Seven states have decanting statutes, Alaska, Delaware, Florida, New Hampshire, New York, South Dakota and Tennessee. Ohio, Pennsylvania, and Virginia are among states considering decanting statutes. There are differences as to who can be beneficiaries, what interests can be changed, the extent of the distribution powers, whether a trustee can exercise decanting powers across state lines, and whether the decanting can affect the perpetuities period.

a. Uses. Decanting can be used in a variety of situations including 1) avoiding distributions to irresponsible beneficiaries or for beneficiaries that want creditor protection, 2) change in appropriate trustee designation and removal powers, 3) to give more flexibility through powers of appointment, 4) to change the grantor trust status of the trust, 5) to defer a portion of the GST tax on an impending taxable termination by decanting a portion of the trust to a trust that is a non-skip person because no beneficiary has a present interest in the trust, and 6) to change a traditional trust to a directed trust under Delaware law. New York planners have used the decanting power to solve almost problem that they find in trust instruments as long as there is an unlimited power to invade principal as required under the New York decanting statute.

b. GST Issues. If a grandfathered trust or a trust that is exempt due to allocation of GST exemption is decanted with a trust that is not GST exempt, there is uncertainty as to the GST effects. Unless the decanting statute being relied on was in effect when the trust was created (for a grandfathered trust) or when the GST exemption was allocated (for an exempt trust by allocation) , make sure that the "decantee" trust does not increase the interest of lower generation beneficiaries.

c. Delaware Tax Trap. Decanting is treated as the exercise of a limited power of appointment by most statutes. In what has come to be known as the "Delaware tax trap," Section 2514(d) provides that if a post 1942 power of appointment is exercised by creating another power of appointment that can be exercised to postpone the vesting of any interest that was subject to the first power for a period ascertainable without regard to the creation of the first power, the exercise of the first power is deemed to be a gift by the person possessing the power (and a corresponding provision in §2041 may cause estate inclusion for the person that exercises the first power). §S2041(a)(3) & 2514(d). Decanting may be viewed as the exercise of a power to create another power if the second trust confers discretionary powers to create interests that are not subject to the original perpetuities period. The solution is to use the same measuring lives for the perpetuities period in the two trusts.

d. Income Tax Treatment. What if there is undistributed income in the trust being decanted? It is not clear if that is treated as a DNI distribution to the decantee trustee. Several letter rulings say that it is not. (That is very important if a foreign trust decants into a U.S. trust.)

It is unclear what happens if a trust is being decanted into two separate trusts with different assets going disproportionately to the two trusts. For example, if the trust has $100,000 of income and decants into two trusts, one receiving assets worth $50,000 and a basis of $10 and the other receiving an asset worth $500,000 with a basis of $500,000, how is the income allocated? Presumably that is determined either on the basis of relative values or technically under Subchapter J perhaps based on the relative basis of the assets in the two trusts.

13. Changes to Trusts In States With No Decanting Statutes

Many (but not all) of the trust changes may be possible in states without a decanting statute but that are UTC states or that allow liberal modification changes with the consent of all beneficiaries and that have liberal virtual representation provisions. All of the administration changes can be made without tax worry. For example, that is being used frequently to convert the trust to a Delaware directed trustee trust by changing the situs and administration to Delaware, but not necessarily changing the governing law. (However, changing the situs typically changes the governing law only as to administrative matters, but not as to the validity of the trust and the construction of its dispositive provisions. For example, it is not clear if changing the situs to a state with a decanting statute allows use of that statute; the answer depends on whether that is an "administrative" matter.) Also, many other changes can be made under the UTC with court approval, including changes that are not contrary to the settlor's probable intention for tax purposes.

14. Defined Value Transfers

a. Christiansen. The Christiansen case, 130 T.C. No. 1 (2008), upheld a formula disclaimer to a non-taxable beneficiary of an amount equal to the estate tax value less a specified amount that would pass to a private foundation. If the IRS adjusted the estate tax values, the effect of the formula would be to increase the amount passing to the foundation, thus resulting in no additional estate tax. (The IRS apparently did not raise its position in prior rulings that the disclaimant can have no power to impact the distribution decisions of the foundation in order to have a valid disclaimer.) The IRS argued that the formula should be held invalid on public policy grounds by analogy to Procter because the formula discourages audits. The court unanimously rejected that argument because there were other policing mechanisms for amounts passing to charity (such as the fiduciary duties of directors of the foundation). Christiansen is a reviewed decision of the Tax Court, not just a "luck-of-the-draw" opinion by one Tax Court judge in a memorandum decision. The time to appeal ended in December, so the Christiansen case will not be appealed.

b. Importance as to Retroactive Legislation. One use of defined value clauses would be to protect against retroactive legislation. If legislation retroactively (or unknowingly) changes the availability of valuation discounts, the defined value clause would operate from the time of the initial transfer in light of that retroactive legislation.

c. Pending Tax Court Case, Petter v. Commissioner. There is a pending case in the Tax Court addressing the gift to family members of a specific dollar amount as finally determined for federal gift tax purposes, with the excess over that amount passing to charity. That case is Petter v. Commissioner, tried in February, 2008. In that case, the parties agreed to a 35% valuation discount several weeks before trial, and the issue is whether the formula transfer clause will be respected. The IRS agent testified in the case that if the court respects these clauses, the IRS will not audit these types of transactions. However, the IRS does audit estates of first-to-die spouses to confirm that the surviving spouse received the amount that he or she was supposed to receive under a formula marital deduction clause that also reduces the estate tax to zero at the first spouse's death in any event.

d. Status. The IRS clearly does not like these clauses. Indeed, this may be one of the hottest "red flags" in the estate and gift tax area as agents review returns. However, there is no judicial decision saying that they do not work. Carlyn McCaffrey concludes that it makes sense to use defined value clauses for transfers between family members. The judicial tide seems to be going against the IRS on this issue, especially where the "excess value" passes to charity.

John Porter observes that most the defined value cases are settled. The government will not directly say that they are giving any effect to the defined value clause in the settlement, but in reality he thinks they do have an effect on audit settlements.

e. Should Planners Use Them? Carlyn McCaffrey says yes: "We're seeing that valuation clauses are gradually coming to overcome the various challenges, and I think that it is important that all of you make it a part of the tools that you routinely use when you're making transfers of hard-to-value assets."

15. Section 67(e) and Unbundling of Trustee Fees

a. Regulations. The IRS is struggling with writing regulations to §67(e) following the Knight decision, including what approach to take with respect to unbundling trustee fees to make the portion of the fees attributable to investment advice subject to the 2% haircut rule of §67. The IRS delayed applying unbundling for another year in Notice 2008-116, saying that trustee fees need not be unbundled for 2008 returns (like Notice 2008-32 did for 2007 returns).

The IRS has received a number of comments, some suggesting various safe harbors, such as the value of assets under management (a $3.5 million safe harbor would remove 95% of the trust from the 2% rule), or for trusts having multiple beneficiaries. Another suggestion is that in unbundling trustee fees, a certain percentage of the trustee fee might be considered exempt. (This would not reduce the amount of the lost deduction in most cases [because the investment advisory fees may be considerably larger than 2% of AGI], but the entire portion of the fee that is exempted from the 2% rule would be removed as a tax reference item for AMT purposes, and the AMT implications of being a type of expense that is subject to the 2% rule are often much more important than the direct loss of deduction equal to 2% of AGI.)

b. Knight Test. Observe that if a trustee hires an investment advisor, the Knight decision does apply, even for 2008 returns. Knight concluded that investment advisory fees are generally subject to the two-percent floor because "it is not uncommon or unusual for an individual to hire an investment adviser." The court also pointed out that if an investment adviser charges a "special, additional charge applicable only to fiduciary accounts," such fees may be fully deductible. For example, it says a trust may have "an unusual investment objective or may require a specialized balancing of the interests of various parties."

c. Observations About Supreme Court Accepting The Case. Carol Cantrell had interesting observations about why the Supreme Court may have unexpectedly accepted certiorari in the Knight case. (1) The Second Circuit decision used a nonsensical approach of changing "would not" in the statute to "could not," which the Supreme Court Justices had fun ridiculing. (2) There were pedigreed attorneys handling the case, including Peter Rubin (a former clerk to Justice Souter and who took the case full time without charge) and also the lead counsel in the Exxon Valdez case. (3) The taxpayers purposefully filed the certiorari petition only one month before the deadline to be able to get on the last docket of the term in a year in which the Court had not taken a single tax case all year long.

d. Planning Suggestion for Documenting Investment Adviser Fees and Trustee Fees. In light of the Knight decision, Carol recommends preparing a separate fee agreement for investment advisers, spelling out the special balancing requirements for trustees, the necessity of investing in accordance with the requirements of the Prudent Investor Act, the particular needs of the beneficiaries, etc. (Carol's materials include a sample "Investment Delegation Agreement.") There was not any special fee agreement in the facts of the Knight case.

Carol recommends that institutional trustees document the unique things that the trustee does, such as closely reviewing the trust agreement, evaluating situs issues, complying with federal and state filing requirements, evaluating whether to exercise the power to adjust, evaluating requirements for distributions, determining whether to make distributions in cash or in kind, evaluating income tax planning for the trust, evaluating the GST implications of trust distributions, evaluating the tax impact of distributions, etc. (Those things are 98% of the value that the trustee brings; the "stock picking" is the last thing that the trustee does.)

e. Calculation of 2% Floor is Complicated. Calculating the 2% floor is an interrelated calculation if the trust pays the beneficiary more than its DNI. Carol Cantrell says: "The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions (AMID), which depend on its AGI. Thus we have a circular calculation that requires an algebraic formula found only in the IRS instructions to Form 1041, p. 17-18."

f. AMT Effect of Being Type of Expense Subject to 2% Floor. Section 63(d) defines "itemized deductions" to mean deductions other than (1) deductions allowed in arriving adjusted gross income and (2) the deduction for personal exemptions. Therefore, if an investment advisory expense "flunks" §67(e), it is an "itemized deduction." Section 67(b) says that "miscellaneous itemized deductions" includes all "itemized deductions" other than 12 specific deductions listed in §67(b), none of which covers investment advisory expenses. In computing alternative minimum taxable income, §56(b)(1)(A) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b)." Therefore, if an investment advisory expense does not come within the §67(e) exception for trusts and estates, all of the expense (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

The AMT effect can be much larger than the effect of not being able to deduct expenses that do not exceed 2% of adjusted gross income. For example, assume a trust has $100,000 of investment advisory expenses, and $100,000 of adjusted gross income. Despite the 2% rule, the trust can still deduct $98,000 for taxable income purposes, resulting in negligible "regular" income tax. However, for AMT purposes, no deduction would be allowed; after reduction for the $22,500 AMT exemption, the 26% tentative AMT tax is roughly $20,000.

The AMT effect is carried through to beneficiaries who receive trust distributions in excess of the trust's taxable income. Although the beneficiary will not have any taxable income if the trust has $100,000 in gross income and $100,000 in deductions, the K-1 to the beneficiary will report the $100,000 as an adjustment that must be added back for AMT purposes on the beneficiary's tax return. Distributions carry out regular taxable income first to the beneficiaries, leaving tax preferences in the trust. If distributions are less than taxable income, the AMT tax preferences stay in the trust. Excess distributions carry out tax preferences to the beneficiaries. Carol Cantrell says that the ideal plan, for AMT purposes, is for the trust to distribute more than its taxable income but less than the AMTI, and to split the preferences between the trust and the beneficiaries (because each taxpayer has its own AMT exemption). "Distributions are a dynamite cure for both the 2% rule and the AMT."

g. Legislative Proposals; Revenue Cost. Some Congressmen are considering a bill proposal to delete the delete the second clause of §67(e)(1) ("and would not have been incurred if the property were not held in such trust or estate"). The AICPA Society has prepared an impressive letter supporting the proposal, listing 11 reasons why such repeal makes sense. The Joint Tax Committee released its score on the proposal, estimating a $3.6 billion cost over a 10-year budget window. However, "most everyone who has studied this issue believes that the JTC estimate is grossly overstated based on current IRS statistical data."

h. Strategy to Avoid 2% Floor for Large Family Trusts. Carlyn McCaffrey suggests a technique to avoid the 2% floor for large family trusts. The technique is for the family trusts to have a C corporation ("Newco") formed by one of the trusts hire an investment manager. The trusts would transfer their assets to an LLC. Newco would provide investment advice to the LLC in return for receiving a profits interest up to a maximum x% of assets on the first day of each year. The effect is to convert investment fees from a deduction to an exclusion from income, because the trusts have their income from the LLC reduced by the allocable share of income allocated to Newco. (Exclusions from income are not subject to the 2% floor and are not alternative minimum tax preference items.) Newco should be able to deduct the fees that it pays to outside investment advisors, because it is in the trade or business of giving investment advice. Also, the limits in §67 on miscellaneous itemized deductions do not apply to C corporations (that is why it is preferable that Newco be a C corporation). The toughest issue is whether the allocation of income from the LLC will be respected. It should be as long as it is actually respected by the parties. The parties should not change the profits allocation each year on a year by year basis if too much or too little is allocated to Newco to cover the cost of the outside investment advisor. (If Newco begins receives "too much," Newco could make additional capital contributions to the LLC.) The downside if the allocation of income is not respected, apart from transaction costs, is that the family is back in the position it would have been in if it had not used this structure.

16. Charitable Lead Trust Issues

Charitable lead annuity trusts shine in a low interest rate environment, because value is transferred to remainder family beneficiaries if the assets beat the low §7520 rate (2.0% for February 2009). There were two announcements from the IRS this year dealing with CLTs.

a. IRS Approved Forms. Revenue Procedures 2008-45 and 2008-46 provide forms for inter vivos and testamentary CLUTs (similar to Revenue Procedures 2007-45 and 2007-46 last year for CLATs). They confirm that the percentage payouts for CLUTs can vary from year to year (similar to the 2007 forms confirming that CLATs can vary the charitable annuity amount payable from year to year in the trust instrument). They also confirm that a third party substitution power can be used to make the trust a grantor trust.

b. Ordering Rule. The IRS has issued proposed regulations providing that ordering provisions in CLTs (saying that the "worst" income comes out first, when it is distributed to charity) will not be respected. Prop. Reg. §1.642(c)-3 & 1.643(a)-5. Under the proposed regulation, unless the ordering provision in a document has economic effect, it is disregarded in determining the character of income paid permanently set aside or used for charity. The regulation gives an example of a CLAT which provides that the annual annuity will be deemed to be paid first out of ordinary income, second from short-term capital gain, third from fifty percent of the UBTI, fourth from long-term capital gain, fifth from the balance of UBTI, sixth from tax-exempt income, and last from principal. (The goal is to have the "bad" income distributed to charity, so that the "good" assets [such as tax-exempt income or principal] would be left to be distributed to remainder (family member) beneficiaries at the end of the charitable term. The regulation says the provision does not have economic effect because the amount to be paid to charity is not dependent on the type of income from which it is to be paid. The result is that the distribution to charity that qualifies for a charitable deduction under §642(c) is deemed to consist of a proportionate part of all classes of income. (Some had feared that the IRS might attempt to adopt a rules that said the lesser taxed categories of income would be deemed distributed first.) The proposed regulations would apply to taxable years beginning after the regulations are finalized. Some planners have said that the absence of a grandfather provision is unfair for existing trusts with an ordering provision in the instrument because an existing regulation recognizes such ordering provisions, and some trusts may have planned their investments in reliance on that regulation.

   Carlyn McCaffrey points out that under current law, ordering does not matter for ordering ordinary or capital gain income, just for unrelated business taxable income and tax exempt income. If a CLT had 50% of its income as interest and 50% as long term capital gain, it would not matter how the §642(c) deduction is allocated between those two categories because the charitable deduction is allowed first against the ordinary income of the trust, regardless of the source of the payment. The ordering rule matters for tax exempt income because the §642(c) deduction is allowed only to the extent one can show that the distribution to charity actually came out of gross income, and tax exempt income is not gross income. It matters for UBTI only because §681 limits the §642(c) deduction where the distribution to charity is allocated to UBTI.

Carlyn McCaffrey also observes that it should be possible to structure the CLT to comply with the economic effect rule under the proposed regulation to permit the kind of ordering that is important — i.e., UBTI (because there is no point in creating a CLT to invest in tax-exempt income). Having UBTI is sometimes unavoidable where the CLT will invest in various partnerships that have acquisition indebtedness income or trade or business income. Suppose a trust is required to pay $10,000 to charity each year, determined as follows:

"(i) To Charity A from gross income other than from UBTI, but including gross income received in prior years not previously distributed, as much of such gross income as does not exceed $10,000.

(ii) If the gross income described in clause (i) is less than $10,000 but the trust has gross income that consists of UBTI, the trust must distribute such income up to $10,000 to Charity B instead of Charity A.

(iii) If the gross income described in clauses (i) and (ii) is less than $10,000, principal would be distributed to Charity C up to the $10,000 required to be distributed, less the amounts that have already been allocated to Charities A and B in clauses (i) and (ii)"

The ordering provision would then have economic significance, and the ordering rules in the trust documents should be respected.

17. Division of Charitable Remainder Trusts

The IRS has issued many letter rulings in the past addressing the tax effects of an early division of a CRT with multiple lead beneficiaries into separate trusts, one for each of the beneficiaries (and some of them dealt with early terminations of CRTs). (The issue comes up most frequently in the case of a divorce, and the ex-spouses no longer want to be tied together with the same CRT.) Revenue Ruling 2008-41, 2008-30 I.R.B. 1, addresses the division of CRTs into new separate CRTs on a pro rata basis, in two different situations. The Ruling concludes that the pro rata division (i) does not cause the separate trusts to fail to qualify as CRTs under §664(d), (ii) is not a sale, exchange or other disposition producing gain or loss, the basis of each separate trust's share of each asset is the same as the share of the basis before the division, and the holding period includes the holding period as held by the original trust, (iii) does not cause a termination under §507(a)(1) and does not result in an excise tax under §507(c), (iv) is not an act of self-dealing under §4941, and (v) is not a taxable expenditure under §4945. (The Revenue Ruling did not address non pro rata divisions because that would have required the input of the income tax group of the IRS regarding the potential application of Cottage Savings.)

18. Restricted Management Accounts

Revenue Ruling 2008-35, 2008-29 I.R.B. 116 provides that restricted management accounts will not result in any valuation discounts. Some planners had suggested using restricted management accounts as a "poor man's family limited partnership." Commentators have been very critical of the analysis in the Revenue Ruling, but it is likely that the IRS position will be upheld. Pam Schneider concludes that "only the most aggressive clients would be willing to use this technique at this point."

19. Family Limited Partnership Issues

Dennis Belcher observes a "herd mentality" approach — analogizing to a herd of wildebeests in Africa; those in the middle of herd survive while stragglers are eaten. Plan FLPs so that the plan does not stick out as a "straggler" with red flags waiving at the IRS agent.

a. Additional Guidance Coming Under 2704. The IRS apparently has been working on additional guidance (presumably regulations) under §2704. These probably relate to the statutory authority to issue regulations regarding the effect of a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." I.R.C. § 2704(b)(4). These regulations could potentially substantially restrict FLP discounts. See further discussion of this issue in Item 6.g above.

b. Cases in 2008.

(i) Mirowski, T.C. Memo. 2008-74. Judge Chiechi rejected the IRS's §2036 argument in a case that seemed to have bad facts, including that the decedent died within 10 days of creating the LLC (but the court emphasized that her death was unexpected), and \$36.4 million of distributions from the LLC were made after the decedent's death to pay gift taxes on substantial gifts that the decedent intended to make when the LLC was created and to pay estate taxes and other estate obligations.

The IRS argued that the assets in the partnership (including the assets attributable to a 48% interest that was given to the daughters' trusts) should be included in the decedent's estate under §§2036(a)(1), 2036(a)(2), 2038, and 2035(a). The decedent retained assets for living expenses, but the IRS argued that §§2036(a)(1) and (a)(2) and 2038 applied to the contribution of assets to the LLC, and to the 48% gifts of the LLC interests, and that §2035(a) applied to all of the transfers. The court rejected all of those arguments.

As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the court emphasized that the decedent's death was unexpected and that there was no understanding that the LLC assets would be used to pay gift taxes, and the estate taxes were not discussed or anticipated because no one expected the decedent to die any time soon after the transfers. The court did not apply §2036(a)(2) or 2038 even though the decedent was the sole general manager of the LLC at her death. Section 2035 did not apply because neither 2036 nor 2038 applied, so she never relinquished rights that would have otherwise triggered inclusion under §§2036 or 2038.

(ii) Astleford, T.C. Memo. 2008-128. This gift tax case allows lack of control and marketability discounts for tiered partnership interests. An FLP owned a 50% interest in a real estate general partnership and various other real estate tracts. An approximate 20% absorption discount was allowed for valuing a 1,187 acre tract in the general partnership. The FLP's 50% interest in the general partnership was valued as a partnership interest rather than as an assignee interest. Even so, a 30% combined discount for lack of control and marketability was allowed for the FLP's 50% interest in the general partnership. An approximate 17% lack of control and 22% lack of marketability discount (for a seriatim discount of about 35%) was allowed for valuing gifts of 90% of the limited partnership interests (three 30% gifts in 1996 and 1997). Thus, significant discounts were allowed at three different levels.

(iii) Holman, 130 T.C. No. 12 (2008). A retired Dell employee and his wife created an FLP to hold some of their Dell stock, intending to make gifts of limited partnership (or LP) interests, and they made gifts of most of their LP units six days later. They made subsequent annual exclusion gifts about two months later (at the beginning of the next calendar year) and one year after that. The agreement contained commonly used transfer restrictions, restricting transfers of LP interests without approval of all partners, and giving the partnership the right to purchase non-permitted assignments at the fair market value based on the right to share in distributions (i.e., considering discounts) of those assignee interests.

No Step Transaction. The Tax Court (in a "regular," but not reviewed decision) rejected the IRS argument that the gift of LP interests six days after the partnership was created was an indirect gift of a proportionate part of the assets contributed to the partnership (i.e., without a discount). The court said that the IRS appears to be arguing that the interdependence test applies, and that test requires that the legal relations created by one transaction would have been fruitless without a completion of the series. The court concluded that while the parents intended to make gifts of LP interests when they formed the FLP, it could not conclude "that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift." Indeed, the court noted that the IRS did not contend that the step transaction or integrated transaction doctrine applied to the gifts made in early 2000 (two months after the creation of the FLP) and in 2001. The court gave two reasons for distinguishing the Senda court's conclusion that transfers to partnerships coupled with transfers of limited partnership interests to their children on the same day were "integrated steps in a single transaction." First, the transfers in this case were not made the same day. Second, there is a "real economic risk of a change in value" of the Dell stock (and the value of the LP interests). The court believed that the IRS conceded that a two-month separation is sufficient to give independent significance to the funding and the gift two months later in early 2000, presumably because of the economic risk of a change in value during the two-month period.

Section 2703 Applied to Ignore Certain Transfer Restrictions in Agreement. The court also concluded that transfer restrictions in the agreement must be ignored under §2703 in valuing the transfers. (The reasoning as to the bona fide business arrangement test would seem to apply to many FLPs consisting of investment assets and the reasoning as to the "device test" would seem to require ignoring transfer restrictions for valuation purposes in many buy-sell agreements involving family members, even for actively managed businesses).

Low Discounts. The court valued the transferred LP interests by applying combined lack of control and marketability discounts of 22.4%, 25%, and 16.25% in 1999, 2000, and 2001, respectively. (Part of the rationale for applying low marketability discounts was based on assuming that the partnership would have an incentive to purchase any interest that a limited partner wished to transfer, which would seem to violate the hypothetical willing buyer-willing seller test for valuation purposes.)

Appeal to 8th Circuit. The taxpayer (represented by John Porter) has appealed the case to the 8th Circuit regarding the §2703 and the valuation issue. The IRS did not file a cross-appeal as to the step transaction issue. (Many planners had hoped that the circuit court would review the step transaction analysis, because they believe the contribution to the partnership and the gifts of partnership interests are independent of each other, particularly in light of the fact that the donees end up with partnership interests and not a pro rata part of the assets, and that the length of time delay is irrelevant. The time delay reasoning leaves open a fact question in each case about how much time is needed for a "real economic risk of a change in values," especially for assets other than a marketable securities portfolio.)

(iv) Gross, T.C. Memo 2008-221. The same judge who wrote Holman again rejected the IRS's position that gifts of limited partnership interests that are made soon after the partnership is created should be treated as indirect gifts of the assets contributed to the partnership (without a discount). In Gross, the gift was made at least 11 days after various publicly traded stocks were contributed to the partnership.

The case involves some messy facts (including that the parties did not get around to signing the limited partnership agreement until after the contributions to the partnership had been completed, but the parties had previously agreed to the essential terms sufficient under New York law to create a partnership). The opinion reiterates the test that the time delay between the date of funding and the date of the gifts must be long enough so that there is a "real economic risk of a change in value." The court concluded that 11 days was long enough where the contributions to the partnership consisted of a portfolio of "heavily traded, relatively volatile" stocks.

(v) Hurford, 2008 T.C. Memo 278. The Tax Court rejected an overly aggressive estate plan for a surviving wife who had been diagnosed with stage three cancer. The plan involved the contribution of all assets owned by Wife (and even assets that belonged to her predeceased husband's estate) into FLPs, and selling the partnership interests to two of her three children for private annuities (with the two children agreeing to share the eventual value with her third child). Wife died only about 10 ½ months after the private annuity transaction. The estate was worth $14 million when Husband died and Wife's estate tax return several years later reported a total gross estate of only $847,000. The court addressed (1) whether §2036 and §2035 applied to the creation of the FLPs (to bring all of the contributed assets back into Wife's estate without a discount) and (2) whether the transfer of partnership interests to the children in return for a private annuity similarly should be disregarded under §§2036 or 2038. The court concluded that the bona fide sale for full consideration exception to §§2036 and 2038 did not apply to the creation of the partnership or the private annuity transaction. Section 2036(a)(1) coupled with §2035 required the inclusion in Wife's estate of all assets that Wife contributed to the FLPs without a discount because there were various reasons to believe that there was an implied agreement that Wife would continue to enjoy benefits of the contributed assets. Furthermore, the assets would have been included in Wife's estate because the private annuity transaction did not pass muster under §2036 or §2038. In light of the extreme facts in the case, the IRS alleged penalties, but the court held that the executor reasonably relied on professional advice and refused to apply penalties.

(vi) Case Summary for 2008. Dennis Belcher concludes that "all in all it was not a bad year for family limited partnerships. The most troublesome thing was the §2703 analysis that came up in Holman."

c. Amounts of Valuation Discounts. Audit cases are consistent with the Appeals Settlement Guidelines. Agents argue that discounts should be slotted based on the approach in the McCord, Peracchio, and Lappo Tax Court cases. The lack of control is based on the type of assets, and is determined by reference to closed end funds. Marketability discounts are typically allowed in the range of 20-25%. (However, the recent Holman case, discussed below, allowed marketability discounts of only 12.5%, and overall discounts in three different years of only 22.4%, 25%, and 16.5%.) The IRS allows larger discounts for real estate than for securities. John Porter is seeing that approach argued uniformly throughout the country. In Jelke and Temple, the court allowed only about a 15% lack of marketability discount and IRS agents often point to those cases in settlement discussions, but Daily, Church, and Kelley had much larger discounts. The Astleford case, discussed below, allowed a combined lack of control and marketability discounts in two different years of 33.96% and 35.63% for an FLP that owned interests in various real estate properties and partnerships (in addition to discounts allowed at the subsidiary partnership level.) In Gross, the parties agreed to a 35% valuation discount before trial. Similarly, in Petter v. Commissioner (discussed below), John Porter reports that the parties agreed on a 35% valuation discount several weeks before trial.

The amounts of discounts do not depend on the region of the country. John Porter handles FLP cases all over the country, and he cannot discern a pattern of discounts based on the region of the country. Even in the same region, he sees significant differences among agents. There is an effort to coordinate FLP discount settlements at the appeals level, but not at the field agent level.

d. Discount Amounts May be Greater Currently In Light of Extremely High Illiquidity and Volatility in Financial Markets. The *lack of control* discount is often based on closed end funds. Typically, discounts are in the 6-7% range with municipal bond funds and in the 8-12% range for equity components. In mid-October, 2008, the average discount in municipal funds was almost 30%, and the average discount in equity funds was 20-30%. The net effect is that under the standard methodology for determining lack of control discounts, allowable discounts appear to have tripled or more based on extreme volatility. (Of course, the high discounts are in addition to the generally depressed values of many real estate and financial assets.)

In addition, FMV Opinions, Inc. reports that higher volatility results in larger *lack of marketability discounts* as well. It cites data from extensive restricted stock studies to show that higher discounts are reflected in the price of private placements of restricted stock of publicly traded companies for companies that have higher volatility in their stock prices. An "FMV Valuation Alert" from FMV Opinions, Inc. (received by this author on October 23, 2008) concludes:

> "It is important to note… that in today's volatile environment, volatility is significantly greater than ever recorded historically or reflected in the historical

restricted stock data. If there is a linear relationship between VIX [the Chicago Board Options Exchange's Volatility Index] and the discount for lack of marketability, as of September 19th when the VIX was 32.07, the discount for lack of marketability should be 9.7 percentage points higher than the discount selected during normal times... With a VIX reading of 69.95, as reflected on October 10th, the discount for lack of marketability should be 41.9 percentage points higher..."

e. Section 2036(a)(1). John Porter reports that there have been 26 §2036 cases through the Fall of 2008; the taxpayer won five and the IRS won the rest. But 99% of §2036 cases are settled on audit, and in FLP audits, the argument is typically over the amount of the discount.

(i) General Approach; Implied Agreement. This has been the government's silver bullet with respect to poorly operated FLPs and LLCs. There is no one factor that causes inclusion. There is an amalgamation of bad facts in each case, and the court concludes that there was an implied agreed between family members that the senior member can continue to have access to assets in the same manner as if not contributed to the partnership.

(ii) Recently Tried Case Involving Pro Rata Distributions. John Porter recently tried a case in Philadelphia in which the partnership made pro rata distributions equal to 80-90% of the net income of the partnership. Even pro rata distributions are sensitive to the government — they argue that the distributions reflect a §2036(a)(1) right. John is not aware of any case that said pro rata distributions cause §2036 inclusion, but the IRS is looking at that, especially where the distributions constitute about all of the income. John said that should not trigger §2036(a)(1) because it is a distribution of net income after expenses and holdbacks of amounts needed for reasonable future needs.

(iii) Recently Tried Case Involving Tax Distributions For Payment of Income Taxes on Flow-Thru Income. John Porter tried another case in the Fall of 2008 in which the IRS argued that making "tax distributions" (to permit the partners to pay income taxes on the flow-thru income from the partnership) was sufficient to evidence an implied agreement of retained enjoyment under §2036(a)(1). (In that case, the decedent owned 98% of the partnership interests.) In that case, the IRS also made the argument that allocating income to capital accounts evidences an implied agreement under §2036(a)(1). (That argument seems outrageous — what else is the partnership to do with accumulated income?)

(iv) Key Bad Facts and Red Flags. While there have been a variety of §2036 cases that held for the government, most involved "bad facts" cases with some noted similarities. The following lists some of the factors that John Porter sees as "red flags" to the IRS:

- FLPs created with no negotiation; sometimes by the decedent and sometimes by a child acting under power of attorney with little contributions by others. (Litigators often prefer having other family members make contributions to the FLP.) While this factor has been mentioned in various cases, it has not been a particularly deciding factor in any case.
- Decedent transferred virtually all of his or her assets into the FLP.

- During the balance of the decedent's lifetime (sometimes very short, sometimes several years), the distributions are disproportionate to what others get; often not reflected on partnership books, sometimes reflected as loans or payment of management expenses Harper and Bigelow.
- Personal loans to partners, Bigelow.
- Failure to follow formalities. If a mistake is made in the operation of the partnership, correct the mistake as soon as possible. It is very important to have a good accountant and good books and records. John Porter's preference is to have separate books and records for the capital accounts, in addition to the income tax reporting records. The IRS is looking to make sure that things required in the boilerplate of the partnership agreement are being done.
- Absence of non-tax purposes. In every taxpayer favorable §2036 case, the taxpayer has won on the bona fide sale exception because there were legitimate and significant non-tax purposes. While it should not be critical to meet the exception as long as there is no retained enjoyment, the cases have treated the bona fide sale exception and the retained interest issue as interrelated — often applying a similar analysis to each issue.
- Attorney communications that focus just on valuation discounts as the purpose for creating an FLP. As a practical matter, the attorney typically testifies in FLP cases as to the purposes of creating the FLP (because of the vital importance of having valid non-tax purposes, discussed immediately above), so the attorney-client privilege will be waived and the IRS will be able to review all correspondence between the attorney and the client. There is nothing wrong with attorney communications addressing tax issues — as long as they also address the non-tax purposes of the FLP.

(v) Post-Death Use of Partnership Assets. Post-death use of partnership assets has become a hot item. In Erickson, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. It would seem that the use of partnership assets after death is irrelevant as to retained right to enjoy assets under §2036 "for life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death" As Chuck Hodges put it: "Courts sometime say that they can also consider cash flow needs after death. That is wrong, but it is court precedent." In any event, the IRS is clearly looking at it.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations:

- It is best is to borrow from a third party. But a bank may be unwilling to do that using only the partnership interest as collateral.
- Borrow from an insurance trust or a family entity, secured by the partnership interest.
- There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distribution for taxes are made all the time from

partnerships, but usually income taxes. John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction) Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases. (However, John says that he has cases in which the IRS argues that Graegin loans from an FLP to the estate evidences a retained enjoyment under §2036.)

[Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.]

f. Section 2036(a)(2). Should a senior family member serve as the general partner of the partnership? Not many cases have addressed §2036(a)(2) — Kimbell and Strangi. Conservative planners prefer that the decedent own none of the general partner interest, and that the decedent got rid of the general partner interest more than 3 years before death. But many senior family members are not willing to contribute assets to an FLP unless they have some say in the management. How should the FLP agreement be planned to avoid §2036(a)(2)? John Porter says that under Estate of Cohen, 79 T.C. 1015 (1982), if there are reasonable constraints on the exercise of discretion that can be enforced in a state law proceeding — so that the general partner can't act "willy nilly," § 2036(a)(2) should not apply.

If senior family members serve as the general partner (or are owners of the entity that serves as general partner), include a fiduciary duty on the general partner and do not allow distributions in the "sole and absolute discretion" of the general partner, and include other more than de minimis partners to whom the fiduciary duty is owed. Also, do not include exculpatory language that would exculpate the general partner as to distribution decisions. (However, in Kimbell, there was exculpatory language and the taxpayer still won the §2036(a)(2) issue.)

As a practical matter, the IRS does not seem to be pressing hard on §2036(a)(2) claims. For example, in Mirowski the IRS did not even argue that the decedent's serving as the sole manager of the LLC by itself triggered §2036(a)(2). (Instead, the IRS tried to point to language in the agreement suggesting that the manager could make disproportionate distributions, and the court rejected even that argument and held that §2036(a)(2) did not apply to gifts of LLC member interests.) However, the IRS does sometimes still make the §2036(a)(2) argument in addition to other arguments under §2036(a)(1). For example, John Porter is involved in an ongoing Tax Court case in which the decedent was one of three members of an LLC which was the general partner of the FLP, and the IRS is making the "in conjunction with" argument that was raised by Judge Cohen in Strangi.

For clients that wish to plan as conservatively as possible regarding the §2036(a)(2) issue, some planners prefer using an irrevocable trust as the general partner, and if the client wishes to have some degree of input, the client could keep a trustee removal power that complies with Revenue Ruling 95-58.

g. Marital Deduction Mismatch Case. John Porter tried a case in Nov. 2007 (Estate of Samuel Black) involving the marital deduction allowable at the first spouse's death. The IRS argued that the partnership assets were includable in the estate under §2036, but that the marital deduction is allowed only for the value of the partnership interest passing to the surviving spouse. The Hurford opinion also noted this argument in footnote 24. The Black case also involves the availability of an administrative expense deduction as to interest paid by the partnership and a corporation owned by the partnership to borrow funds to loan to the estate to pay estate taxes. (Some planners suggest, to avoid this argument, leaving voting and non-voting stock of an LLC to the surviving spouse at the first spouse's death, so there is no discount for marital deduction purposes. After the first spouse's death, the surviving spouse could sell the voting stock so that he or she is left with only non-voting stock (which should be discounted).

h. Creation of FLP by QTIP. John Porter is involved with a case involving the formation of an FLP by the trustee of two QTIP trusts (together with other partners). The case arose after the surviving spouse's death. The IRS argues that the FLP contribution triggered a deemed gift of the QTIP assets under §2519, and that it caused §2036 to apply in the surviving spouse's estate. As to the §2519 argument, a 1999 Field Service Advice held that a contribution of QTIP assets to an FLP did not constitute a §2519 disposition of assets. FSA 199920016. (With respect to whether there is a deemed disposition, an investment in an FLP would seem to be similar to an investment by the QTIP in a hedge fund in which there is limited liquidity for a number of years.) The IRS reportedly has raised the §2519 issue again in some other audits over the last several years. As to the §2036 argument, John argues that this just constitutes an investment that the trustee is authorized to make and that it can have no impact on §2036 which requires that the DECEDENT made a transfer — and in this case the surviving spouse was not a trustee of the QTIP trust.

20. Impact of Economic Losses and "Madoff" Losses

An informal poll was taken of planners that personally know someone with funds tied up in the Madoff scandal. About 20% of the hands went up.

There is an excellent discussion of issues arising out of the Bernie Madoff case from the Proskauer Rose LLP website, including the transcript of a panel discussion by lawyers in various different practice areas of their firm.

a. Type of Account. A custodial account is not subject to creditors of the financial institution. Assets in a deposit relationship with a bank are subject to the FDIC rules and have coverage; above that, the account holder is a creditor in line with other creditors. Accounts in a brokerage account should be reviewed closely. Securities with a brokerage firm may be loaned by the brokerage firm unless the account form prohibits lending. (Some clients placed securities in brokerage accounts that did not prohibit lending and the firms loaned securities to Madoff; they are now caught up in the Madoff lawsuits.)

b. FDIC Insurance Coverage.

(i) Increase to $250,000 Through 2009. For the period Oct 3, 2008 to the end of 2009, the amount of FDIC insurance has been increased from $100,000 to $250,000.

(ii) Trust Accounts. The FDIC has issued new interim rules "to simplify and modernize deposit insurance rules for revocable trust accounts." F.R. September

30, 2008, 56706-56712. There may be substantially more coverage for revocable trusts than for individually owned assets, because an insurance account gets a $250,000 coverage for each beneficiary of the revocable trust up to five beneficiaries. It does not matter that the beneficiaries have varying interests in the trust. Non-contingent remainder beneficiaries are included as long as they are "named." A "life estate interest" is counted as a beneficiary, but it is not clear how discretionary interests are treated — they may be aggregated as one beneficiary for this purpose.

The FDIC website has a 32 page guide describing how to calculate the coverage and a calculator, "EDIE the Estimator," that will calculate the insurance coverage for accounts.

c. SIPC Insurance. The Securities Investors Protection Corporation insures accounts up to $500,000 including $100,000 of cash, as opposed to the right to get your securities back. But what happens when the securities no longer exist (as in the Madoff situation)? Also, what happens if the SIPC runs out of money? (It now has $1.6 billion of assets, a $1 billion line of credit from the US government, and a $1 billion line of credit from a consortium of international banks.) (The Madoff exposure was estimated by Madoff at $50 billion, but the liquidating trustee has found only $830 million of liquid assets.)

A feeder fund is likely treated as just one account. So if clients did not invest directly with Madoff, they probably have almost no SIPC coverage at all.

IRAs are different than individual accounts. So if an individual has individual funds and an IRA invested in a brokerage account, there are two SIPC coverages.

d. Other Insurance With Fraud Endorsement. As an example, the AIG homeowner's policy contains an endorsement called AIG fraud safeguard coverage. Review policies for coverage, because the time period for making claims may run out if a claim is not made timely.

e. Clawbacks. Under New York law, there may be a clawback for up to six years for all earnings distributed to anyone (regardless of how innocent they are) within six years and for principal distributions if the recipient was not in good faith (and "not in good faith" is construed very broadly).

f. Income Tax Refunds. For many years, the IRS has shared in phantom profits from the Madoff accounts because investors paid income taxes on the phantom profits.

Section 165(a) Theft Deduction. Section 165(a) appears to allow a theft victim to deduct from gross income the amount of the original investment. The §165 deduction is not a miscellaneous itemized deduction subject to the 2% rule, is not a preference item for AMT purposes, and carries back for three years and forward for 20 years.

Timing. The deduction is allowed in the year in which the theft is discovered or a later year if the amount of the loss is not determined until a later year. Therefore, the deduction is not allowed for 2008 because the amount of the loss is not yet determined.

Nonexistent income. Taxpayers can file refund claims for 2005-2007 and for estimated taxes paid in 2008. Anything prior to that would be time-barred. Will the IRS grant any relief to return its "ill gotten gains?" ILM 2004-54030 (which cannot be relied on as precedent) said that victims of a Ponzi scheme were entitled to a deduction in the current year (thus avoiding statute of limitations problems) for interest earned in prior years that did not exist. So a §165 deduction might be allowable even for the time-barred years.

Section 1341 Claim of Right. If a §165 deduction is allowable, a §1341 claim of right will "supercharge" the benefit. If §1341 applies, which seems to be the case if interest, dividends or gains were included under a claim of right and then are disallowed this year or next year, §1341 allows a deduction this year for all of the taxes that were paid in prior years. The year's income must first be reduced by the extra tax paid in prior years. If the extra tax paid in prior years exceeds the current year income, the taxpayer may alternatively reduce his tax for the year of repayment by the amount of taxes for the prior years that were attributable to the inclusion of the income under the claim of right doctrine in those years, and if such reduction in tax exceeds the current year's tax, the excess can be claimed as a refund.

The prospects of getting repaid the income taxes appear good.

g. Estate Taxes. If the theft occurred prior to the decedent's death, the estate tax return could take the position that the assets do not exist. If the theft occurs after the date of death, presumably a §2054 deduction is allowed for theft loss (but then an income tax theft deduction is not allowed to the estate because §642(g) prevents a double deduction).

If the decedent received payments from the fund during the relevant clawback period that the estate may have to repay, the estate may be entitled to a debt deduction. Under current law, that would be based on an estimate of the value of that claim against the estate at the date of death. Under proposed regulations to §2053, no deduction would be allowed until the amount of the claim is actually paid. The estate could file a protective claim for refund to be able to claim the deduction when the amount is repaid, but in the meantime the estate may have to be out of pocket for the attributable amount of the estate tax. (Those regulations apply to decedents who die after the regulations are finalized.)

h. Claims for Refund. Taxpayer-investors may have paid income, gift or estate taxes on phantom profits and value that is nonexistent. Advisors must be extremely careful in the Madoff matter (or other similar Ponzi schemes) to file appropriate claims for refund to keep open the statute of limitations to recover taxes.

Dennis Belcher says if planners take anything away from the Heckerling Institute they should remember this: "If you have anyone that had dealings with Madoff, check the statute of limitations and file whatever claims for refund you can think of to keep the statute open. We fear that the IRS may not come out with guidance on this until after the statute has run on 706s, 1065s, 1040s, or1041s. You don't want to be calling your carrier after you miss something like this."

i. Bayou Case. There is an excellent discussion of the recent Bayou case at www.KLGates.com (click on Newsstand and search for Madoff to find Sept 17 summary of the Bayou case). The summary points out that a number of courts have held that each individual redemption payment is presumptively a fraudulent transfer intended to actually hinder, delay or defraud other investors and may be rescinded by creditors or a trustee. The Bayou case involved attempts to have investors repay amounts received from a Ponzi scheme that was disclosed in August 2005. Two recent Bankruptcy Court cases in Bayou ordered the repayment of many redemption distributions over the prior six years under fraudulent transfer principles. In re Bayou Group, LLC, 362 B.R. 624 (Bankr. S.D.N.Y. 2007); In re Bayou Group, LLC, 396 B.R. 810 (Bankr. S.D.N.Y. 2008). The same court that heard that case is also hearing similar claims in the Madoff case. Rulings from the case are instructive.

(i) Redemption Presumptively Fraudulent. Redemption payments from a Ponzi scheme presumptively satisfied the "actual fraud" prong of the fraudulent transfer standard.

(ii) Good Faith Defense Requires Due Diligence. The "good faith" affirmative defense requires an objective test of whether a reasonable and prudent investor should have been on inquiry notice of fraud, and, if on inquiry notice, whether the redeemer was diligent in its investigation. The redeemer must be able to show that it conducted a diligent investigation of each potential problem or red flag. (Comment: For example, if an investment advisor told an investor that there were concerns with the fund, that might cost the good faith defense.)

(iii) Redemption Payments In Excess of Original Principal Refunded Regardless of Good Faith. Redemption payments in excess of the original principal, or "fictitious profits" have to be refunded regardless of good faith.

(iv) Result. All investors had to pay back all "fictitious profits." In addition, over 90 investors had to pay a portion of the principal payments and several dozen had to repay all of the principal payments made to them during the six-year clawback period.

j. Lessons Learned From the Economic Crisis. Pam Schneider's conclusions:

- If you're a lawyer, you're not an investment advisor and do not pretend to be.
- Diversity means not only diversity as to assets and investment classes, but also as to investment advisors.
- Beware of conflicts of interest.
- Do your due diligence.
- If it sounds too good to be true, it probably isn't true.

21. Impact of Poor Economy on Unitrusts and Power to Adjust

The "smoothing rule" to calculate the percentage amount based on several prior years of average income works fine for an appreciating market or for "normal" down years. However, in a "black swan once-in-a-lifetime meltdown" such as in 2008 (hopefully it is only once in a lifetime), the effect can be quite dramatic. What was intended as a 4% distribution might end up being 7% or more if values have plummeted after the valuation date.

a. Unitrust. If the distribution ends up being 7%, for example, is that still treated entirely as income in light of the fact that the §643 regulations specifically authorize a 3%-5% unitrust amount? Yes, because they also specifically allow using a smoothing approach.

b. Power to Adjust. What if the distribution ends up being a distribution of original corpus in the trust (i.e., it is greater than the combined growth of the trust since inception)? The New York statute does not require that there be appreciation to treat the specified percentage amount as income. However, in light of the fact that distributions are being made out of corpus, the trustee should revisit the application of the adjustment to determine if it still appropriate.

c. Charitable Endowments. The rules are different for charitable endowments. Under UMIFA, appreciation above "historic dollar value" could be reached where the foundation authorized the distribution of income. Under UPMIFA, a distribution in excess of 7% is deemed to be encroaching on corpus and imprudent. A FSB release says that restricted endowments must be reviewed and any violation of a restriction must be disclosed.

d. Warn Beneficiaries Ahead of Time. Dennis Belcher gives this sage advice: "Prepare the income beneficiary for income going down… We've learned — Beneficiaries can live with disappointment but they can't live with surprise. 'If the income is going down, we need to know a year in advance, as opposed to checks getting smaller and smaller and smaller.' Disgruntled beneficiaries have a way of finding lawyers who have a way of creating mischief for trustees."

22. Optimal Planning Strategies in Politically Uncertain and Economically Turbulent Times

Jonathan Blattmachr discussed transfer planning opportunities in light of the current political and economic situation. This section includes comments by Jonathan as well as by various other speakers and panelists with respect to planning alternatives in this current period of substantial declines in the market but with (hopefully) substantial appreciation for the future. (Some of the ideas come from a presentation by panelists addressing "best practices for the adventuresome estate planner.")

a. "Perfect Storm" for Transfer Planning. There is a "perfect storm" effect of contributing factors making this the best time for transfer planning.

(i) Legislative Uncertainty. There is legislative uncertainty that some strategies may be taken away — such as valuation discounts, GRATs (that may be viewed by some as an "black I win, red I get back 99.99% of my bet" economic deal that should be too good to be true), and QPRTs (viewed by some as artificial).

(ii) Low Values. Values are very low now, and they eventually will rebound. Freeze strategies could transfer much of that future appreciation. (Jonathan Blattmachr predicts that the Dow Jones will be 30,000 or higher in ten years — because knowledge is now doubling about every 18 months, and in ten years we will know much more than we know today in many fields, including manufacturing, medical science, etc.)

(iii) Low Interest Rates. There are current historically low interest rates (the AFR for February 2009 is 2.0%, the lowest ever), so the future appreciation above a low hurdle rate (the §7520 rate for GRATs or CLATs and the AFR for sales) can be transferred.

b. GRATs. (See also Item 23 below for further discussion of GRAT planning issues.)

c. Long Term Sales to Grantor Trusts. Long term sales lock in the benefit of the current very low interest rate for the life of the note. The term should not be longer than the seller's life expectancy. The sale takes advantage of valuation discounts that are currently available. If interest rates drop even further, a new lower interest rate note can be substituted without tax consequences. (This issue is discussed further in Item 24.p below.)

Most of the taxpayer-adverse cases are in the estate tax areas involving §2036 — not the gift tax area. File a gift tax return; "In three years, it's over" and the trust can prepay the note whenever the trust thinks adequate appreciation has developed.

(See also Item 24 below for further issues regarding sales to grantor trusts.)

d. Sale to Grantor Trust Created for Client By Spouse. If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor 's estate, but the client would have achieved the goal of transferring as much as possible as the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. Jonathan observes that the IRS will not audit these types of transactions; "the IRS is only in it for the money."

e. Sale to Grantor Trust With Defined Value Approach. If the value of the transferred assets exceeds the value of the note, a gift results. One possible "defined value" approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial "seed gift" to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to incomplete gift trust. If a court ultimately determines that the note does not equal the full value of the asset that is sold to the trust, the gift element would pass to an incomplete gift trust, and there would be no immediate gift taxation.

f. Sale With Disclaimer of Any Gift Element. Another possibility is to use a disclaimer even for a sale to grantor trust. The trust would specifically permit a trust beneficiary to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula: "To the extent any gift made by father to me, I disclaim 99% of the gift."

g. Underwater Sales to Grantor Trusts. If a sale to a grantor trust has become underwater, alternative approaches include:

- Renegotiating the interest rate if the AFR has become lower (see Item 24.p below);
- Renegotiating the principal amount of the note (but why would the grantor renegotiate for a lower principal payment?; there seems to be no advantage to the grantor unlike the typical bank renegotiation in which the bank may renegotiate in order to receive some upfront payment or more favored position; the trust has nothing "extra" to grant to the grantor in a renegotiation; this approach seems risky);
- Have the grantor sell the note from the original grantor trust that purchased the asset to a new grantor trust (the note would presumably have a lower value than its face value; any appreciation above that value would inure to the benefit of Trust 2 even though Trust 1 ends up having to pay all of its assets on the note payments; a big disadvantage is that the new trust would have to be "seeded" and the value of the underlying asset could decrease even further so that the seeding to Trust 2 would be lost as well); or
- The grantor could contribute the note from the grantor trust to a new GRAT (future appreciation would inure to the benefit of the GRAT remaindermen but there would be no new "seeding" requirement which could be lost as well if there were more deprecation in the value of the underlying assets).

(Mil Hatcher presented an excellent discussion of this topic at the ACTEC 2008 summer meeting.)

h. Reverse Freeze. Transfer preferred interests to the children and have the parents retain the common. Appraisers say that preferred interests in a family limited partnership would need a preferred return of 10-12% to be worth face value. (Shannon Pratt recently told Jonathan that in the real world, investors would demand a 25% or higher return.) If the overall returns are 2-4% but the children receive a return of 10-12%, assets will be sucked from the parent's estate to the children. Use grantor trusts as the partner with the parent to avoid adverse income tax effects.

i. Accelerating CLATs. Use accelerating CLATs (with most of the amounts payable to charity coming in later years), provided you can do it during lifetime.

j. QPRTs. Even during these periods of very low interest rates, QPRTs can be desirable. Real estate values are low. Also, even though the value of the retained income interest goes down with lower rates, the value of the retained reversion goes up. Calculations reflect that you get about the same discounting whether the §7520 rate is high or low.

k. Split Purchase of Residence. There are three disadvantages of QPRTs: 1) It is not possible to leverage the GST exemption; 2) The grantor must survive the term to have the residence excluded form the grantor's estate; and 3) The grantor must pay rent following the end of the QPRT term. A split purchase of a residence, with the client purchasing a life estate and a GST exempt trust purchasing the remainder, avoids those disadvantages. The personal residence exception of §2702 applies. Letter Ruling 200840038. The favorable letter rulings do not address §2036, but §2036 should not apply if an "old and cold" trust is used to purchase the remainder interest. For example, in Letter Ruling 9206006, the IRS ruled that §2036 applied where the purchaser of the remainder interest used funds borrowed from the holder of the life estate to finance most of the purchase of the remainder interest.

Split Purchase Involving Spouse to Avoid §2036. The following scenario might be a way of reducing the §2036 risk. Husband (for example) buys a residence from Wife for cash. Husband creates a GST exempt dynasty trust. Husband sells Wife a life estate and the dynasty trust the remainder interest in the residence. There should be no inclusion in Husband's estate under §2036 because Wife is purchasing the life estate in the residence, not Husband. (Of course, if Husband survives Wife, he will have to rent the residence from the dynasty trust; it should be structured as a grantor trust as to Husband.)

l. Self-Settled Trusts. Self-settled trusts can be used to overcome the "King Lear — I'm too poor'" concern of some clients. Do it in a state like Alaska or Delaware so that creditors do not have access to the trust, in order to alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. ("The settlor does not care if the money comes to him or his wife if he is happily married.") The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary.

m. Strategies for Avoiding A Step Down in Basis At Death. In light of the drastic market decline, some clients in poor health will be most interested in avoiding a step down in basis at the anticipated death of the individual. Alternatives include the following.

(i) Sale to Unrelated Person. If the asset is sold during life, the loss can be realized, but that is sometimes not possible.

(ii) Give or Sell Asset to Spouse Before Death. If the owner gives or sells the assets to his or her spouse before death, there is no income recognition and carryover basis applies — so the spouse keeps the benefit of the high basis in the assets. Treas. Reg. §1.1041-1T(d) Q&A 11.

(iii) Gift Before Death to Someone Other Than Spouse; Bifurcated Basis Rules. If a gift is made to someone other than the donor's spouse, the donee has the donor's basis for determining gain but just the fair market value of the asset (if lower) for purposes of determining loss. §1015(a). While the donee would not be able to take advantage of the full loss if the property is sold soon thereafter, the person would keep the benefit of the higher basis if the property is not sold until it has regained it value above the original basis (adjusted for gift tax paid on the unrealized appreciation, §1015(d)(6)).

(iv) Sale to Related Party; Loss is Preserved for Later Disposition. The seller cannot take a loss when property is sold to a related party, §267, but the loss is preserved for use by the purchaser on a later disposition to an unrelated party, §267(b).

(v) Strategy of Contributing Asset to Partnership No Longer Available. Under prior law, a contribution of appreciated basis to a partnership would allow the partnership to continue to keep the high basis following the death of the partner if there were no §754 election in effect. However, Section 743 now requires a §754 election to adjust the inside basis if there is a contribution of assets with a "substantial built in less" of more than $250,000.

23. GRAT Planning Issues

a. Short-Term GRATs. Monte Carlo simulation studies demonstrate that a series of short-term GRATs is preferable to one long term GRAT because of the risk of several years of bad performance eliminating the gains from other years. Use short term GRATs if the client believes there will be no legislation prohibiting GRATs in the future. The preferred GRAT arrangement is a steeply declining two-year GRAT, with a plan to roll the very large annuity payment made at the end of the first year into a new GRAT. The effect is to convert the economics into a one-year GRAT situation, locking in the gains that occur during each one year period.

b. Long-Term GRATs. Longer term GRATs may be preferable if the planner believes legislation will place substantial restrictions on GRATs in the future. Even though many planners believe that such legislation will not be enacted, planners may want to consider creating longer term GRATs in order to be able to shift appreciation over a longer term as opposed to creating a two-year GRAT and then not being able to roll over the repaid annuity amounts into further GRATs if there is adverse legislation. The risks of longer term GRATs are (1) death during the term, and (2) several years of bad performance wiping out (or reducing the benefit of) gains in other years. The second risk can be managed by purchasing volatile assets from the GRAT after years of substantial gains, and Jonathan does not believe that constitutes a prohibited "commutation." (That would obviously give up the possibility of transferring even further growth over the balance of the long term GRAT, but at least there is the flexibility to lock in large gains in the early years of a long-term GRAT.)

c. Purchasing Asset From Short-Term GRAT and Contributing to Long-Term GRAT. A corollary to the decision to prefer long-term over short-term GRATs is to consider purchasing a potentially highly appreciating asset from a short term GRAT and rolling it into a long term GRAT for fear that there may be future legislation restricting the use of GRATs that would not permit rolling over funds into new GRATs.

d. Underwater GRATs. In light of the economic downturn, there are now a lot of underwater GRATs. The likely appreciation over the balance of the GRAT term may be unlikely to overcome the current losses in the GRAT in order to result in any transfer to family members at the end of the GRAT term (or even if there is subsequent appreciation, it would be largely offset by losses that have already occurred). One solution is for the client to repurchase the depreciated assets from the GRAT and re-GRAT them. Often that happens under a grantor substitution power. (Letter ruling 200846001 confirms that neither the existence nor the exercise of a grantor substitution power will disqualify the grantor's interest as a qualified annuity interest under §2701(b)(1). Curiously, in that situation the substitution power was exercisable in a fiduciary capacity, which obviously would not trigger grantor trust status under §675(4)(C).)

Another possible solution, if the grantor does not have cash to purchase the depreciated assets from the GRAT, is to have the grantor contribute the right to the annuity payments into a new GRAT. If the original GRAT is underwater, the annuity from the original GRAT will not be worth full face value, so the annuity payments will be contributed to the new GRAT at a depreciated value. If there is further appreciation in the original GRAT's assets, it would be able to pay more annuity payments than the value that was placed on the annuity stream in the new GRAT, resulting in value that could be transferred from the new GRAT at the end of its term. There would be some uncertainty over how to value the annuity payment rights when they are contributed to the new GRAT.

e. Formula Description of Annuity to Produce Targeted Low Remainder Value. Carlyn McCaffrey uses a formula to describe the annuity amount to result in a targeted value of the remainder interest. This would avoid the problem of sending GRAT documents to the client with numerical factors based on the current month AFR and then having the client, unknown to the attorney, sign the document in a later month after the AFR has changed.

f. Simplified Mechanics for Rolling GRATs. Carlyn McCaffrey uses provisions in GRATs allowing the grantor to transfer assets into a separate GRAT, having same terms as the original GRAT, by merely attaching a schedule of assets that are transferred into the new GRAT and have the schedule signed and dated by the grantor and trustee to acknowledge the creation of the new GRAT.

g. GRAT With Options. Wealth Transfer Group LLC secured a patent dealing with the contribution of options to a GRAT. Litigation involving the contribution of options to a GRAT by John W. Rowe (a prior CEO of Aetna) resulted in protracted patent litigation that was settled with a confidential settlement agreement. A possible strategy of using options in connection with a GRAT would be to contribute options to an FLP or LLC and transfer an interest in the FLP or LLC to a GRAT. However, coordinate with a patent attorney before using this strategy to appraise whether this would violate the existing patent regarding the direct contribution of options to a GRAT. Another planning option would be to sell options to a grantor trust rather than using a GRAT.

h. Zeroed Out GRATs. Respected attorneys differ as to whether GRATs should be planned to zero out completely the remainder or to leave a low value. For example, Carlyn

McCaffrey prefers leaving a small remainder interest for hard-to-value assets contributed to GRATs for fear that the IRS might raise a Procter argument, despite the regulatory authorization of the use of formula clauses to describe the annuity amount. However, Lou Harrison does use completely "zeroed out" GRATs.

i. Split Purchase GRAT. Section 2702 generally removes the estate and gift tax advantages of joint purchase transactions. The purchaser of the term interest is treated as initially purchasing the entire property and then transferring the remainder interest while retaining the income interest. The retained income interest is valued at zero because it is not a qualified annuity or unitrust interest.

If the retained interest is a qualified annuity (or unitrust) interest, it would seem that the actuarial value of the qualified interest could be subtracted in determining the amount of the gift made by reason of the deemed transfer of the remainder interest. See Treas. Reg. §25.2702-4(d), Ex.1 (retained interest in a joint purchase transaction is valued at zero "because it is not a qualified interest"). Commentators for years have indicated that this supports a joint purchase transaction in which the client would purchase a qualified annuity (or unitrust) interest payable from the acquired property, with an independent party (such as a GST exempt trust) purchasing the remainder. See Blattmachr & Painter, When Should Planners Consider Using Split Interest Transfers?, 21 EST. PL. 20 (1994); Practical Drafting 2482 (Covey ed. 1991).

Survival of Term Not Required; Annuity Can Last for Life. The joint purchase approach has a significant advantage as compared to a grantor contributing property to a GRAT, because with a GRAT the grantor must survive the term of the annuity interest to avoid having the trust assets included in the grantor's estate. Under the joint purchase approach, the value paid by the grantor for the qualified annuity interest would be excluded from the gross estate, assuming the payment equaled the actuarial value of the retained annuity interest, regardless of whether the grantor survived the term of the annuity interest. (Indeed, an annuity for the grantor's life could be used.)

Being able to use a life annuity may be very desirable for some clients who would like to assure continued cash flow for their lifetimes.

Several early rulings suggested that the parent (who contributes an amount equal to the present value of the retained qualified annuity interest) would receive inadequate consideration, citing the reasoning of Estate of Gradow, 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990). Letter Rulings 9515039, 9412036. However, a variety of more recent cases have recognized sales of remainder interests, and have held that "adequate and full consideration" need only equal the value of the remainder interest transferred by the decedent. E.g., Estate of Magnin, 184 F.3d 1074 (9th Cir. 1999); D'Ambrosio, 101 F.3d 309 (3rd Cir. 1996); Wheeler, 116 F.3d 749 (5th Cir. 1997).

The IRS has ruled negatively on a joint purchase GRAT transaction, ruling that §2036 and 2039 required the inclusion in the grantor's estate of a proportionate part of the property attributable to the overall consideration paid by the decedent in acquiring the life interest. Letter Ruling 9412036. However, the IRS has subsequently changed its position on applying §2039 to GRAT transactions, and §2036 should not apply if the remainder interst paid full value for its interest. That ruling has been soundly criticized by commentators, including the BNA Portfolio on §2702.

Income Tax. Complicated income tax issues (such as the ability to avoid gain recognition on funding annuity payments with appreciated assets) are avoided if the purchaser of the remainder interest is a grantor trust.

GST Effect. The ETIP rules do not apply for GST purposes if the split purchase avoids inclusion of the term holder's interest in his or her estate, so a GST exempt trust could be the purchaser of the remainder interest. The Split Purchase GRAT is a way of leveraging the GST exemption.

j. Leveraging GST Exemption By Sale of Remainder Interest in GRAT. GST exemption probably cannot be allocated to a GRAT until the end of the GRAT term. (While there is an argument that the ETIP rule does not apply, most planners are unwilling to rely on that position in a planning context.) One possible planning strategy is to have the remaindermen under a GRAT sell their remainder interest (assuming the GRAT does not have a spendthrift clause that prohibits such transfers) to younger generations or to a GST-exempt trust. See generally Handler & Oshins, The GRAT Remainder Sale, 142 TR. & EST. 33 (Dec. 2002). If the sale is made soon after the GRAT is created and before there has been any substantial appreciation in the GRAT assets, the remainder interest should have a low value. A concern is that the IRS may argue substance over form and recast the series of transfers as the creation of a GST-exempt GRAT (which is not permitted).

The subsequent sale transaction by the GRAT remaindermen should be independent of the initial creation of the GRAT. (For this purpose, it would be best if the GST-exempt trust that purchases the remainder interest is created far in advance of the creation of the GRAT.) Observe that if the remaindermen of the GRAT and the GST-exempt trust that purchases the remainder interest are both grantor trusts for income tax purposes, there should not be any gain recognized as a result of the sale transaction.

The IRS has informally indicated its position that it will treat the sale of the remainder interest as a contribution to the trust by the seller so that the trust has two grantors for GST purposes. The portion owned by the seller of the remainder interest is just the small amount paid for the remainder interest. The original grantor is deemed to be the grantor of the balance of the trust (which is almost all of the trust) for GST purposes. Ltr. Rul. 200107015; Cf. Treas. Reg. §26.2652-1(a)(1) Example 4 (trust is created for child for life with remainder to grandchild; a transfer by child of his or her income interest will not change the transferor, and parent is still treated as the transferor "with respect to the trust" for GST purposes).

The IRS's approach is to consider the original donor who created the GRAT as a transferor along with the children who assigned their remainder interests to the grandchildren or to a dynasty trust. Ellen Harrison points out this argument is analogous to the one the IRS lost in D'Ambrosio v. Comm'r, 101 F.3d 309 (3d Cir. 1996) and Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997). In those cases, the IRS failed to convince courts that "full and adequate consideration" for the sale of a remainder interest was much more than the actuarial value of the remainder interest. Similarly, the gift of a remainder interest by the donor's children should not be treated as something other than a gift solely by the children.

An additional twist on this planning strategy is that the children (or preferably a grantor trust that is the remainderman of the GRAT) might buy back the remainder interest from the GST exempt trust before the end of the GRAT term. This strategy gets additional

CASH to the GST trust (the difference between the amount paid by the grantor in the repurchase and the amount received by the grantor in the sale of the remainder interest soon after the GRAT is created.) At the end of the GRAT term (i.e., at end of the ETIP), nothing is passing to grandchildren — children (or a grantor trust for them) own the remainder interest, so there should be no GST effect at that time.

24. Grantor Trust Issues

Howard Zaritsky (and various other speakers) addressed grantor trusts.

a. Tax-Free Compounding Very Significant. Jonathan Blattmachr indicates that the most important thing in estate planning is using grantor trusts, and the most important thing in financial planning is income tax free compounding. That is more important than getting 30% discounts, using GRATs, etc. Howard says that almost all irrevocable trusts should be grantor trusts. That increases the benefit of everything else the client wants to do.

b. Change Communication to Clients. Howard's thesis is that attorneys should continue to use grantor trusts, but change how they communicate with clients. There are many areas for which there is just analysis and no clear rulings. Communication with clients should include a lot of "you should know there is no clear law on this point"

c. Power to Add Beneficiaries. Howard's favorite trigger power is using a non-adverse party as trustee with a sprinkling power over income and principal coupled with someone having the power to increase the class of beneficiaries.

   Client Concern of Losing Control. The client concern may be giving someone the power to rewrite the instrument by adding to the class beneficiaries. However, merely adding to the class beneficiaries does not mean that the additional beneficiary will receive a distribution. There can be checks and balances by giving one person the right to add to the class of beneficiaries, but relying upon a different person (a non-adverse party trustee) to decide when distributions should be made in accordance with the standard described in the instrument.

   Who? Trustees should not hold the power to add beneficiaries. In light of the trustee's fiduciary duty, how can the trustee justify adding new beneficiaries without breaching its duty to existing beneficiaries? If the trustee cannot exercise the power as a practical matter, in light of the fiduciary duty, the IRS could argue that it is not a grantor trust. Howard is also reluctant to give the power to add beneficiaries to a "trust protector" for fear that the instrument or a court may determine that the trust protector similarly has fiduciary duties.

   Ultimate Contingent Beneficiary. If the instrument gives a person the power to add charities selected by the person as additional beneficiaries, make sure that the ultimate contingent beneficiary clause in the trust agreement does not include any charities that may be selected by the trustee. In that case, all charities would already be contingent beneficiaries.

d. Spouse Powers and Interests. Section 672 says that interests or powers held by the grantor's spouse are imputed to the grantor for grantor trust purposes as long as the parties were married and not legally separated at the time the trust was created. It does not matter if the parties later divorce. The legislative history of the 1986 Code says that this is determined based on whether the spouses were eligible to file a joint return when the trust was created. That could create potential problems, because a joint return cannot be filed if one spouse is a nonresident alien or if the spouses have different taxable years. Relying on spousal attribution is appropriate, but realize that there may be potential questions.

e. Nonfiduciary Substitution Power. A nonfiduciary substitution power under section 675(4) is the most inconsequential trigger power possible — it does not have any impact on the dispositive scheme of the trust.

Nonfiduciary Issue. The regulations say that whether the power is exercisable in a nonfiduciary capacity is a facts and circumstances issue. Howard says that is baloney. If the document says it is not held in a fiduciary capacity, he cannot think of any way it can be held to be in a fiduciary capacity. In light of the nonfiduciary requirement, the power should not be held by trustee. Technically, a trustee could hold a substitution power itself in a nonfiduciary capacity, but there is a presumption that it is held in a fiduciary capacity.

Third Party Substitution Power. Howard is now comfortable using third party substitution powers. Section 675(4) speaks of have the power to "RE-acquire" trust assets, but the IRS has issued many private letter rulings and the revenue procedures giving forms for CLATs and CLUTs recognize third party substitution powers as causing grantor trust treatment. (Furthermore, there are indications from other provisions in the statute that the substitution power referred to is not limited to one held by the grantor.) Howard concludes: "The IRS believes the 'RE' letters are irrelevant. They have never been a literate group, and I'm comfortable with it now."

Non-adverse Party. The Code does not require that the person holding the substitution power be an adverse party, but the regulations do. Reg. §1.675-1(b)(4). An attorney might succeed in showing that the regulation is an unreasonable construction of an ambiguous statute that is not valid. However, attorneys cannot do planning on the assumption that they can overturn the regulation; particularly one that has been around for 54 years, and for which the Code has been recodified during that period, implicitly confirming the regulation.

Equivalent Value. The statute requires a substitution with assets of "equivalent value." The statute does not say "equal value." The IRS could conceivably argue that requires a consideration of basis, holding period, and liquidity "equivalence."

Independence of Trustee. Revenue Ruling 2008-22 says that the existence of a nonfiduciary substitution power will not trigger §2036 or §2038, but one of the requirements is that the IRS looks to the fiduciary duty of the trustee to make sure that equivalent assets are substituted. In light of that, use a trustee with some semblance of independence; the IRS may examine whether the trustee will exercise its discretion to assure equivalency. It is probably best not to use the grantor's spouse as trustee if the grantor trust trigger power is a grantor substitution power.

S Corporation Stock. Trust instruments sometimes provide that if the trust ever acquires S corporation stock, the income must be distributed currently. In that case, a grantor substitution power would give the grantor the power to impact distributions, so a grantor substitution power should not be used in that type of trust.

f. Power to Lend Without Adequate Security. Giving the trustee the power to lend to the grantor without requiring adequate security causes grantor trust status. Do not give the grantor the power to require the trustee to make loans to the grantor. Howard used to worry that if the trustee reduces the security, does the trustee have to increase the interest rate in order to satisfy the trustee's fiduciary duty of looking out for the best interest of the trust. If so, isn't the security (if any) then “adequate” in light of the other features of the loan? However, Howard concludes that the section only makes sense if the security and interest are treated independently.

g. Payment of Insurance Premiums. Despite the language of the statute, it is not clear that merely authorizing paying insurance premiums is enough. There are old cases under the prior Code language saying that there must be actual payment of insurance premiums to cause grantor trust treatment. Field Advice 20062701F says that mere naked language authorizing payment of insurance premiums is sufficient, but Howard would not rely on that. The practical effect is that ILITs could file returns as grantor trusts, but do not rely upon this power if the client wishes to sell assets to the trust, and it is important for that purpose that it be a wholly grantor trust.

h. Addition of Grantor Trust Trigger Power by Court Reformation Proceeding. In Letter Ruling 200848017, the IRS held that if a trust is modified in accordance with state law to add a nonfiduciary substitution power, the trust would become a grantor trust.

i. Crummey Powers in Grantor Trusts. Section 678(b) says that the original grantor trust rules applicable to the original grantor take precedence over treating a beneficiary with a withdrawal power as the owner of the trust; however that applies only “with respect to a power over income” and a Crummey withdrawal power is a power over principal. Nevertheless, the IRS has now issued 40 private letter rulings saying that the grantor power trumps over the Crummey power holder. Some of the earlier rulings explain that “income” means from any portion of the trust, not just fiduciary accounting income. Even so, many planners avoid using Crummey powers if it is vitally important that the trust be a grantor trust (such as where the stock holds S corporation stock, even though interestingly many of the Crummey trust/grantor trust rulings arose in the context of a trust that owns S stock and wanted to qualify for the grantor trust exception for qualified S shareholders.)

Even if the grantor-owner treatment trumps the beneficiary-owner treatment, what happens when the grantor dies? Does the grantor trust treatment as to the beneficiary become resurrected? At one time, the IRS issued a private letter ruling saying that the beneficiary would become the owner, but it later withdrew that portion of the ruling. Letter Ruling 9321050, revoking 9026036 on the §678 issue. (The uncertainty does not bother Howard.)

j. Tax Consequences at Death of Grantor. There has been much analysis about what happens at the death of the grantor, but no rulings or cases are “on all fours.” The correct answer seems to be that death is not a recognition event. (For example, if a person dies owning property with debt in excess of basis, that does not cause gain recognition.) Howard would even consider taking a case on a contingency basis that death does not cause a recognition event for the grantor trust.

Some commentators believe that death does not cause income recognition; nevertheless a basis step up occurs. Not everyone agrees. While there may be sound technical reasons supporting that view, Howard believes that the Tax Court will not likely rule that way — it overrules a fundamental tax principle that the judges perceive. However, clients should be able to achieve a basis step up at the client's death by exchanging cash to the grantor trust in exchange for appreciated assets held by the trust, so that the appreciated assets would be in the grantor’s estate at death and therefore receive a stepped-up basis.

"However, a lot of clients do not call you the day before they die. Clients can be difficult."

k. Toggling. Clients who actually understand what happens with grantor trusts want to know if they will be able to end the grantor trust status. If the client does not ask that, keep explaining how the grantor trust works; "they don't understand it yet."

It is possible to build in flexibility to turn off the grantor trust power. Whoever holds an interest or power that causes grantor trust treatment should have the ability to relinquish that interest or power. Alternatively, a third person could be given the ability to cease the trigger power or interest.

Trustee Relinquishing Trigger Power. If the trustee has the ability to relinquish the trigger power, how can the trustee justify turning off a power that renders the trust subject to income tax? The trustee's fiduciary duty is to the trust beneficiaries and not to the grantor. One alternative might be to add a quid pro quo. For example, the trustee can terminate the right of substitution, but if it does so, the ascertainable standard would be replaced by an "any good cause" standard that would favor the beneficiaries. The trustee would then have to justify that relinquishing the substitution power (causing the trust to have to start paying income taxes) is a good deal for the trust in light of that quid pro quo.

Howard has the same concerns with giving a trust protector the power to relinquish the trigger power. The protector might be in the position of having a fiduciary duty. He prefers to give an "untitled" person the power to relinquish the trigger power.

Another way to toggle off grantor trust status is to appoint an adverse party as trustee and require that the adverse party consent to distributions in most cases.

Toggling On. Toggling back on the power is technically possible, but Howard would not do it. If the grantor (or even a third party) can "turn on" grantor trust status again, it will look like grantor retained control.

In Letter Ruling 200848017, the IRS held that if a trust is modified in accordance with state law to add a nonfiduciary substitution power, the trust would become a grantor trust. That is the way that Howard would rely upon to toggle grantor trust treatment back on, if necessary.

l. Timing of Cessation of Grantor Trust Treatment. Does grantor trust status end as of the end of the year or as of the date that the grantor trust trigger power is relinquished? The answer seems to be that grantor trust status terminates either the moment or the end of the day that the grantor trust trigger power is relinquished, causing a short taxable year. The Madorin case is the best authority. That case indicates that the trust had to report future income, from the moment that grantor trust status of the trust ended. (However, if actual borrowing by the grantor was the trigger power, grantor trust status extends to the end of the year.)

m. Multiple Powers. There is no need to have to use multiple grantor trust trigger powers, but everyone does it. "If the power doesn't hurt, put it in." An informal poll of the audience indicates that most planners are using multiple trigger powers.

n. Favored Grantor Trust Triggers.

(i) Howard Zaritsky: Substitution power and using a non-adverse party as trustee with a sprinkling power over income and principal coupled with someone having the power to increase the class of beneficiaries.

(ii) Pam Schneider: Substitution power.

(iii) Carlyn McCaffrey: Substitution power. Also giving a related (but non-adverse) party a lifetime power of appointment.

(iv) Dennis Belcher: He typically uses two powers, a substitution power and a power to add charitable beneficiaries.

(v) John O'Grady: Substitution power.

(vi) Steve Akers: Sprinkling power with related (but non-adverse) parties as more than half of the trustees if that works in the client situation. Also substitution powers. He sees substitution powers as the most common grantor trust trigger in instruments that he reviews.

(vii) Lou Harrison: Power of third party not in fiduciary capacity to add beneficiaries.

o. Sales to Grantor Trusts; Seeding the Trust.

(i) Size of Seeding. There is lore suggesting that the trust should have an equity value of 10% after the sale. (This would be a 1:9 ratio, meaning that the "seed" should be 1/9th or 11.111% of the sale amount.) However, the amount required is what is appropriate to justify selling assets for a note, taking into account all relevant facts and circumstances. It would be preferable to obtain confirmation from a commercial lender that the same loan would be made given the surrounding facts. (However, that step often does not occur and should not be essential.

(ii) Delay in Sale After Seeding? Some planners have suggested that the Holman decision, which rejected application of a step transaction doctrine to the contribution of assets to an FLP followed by gifts of partnership interests where there was an economic risk of a change in value between the two dates, indicates that there should be some delay in the time of "seeding" the trust and the time of the sale. The concern is that the IRS would treat the overall transaction as a bargain sale and apply §2036 to the transaction as a gift with a retained interest in the asset. Panelists believe that the gift to seed the trust and the subsequent sale are two separate transactions that have independent economic effects and that a lengthy seasoning period is not required. (A delay of 7-10 days should be sufficient.)

(iii) Guarantee. If a guarantee is used to provide the seeding, some planners take the position that the trust does not need to pay for the guarantee if it is provided by a trust beneficiary. Analogy is made to life insurance trust cases that have held that there is no transfer by a beneficiary who pays a premium payment on life insurance owned by the trust in order to protect his or her interest in the trust. However, most planners would have the trust pay a commercially reasonable amount for the guarantee, and appraisers often appraise the annual fee at 2-2 ½ % of the guarantee amount.

p. Refinancing Notes to a Lower AFR. In light of the recent substantial declines in the applicable federal rate, planners often face the issue of whether notes from sales to grantor trust s may be renegotiated to use the lower AFR. An excellent article appears in the July 2008 issue of Journal of Taxation by Jonathan Blattmachr, Bridget Crawford, and Elisabeth Madden. The article concludes that changing to the lower interest rate should not cause adverse tax consequences, particularly if there is a prepayment right and if there is no "disposition" issue under the installment sales rules of §453. (A sale to a grantor trust probably does not qualify for installment sales treatment in any event because it is not treated as a transfer for income tax purposes.) Various speakers during the week confirm that they have routinely done this over the last year. Jonathan indicates that he is doing a half dozen note substitutions every month. He recommends that planners should contact clients about this opportunity and monitor interest rates. Some planners prefer to renegotiate the note terms in some degree when the interest rate is changed, but other respected planners say that should not be necessary.

q. Creative Uses of Revocable Trusts. Several creative uses of revocable trusts include the following. 1) Vehicle for making education expense payments by creating a revocable trust with a third party trustee to consider requests from family members for educational expense payments; 2) Private foundation replacement by putting assets into the revocable trust and the having the family meet periodically to discuss charitable gifts (like with a private foundation) and have the trustee makes the charitable distributions (but of course, no charitable deduction would be allowed until distributions' were actually made to charity; 3) Vehicle for making large deathbed gifts, by giving someone the power at anytime to remove the power to revoke — so the agent could, even over the weekend if the client becomes critically ill, remove the power to revoke and complete the gift.

25. Planning Strategies With QTIPs During Surviving Spouse's Lifetime

a. Trigger §2519 and Pay Gift Tax. A gift of an interest in the QTIP is treated as a gift of the entire QTIP. If the spouse gives his or her income interest, there is a right of recovery of gift taxes attributable to the deemed gift of the remainder interest, and an interrelated computation is required to determine the net amount of the gift. See Reg. §§25.2207A-1(b); 25.2519-1(c)(4). Paying gift tax rather than estate tax at the surviving spouse's death can reduce the overall tax.

b. Section 1058 Loan of Stock to Surviving Spouse and GRAT. The QTIP trust cannot contribute assets to a GRAT; permitting distributions to anyone other than the surviving spouse would disqualify the trust from QTIP treatment. Turney Berry suggests a §1058 loan of securities to the spouse and having the spouse create a GRAT with the securities. Under §1058, if an individual or trust lends marketable securities to someone else, that is not treated as a sale of the securities, but just a loan. The securities must be returned on demand, and the borrower must pay the lender for any distributions or dividends received while holding the stock. The spouse might borrow the securities, and transfer them to a GRAT. The QTIP is not frozen, because the securities must be returned to the QTIP at some point. However, if the securities appreciate, most of the appreciation will remain in the GRAT, and the surviving spouse will have to use other assets to repay the QTIP, thus depleting the surviving spouse's estate. There are various income tax disadvantages with this approach. Payments made to the lender to repay the dividends are viewed as ordinary income to the lender and lose their tax favored dividend treatment to the lender. The payments are §212 deductions to the borrower and are subject to the 2% haircut rule and the AMT.

c. Sale of Securities to Surviving Spouse. While this would generate a tax on the sale, the capital gains rate is just 15% and the tax is paid from the QTIP thereby reducing the amount subsequently subject to estate tax, resulting in a tax rate of about 8%.

Furthermore, there may be no gains because of the step-up in basis at death and the recent market meltdown.

d. Contribution to FLP. If the QTIP invests in an FLP, the IRS may argue that constitutes a §2519 disposition by the spouse resulting in a large taxable gift. See Item19.h above.

26. Using §2038 Trust to Obtain Basis Adjustment

In community property states (and Alaska) the entire community property of both spouses gets a stepped up basis at the death of the first spouse. In common law states, getting a stepped up basis at the first spouse's death, regardless of whether the propertied spouse dies first, may take priority over bypass trust planning. Assume husband is the spouse with appreciated property. One approach would be for the husband to transfer the appreciated property to an "estate trust" for his wife (providing that assets will pass to the wife's estate at husband's death). (There is no necessity that the wife has a mandatory income interest.) The husband would retain a power to terminate the trust and distribute the assets to the wife at any time. (This is a completed gift, despite husband's power to accelerate the distribution to the wife, Reg. §25.2511-2(d), but the estate trust qualifies for the gift tax marital deduction.) While the retained power to accelerate the distribution to the wife does not prevent the transfer from being a completed gift, it still causes the assets to be includible in the husband's estate under §2038 if he dies first (thus getting a stepped up basis under §1014(b)(9)). If the wife dies first, the property would pass to her estate under the terms of the trust, and would therefore get a stepped up basis. Regardless of which spouse dies first, the property is included in his or her gross estate and qualifies for a basis step-up.

If a general power of appointment trust were used, instead of an estate trust, Rev. Rul 70-153 says that only the value of the remainder interest is includable in the grantor's estate where the beneficiary has a nondiscretionary right to income. An inter vivos QTIP trust will not work for this purpose because regulations make clear that §§2036 and 2038 do not apply to the grantor of an inter vivos QTIP.

Section 1014(e) generally prevents a stepped up basis where a gift to a decedent is made within a year of death and passes back to the donor. That section will not apply if the grantor lives at least one year after funding the trust even if assets revert to grantor (which will depend on the terms of the donee spouse's will) upon the donee spouse's death.

27. Simplifying Generational Philanthropy

Kathryn Miree discussed practical aspects of charitable planning with clients.

a. Practical Problems; Client Temperament and Goals. Most problems that arise with charitable planning entities are for practical rather than legal reasons. The planner must appraise the client's temperament and willingness to follow advice to comply with detailed technical requirements. Clients too often have a "McDonalds drive-thru" mentality in ordering up a private foundation, but the planner should know it is totally unsuitable for a particular client. The planner should dig into the client's specific goals regarding philanthropy, such as creating a platform for the family to join together in pursuing philanthropy, to teach values, to bolster the image of the family in the community, to identify the family name with a particular endeavor, etc. The goals impact the form of the charitable entity that should be used.

The planner should apply practical judgment to keep the client from making inappropriate decisions on philanthropic structuring. If the donor is unsure or priorities are unclear, choose a temporary or short term option that does not forestall a more permanent option in the future.

b. Small Private Foundations. There were approximately 80,000 private foundations at the end of 2006. The number of private foundations grew by about 50% between 2000 and 2006. There are estimates that 48-65% of all private foundations are less than $1.0 million in size. That is a very small size for a private foundation. The cost to form a private foundation is typically about $15,000, and there are significant annual costs to maintain and administer the foundation. For example, for a $100,000 private foundation, the annual administrative costs could be 3.8% or higher, significantly reducing over time the amount of charitable funds that could be distributed.

c. Type III Supporting Organizations. Until the Pension Protection Act of 2006, Type III supporting organizations ("SOs") provide almost as much control to the client's family as private foundations but they are public charities not subject to many of the disadvantages of private foundations. However, there are many more restrictions that apply after the Pension Protection Act of 2006. The book is not yet completed on restrictions that will be applied to Type III SOs. The Pension Protection Act required a study of abuses, which was supposed to be completed in 2007. Also, Treasury was directed to select the amount that would be required as mandatory distributions. They have yet to do so, but it is likely that the amount will be the same as the 5% requirement for private foundations.

d. Five Percent Minimum Distribution Requirement. The 5% minimum distribution requirement for private foundations (and that may be applied to Type III SOs) is creating substantial problems in the current economic downturn. Many portfolios have lost 40% of their market value last year, and distributing an amount equal to 5% of the average monthly market values of the foundation for the prior year is a definite penalty.

e. Revocable Charitable Trust. The revocable trust acts like a private foundation. At the client's death, it could terminate into a philanthropic form such as a private foundation, donor advised fund, or SO. However, the client keeps control by being able to revoke the trust arrangement at any time if the client decides that he or she does not want to put up with the requirements of administering the fund. Of course, there is no charitable deduction until the trust makes charitable contributions, there is no exemption from income tax, and the assets are subject to the client's creditors. But this is a good alternative for the client to live with a foundation for several years before irrevocably committing funds to a private foundation.

f. Kitchen Table Philanthropy. Clients often just want to perpetuate their values and find ways to engage their children in philanthropy. Kathryn suggests what she terms "Kitchen Table" philanthropy. It is a tool that does not involve the trauma of a supporting organization or private foundation or even a donor advised fund. It is appropriate if the client wants to keep maximum control and primarily wants to pass on values to children. (It is the same general concept as using a junior board model with a private foundation.) The "Kitchen Table" philanthropy concept involves the following steps.

(i) Get the children around the kitchen table (starting at about age 8-9 or so). Decide how much money to allow each child to allocate (for example, $200 or $500; the amount is not overly important, it will seem like a large amount to the child).

(ii) Ask each child — "What are your areas of charitable interest?" The parent will probably have to lead the children through areas they are interested in (Boy Scouts, church, choir, etc.) When Kathryn took her children to school every day, they passed by a group of homeless persons. Her youngest child wanted a grocery cart like they had. Kathryn explained that they had a grocery cart-because they had no place to sleep. That astounded her son — that anyone did not have a bed like him. So helping the homeless was important to him. For others, the area of interest may be museums, zoos, etc.

(iii) Within that area, find two or three organizations in the local area that address that interest. Send the children to the web to identify places in that city. Give them three-to-four questions to answer. For example, who does the charity serve, etc.

(iv) As they decide on charities, call the charities and arrange for a tour. When you explain the purpose, most charities would be most willing to comply

(v) Come back to table and ask each child how to spend his or her amount.

That is a model that allows parents to pass on values to their children and grandchildren, and teaches children how to give and to focus on philanthropy that is important to them.

g. Trend Toward Shorter Term Foundations. There is a trend toward using terminating short-term foundations. For example, the Gates Foundation, after the Buffet contribution, terminates 50 years after the death of the last to die of Bill and Melinda Gates and Warren Buffet.

h. Paying Family Members. Private foundations can pay family members for providing management, legal or investment services as long as the compensation is reasonable and reflects the value of the services provided. There are many surveys that provide a range of reasonable salaries for various sizes of foundations. The determination must factor in the number of hours each week that the family member will spend at the foundation office. Family members cannot be paid compensation from a donor advised fund or supporting organization.

28. Return Preparer Penalties

a. Overview of Standard. Section 6694 was amended in the Small Business and Work Opportunity Act of 2007 to strengthen the return preparer penalties. Section 6694 was amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50%) likelihood of success to avoid penalties. I.R.C. §6694(a)(2)(B). (The Emergency Economic Stabilization Act of 2008 (often referred to as the bailout act) changed the "more likely than not" standard to "substantial authority.") If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard (which may be as low as a 10% likelihood of success). I.R.C. §6694(a)(2)(C).

b. Overview of Comparison to Taxpayer Penalty Standards. Very briefly, the major taxpayer penalty provision is for the substantial understatement of income tax, if the understatement is the greater of (1) 10% of the tax shown on the return, or (2) $5,000. The standard for avoiding taxpayer penalty is substantial authority. Therefore, for this taxpayer penalty, the standard to avoid penalties is the same for taxpayers and for preparers.

The other taxpayer penalties (including penalties related to estate and gift taxes) can be avoided if there is "reasonable cause and good faith" or a "realistic possibility of success" (which has been referred to as a 1 in 3 likelihood of success). If the taxpayer discloses a problematic issue, the standard drops to "reasonable basis" (which a recent IRS Fact Sheet says means a 10% likelihood of success, see paragraph j below.)

Accordingly, for estate and gift taxes, there is still a higher standard for preparers than taxpayers to avoid penalties. Therefore, the disclosure rules (to drop the standard to a "reasonable basis" standard) is still important following the 2008 change of the basis standard to a "substantial authority" standard (rather than the higher "more likely than not" standard).

c. Disclosure Methods — Signing Preparers. This is where the proposed regulations provide significant additional leniency as compared even to the favorable provisions in Notice 2008-13. Three permissible disclosure methods are described for signing preparers. One method is to file a Form 8275 or Form 8275 R with the return, Reg. §1.6694-2(d)(3)(i)(A). The second method is to deliver the return to the taxpayer with a disclosure attached. Reg. §1.6694-2(d)(3)(i)(B). The third method applies for returns other than income tax returns. (The regulation refers to returns subject to penalties pursuant to §6662 "other than the substantial understatement penalty under §6662(b)(2) and (d)." Section 6662(b)(2) and (d) refer to income tax returns.) Under this method that applies to estate and gift tax returns, the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under §6662, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(i)(C). Therefore, the preparer can always reduce the reporting standard from a substantial authority standard to a mere reasonable basis standard (for returns other than income tax returns) by merely advising the taxpayer of the taxpayer penalty standards under section §6662.

The regulations give detailed guidance as to the requirements for giving sufficient advice about penalties in order to use the more lenient disclosure standards. Reg. §1.6694-2(d)(3)(iii).

- Each Position That May Not Meet Substantial Authority Standard. The preparer must address each position for which there is a reasonable basis but not a substantial authority basis for the position.
- Tailored to Taxpayer. "The advice to the taxpayer with respect to each position… must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances." Id. The preparer must contemporaneously document the advice.
- Boilerplate Not Sufficient. "There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement …" Id.
- May Use Form or Template. "Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code." Id. The Preamble to the final regulations says that "Tax return preparers, and their firms, may use standard language to describe applicable law and may adopt a standard approach to disclosure issues."
- Single or Separate Documents. The advice may be given in a single document covering all positions, or in separate documents for each position. Id.

Practical Planning Pointer. While a boilerplate notice is not sufficient, observe that the notice required is of the penalty standards that apply to the taxpayer under §6662 (or for a nonsigning preparer, advice to the taxpayer of the opportunity to avoid penalties under

§6662 or advice to another return preparer of his or her disclosure requirements). That would seem to be a very similar notice for all situations, as long as there is listing of each position for which the substantial authority standard may not be satisfied. Preparers may be able to develop a format that will generally be used for giving the requisite advice, and list the particular positions on the return that may have inherent uncertainty as to satisfying the substantial authority standard.

d. Exception for Advice Given Before Transaction. In describing who constitutes non-signing return preparers, the regulations provide that if an advisor gives advice both before and after the transaction, if the amount of time afterward is less than 5% of total time both before and after, then the person is not a preparer. Planners suggested that advisors in planning transactions who anticipated having to advise another signing return preparer about reporting the transaction could avoid being treated as a preparer by giving all advice before the transaction and preparing a lengthy memo of how to report the transaction — so the planner would not have to spend any time afterward. However, the final regulations add an anti-abuse rule saying that time spent on advice before the transaction will be taken into account if the facts and circumstances show that the advice was given before the transaction primarily to avoid being treated as a return preparer. Reg. §301.7701-15(b)(2)(i). Lou Mezzullo believes that in typical planning situations, for example such as a sale to a grantor trust, preparing a memo describing the tax effects of the transaction would be satisfactory to satisfy this exception.

e. Relying on Legal Conclusions. The proposed regulations stated that the preparer cannot rely on legal conclusions offered by the taxpayer. However, many issues involve both fact and legal issues. For example, if the taxpayer says "I'm married to my wife," isn't that a mixed fact and law conclusion? Also corporations have in-house counsel who offer conclusions that the preparer should reasonably be able to rely on. The final regulations dropped the statement that the preparer cannot rely on legal conclusions offered by the taxpayer.

f. Observations from Lou Mezzullo.

(i) Filing Returns. Some firms take the position that they will not file returns any more in light of the return preparer penalties. For example, Lou feels that it is not professionally responsible to tell a client, whom he advised on installment sale, that he cannot file the gift tax return.

(ii) Advice Before Transaction. Planners will often be covered by the exception for advice that is given before the transaction occurs, as long as the facts satisfy the 5% requirement and as long as the advice is not prepared beforehand with the intent to avoid the 5% rule.

(iii) Little Impact on Practice. It is hard to think of transactions involving transfer taxes that we would recommend where do not believe there is substantial authority. Even aside from the return preparer penalties, planners will not want to give advice that they think is incorrect or that is not based on substantial authority. Exceptions will be in special situations in which the planner will specifically focus on how to report and adequately disclose the transaction. Planners will be more concerned about adequately documenting their files to avoid malpractice exposure than about avoiding return preparer penalties.

"I will not change anything that I have done in the past as a result of these rules. The sky is not falling."

29. Partnership Profits Interests

Richard Robinson gave a very illuminating review of ways that partnership profits interests can be used in a variety of situations, other than for hedge fund or private equity fund owners. He has used profits interests for 35 years as a way of getting ownership interests in auto dealerships, manufacturing companies, law firms, oil and gas ventures, real estate ventures, etc, to persons providing services with very attractive tax advantages.

a. Description of Profits Interest. This is only available for partnerships (or LLCs taxed as partnerships). A transfer is made to a person providing services of a right to receive future profits (i.e., both income and appreciation), losses, and distributions, but not a share of the existing capital of the entity.

b. Example Scenario. Parents own 100% of a partnership that can be a business or investment entity. Assume the assets are worth $8 million, but the owners expect the assets to appreciate from $8 to $12 million over the next three years. Parents want to transfer a 20% ownership interest to Mary, a key employee. (Mary could either be an unrelated party or a daughter.) They want to impose a three-year vesting requirement to keep her in the business.

   If this were a corporation or if the parents transferred a traditional capital interest in a partnership, the value of the interest would be taxed to Mary as ordinary income when it is no longer subject to a substantial risk of forfeiture. (The value is a typical fair market value determination, including application of relevant minority and marketability discounts.) If a §83(b) election is filed, Mary would be taxed immediately on the value of the interest (as ordinary income) but the interest would be taxed as capital gain when it is sold.

c. No Income Recognition on Receipt of Profits Interest. Receipt of a partnership profits interest in exchange for services provided to the partnership by a partner, or in anticipation of becoming a partner, is generally not a taxable event regardless of whether it is vested upon receipt, subject to compliance with Rev. Proc. 93-27. To qualify for the no-tax treatment, Rev. Proc. 93-27 requires that the profits interest (1) must not relate to a substantially predictable stream of income from partnership assets such as income from high quality debt securities or a high quality net lease, (2) must not be disposed of within two years of receipt, and (3) must not be a limited partnership interest in a publicly traded partnership.

   No Income Recognition on Later Vesting. Furthermore, if the interest vests at a later time, there is no income recognition when the profits interest vests. Notice 2001-43. (As a result, there is no necessity of filing a §83(b) election upon receipt if a profits interest is not vested, but Richard Robinson always does so in case the IRS later argues that the profits interest does not meet the technical requirements of Rev. Proc. 93-27. He would rather argue about the value of the profits interest on receipt (when he can typically argue for a zero current value, discussed in the following paragraph) than to have to argue about the value on the date of vesting (when the profits interest may have substantial value if there have been substantial accumulated profits).

d. Valuation of Profits Interest If "No Income on Receipt" Rule Does Not Apply. If the profits interest does not meet the technical requirements of Rev. Proc. 93-27 and is taxable on receipt, proposed regulations issued in 2005 contain an elective safe harbor that permits a partnership and the service partner to use the "liquidation method" to value the interest. Prop. Reg. §1.721-1(b)(1) and Prop. Reg. §1.83-3(e). Liquidation value is defined as the amount of cash the recipient of a partnership interest "would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and liquidated." IRS Notice 2005-43, §4.02.

e. Liquidation Rule To Determine If Qualifies As Profits Interest. Rev. Proc. 93-27, §2.01 defines a capital interest as a partnership interest that would give the holder a share of the proceeds if the partnership assets were sold at fair market value and then the net proceeds distributed in complete liquidation of the partnership immediately after the receipt of the partnership interest. A profits interest is an interest other than a capital interest. Therefore, the interest is treated as a profits interest if the holder would not receive a share of the sale proceeds if the partnership assets were sold at fair market value and the proceeds distributed in complete liquidation immediately after receipt of the partnership interest.

f. Booking Up Capital Accounts of Existing Partners to Fair Market Value of Partnership Assets Before Profits Interest Is Issued. The easiest way to structure a partnership to meet the liquidation test is to follow the economic effect test under §704(b) and to structure the profits interest as having a beginning capital account balance of zero. (The primary economic effect test requires that (1) capital accounts be maintained in accordance with the regulation; (2) liquidation proceeds must be distributed in accordance with positive capital account balances; and (3) each partner has an obligation to restore a deficit capital account balance within 90 days after his interest is liquidated. There is an alternate test also that does not require restoring negative capital accounts if the partnership is required to allocate gross income to a partner whose capital account becomes negative.)

To meet this test, the partnership must book up the capital account of the existing partners to the fair market value of partnership assets when a profits interest is issued. To assure that the profits partner has an initial zero capital account, an appraiser should appraise the partnership at the time of the transfer to make sure that all of the value of the partnership at that time is allocated to the existing partners' capital accounts, leaving a zero capital account for the new profits interest. If the assets are not valued correctly, the IRS may argue that the profits interest partners received a disguised capital interest in the partnership.

g. Catch Up Allocations to Shift Ownership More Quickly. In the example described in paragraph b above, the partnership has an initial value of $8 million, and a 20% profits interest is issued to a key employee. Assume the partnership is sold three years later for $12 million. The key employee would receive 20% of the $4 million of appreciation, or $800,000. That is not nearly as much as the key employee would have received had she been issued a 20% capital ownership interest (in which event she would have received 20% of the $12 million, or $2.4 million). If the parties want the key employee to share in 20% of future sale proceeds (not just 20% of the appreciation), but do not want her to incur the upfront tax cost of immediate income recognition, catch up allocations may help allocate more of future sale proceeds to the key employee.

The economic detriment for the profits partners can be solved through a "catch-up allocation," which is a special allocation of future partnership income and/or gain to the profits partner in the amount required to cause her capital account to be in parity with her percentage interest. If that is accomplished by allocating partnership income, ordinary income would be allocated to the partner; if the allocation is gain from the sale of property, capital gain would be allocated to the partner. However, a catch-up allocation may occur from a "book-up" transaction to book-up the capital account of the profits partner without any current recognition of income. (The gain will be deferred until the partnership actually sells the book-up property and then the key employee will recognize gain in accordance with the rules governing "reverse §704(c) allocations.")

The capital account maintenance rules in the §704(b) regulations require that the partnership must revalue ("book-up") the partners' capital accounts to reflect the fair market value of the partnership property upon certain specified events, including additional capital contributions, grants of additional interests for services, and distributions resulting in recharacterization of partnership interests resulting in the issuance of additional partnership interests. Prop. Reg. §1.704-1(b)(2)(iv)(f).

In the example, the partnership agreement might require a special allocation of profits, when the partnership is sold or liquidated, of future partnership gain first to the key employee until her capital account is in parity with her 20% interest. One day before the actual sale, the parents might make an additional capital contribution (which must be more than just a de minimis contribution). There would be a special allocation of 100% of the appreciation to the key employee until her capital account achieves parity with her 20% percentage interest and the 80%/20% sharing ratio would apply thereafter. In this example, the parents would start with a capital account of $8 million and $0 for the key employee. Because the book-up event occurs when there is $4 million of appreciation to allocate, the first $2 million goes 100% to the key employee in the catch-up allocation to bring her capital account into parity with the other partners in the 80/20 ratio. The remaining $2 million of appreciation is allocated to the partners in the 80/20 ratio, bringing the key employee's capital account to $2.4 million. (If the parents contribute, for example, an additional $2 million to trigger the revaluation event, their $2 million contribution would obviously be allocated to their capital account.) When the sale occurs the next day and sale proceeds are allocated based on capital accounts, the key employee is entitled to receive $2.4 million.

h. Overall Effect: Deferred Taxation at Capital Gains Rates. The overall effect is to shift all appreciation to the profits partner with no income tax being paid until the actual realization event. If the realization event is the sale of the business in a capital gain transaction, the value is shifted to the key employee at capital gains rates. In effect, the key employee is in the same position as if she had received a capital interest to begin with, but the taxation is deferred and the entire value may be taxed at capital gains rates.

i. Business Succession Strategy; More Accelerated Transfer Using 99% Profits Interest. Using the profits interest could be used in a business succession planning scenario when the clients wish to transfer ownership to successor owners with deferred and minimal tax effects. Various strategies may be used to transfer value, including GRATs, sales to grantor trusts, etc. Using the profits interest allows the parents to freeze their value in the business at the current value in conjunction with other strategies to transfer the value of the parents' capital interest at the time the profits interest is issued. If the parents allow their daughter who is the key employee and successor owner to run and grow the business, every dollar that adds to the value of the business must be transferred to her at a later time. The freeze effect of the profits interest avoids that.

The strategy might even be used with a 99% profits interest to accelerate the amount of the transfer. (The parents must keep a 1% interest to assure that they remain as partners and are treated as transferring an interest in the partnership and not the underlying assets.) If the parents issue a 99% profits interest to the successor owner, the freeze occurs with only 1% "slippage" vs. other freezing strategies that have a higher hurdle rate. (However, the parents would have to be able to justify issuing a 99% profits interest in light of the value of the services provided to avoid gift issues, as discussed below.)

Non-Active Children. How can this strategy be used in the common situation where some of the owner's children are not involved with the business but the owner wishes to transfer some ownership in the business to them? They are not providing services, so Rev. Proc 93-27 would not apply to profits interests issued to them. However, an entity could be created to provide services to the partnership, and the entity could be granted a profits interest, under the same reasoning as above. Children who are not active in the business could be part owners of that entity; children who are active in the business might have a greater interest in that entity or might receive a salary from the entity.

j. Gift Issues. For income tax purposes, there is no requirement that the value of the profits interest equal the value of services provided. Rev. Proc. 93-27 and Rev. Proc. 2001-43. For gift tax purposes, if the key employee is not a relative, the transaction should fall within the business transaction exception. Reg. §25.2518-2. If the profits interest is transferred to a relative, there is an issue of donative intent and a gift can result unless the value of services to be provided equals or exceeds the value of the profits interest. Gross, 7 T.C. 837 (1946). Furthermore, the profits interest must be valued using traditional valuation principles rather than using the liquidation approach that is allowed to value the interest at zero for income tax purposes under Rev. Proc. 93-27. Knots, 55 T.C.M. 424 (1988) (determined value of profits interest for gift tax purposes by applying a 10% discount rate to the projected future income stream).

Tax Reporting. How can the issuance of the profits interest be reported to satisfy the adequate disclosure regulations to begin the statute of limitations running as to the gift tax value? Reporting the transfer of the profits interest on the income tax returns should be sufficient to start the gift tax limitations period. The regulation provides that completed transfers to members of the transferor's family that are made in the ordinary course of operating a business are deemed to be adequately disclosed under Reg. §301.6501(c)-1(f)(2), even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes.

k. Section 2701. Even if the value of services provided is equal to the value of the profits interest, a substantial gift may still result if the parents' retained interest in the partnership is valued at zero under the special valuation rules of §2701. The parents' capital interest would be an applicable retained interest that must be valued at zero if the capital interest is a "distribution right," which includes the right to receive distributions with respect to the partner's interest unless the right is of the same class or junior to the transferred interest.

Retained Junior Interest Exception. Query in this case whether the retained capital interest is junior to the profits interest? In all respects, the profits interest will receive equal or greater allocations of future income than the capital interest. (However, if the entity is liquidated before sufficient appreciation has occurred to bring the capital account of the profits interest up to the level of the parent's capital account, the capital owner would receive the preferred amount. To that extent, the capital interest is not junior.) Because there are obviously some differences between the capital and profits interest, the IRS may take the position that the same class exception does not apply; if so, the clients might also make the junior interest argument.

<u>Same Class Exception</u>. In any event, Richard believes that the same class exception should apply. The only difference in the partners' interests is that profits will first be allocated to the profits interest holder until her capital account is in parity with her percentage ownership. The fact that the partners' capital accounts are not in the same proportion as their share of profits and losses cannot be considered as a preference or a priority. It is merely a non-lapsing difference with respect to limitations on liability and are not taken into account for purposes of determining whether the partners' rights are identical under Regulation §25.2701-1(c)(3).

TAM 199933992 concluded that limited partners who first received the proceeds from capital transactions until their capital account was reduced to zero had a preference with respect to distributions and the interests were not of the same class. [Even though the same class exception did not apply, that ruling would seem to suggest that the "retained junior interest" exception would apply in the scenario we are addressing because the parents have retained an interest that receives allocations at some times after the transferred interest.] Letter Ruling 9451051 involved preferred stock that received a liquidation preference. The preferred stock also shared in remaining assets after the liquidation preference was paid, but the initial liquidation preference was charged against its share of remaining assets distributed on liquidation. The ruling found that the preferred and common stock were of the same class because the rights of the preferred were only slightly different.

l. <u>Multiple Key Employees</u>. If the owner wishes to transfer profits interests to multiple key employees, the owner could create separate partnerships and grant profits interests to the separate key employees from the separate partnerships.

m. <u>Operational Issues: Cash Flow Exceeds Taxable Income; Stagger Issuance of Profits Interests</u>. If cash flow exceeds taxable income of the partnership (for example, due to non-cash deductions, such as depreciation or due to large distributions from a refinancing), the profits partner could end up with a negative capital account. For example, if there is $500,000 of taxable income and $600,000 of cash flow, a 20% profits partner will first be allocated 20% of the income, which increases her capital account and basis by $100,000, but she receives 20% of the $600,000 of cash flow, which reduces her capital account by $120,000, putting her in a negative capital account situation. Under the §704(b) regulations, if a partner with a negative capital account does not ultimately have the obligation to restore the deficit in the capital account, there must be a "qualified income offset" requiring the partnership to allocate gross income first to the partner with a negative capital account. In the above example, this would mean that $20,000 of ordinary income would be allocated to the profits partner and the other partners would receive a $20,000 deduction.

To avoid the preferential gross income allocation, the profits partner would like to get her capital account back to zero (or larger) as soon as possible. That might be possible if a "revaluation event" occurs (as described in paragraph g above) to restate the capital accounts to book-up the capital accounts for appreciation. One of the events that trigger a revaluation event is the issuance of a profits interest. Therefore, the plan may be structured to stagger the issuance of profits interests. If an owner wants to transfer a 20% profits interest, that might be done by granting a 5% interest for each of 5 years. Each year, the capital accounts could be restated and the appreciation up to that time would be allocated to the profits partner's capital account (until the capital account is proportionate to the percentage interest). An obvious disadvantage of this approach is that it may require multiple annual appraisals to determine the amount of appreciation in the business value to be booked-up.

n. Guaranteed Payment Strategy. In the example being addressed, where owners wish to transfer a 20% profits interest, the owners may wish to assure a certain amount of cash flow to them. (This may be even more critical in the situation of issuing a very large profits interest, such as the example of issuing a 99% profits interest to assist in business succession planning. The parents may want to assure a specified continued cash flow for living expenses.) In that case, the parents could retain their capital interest AND the right to receive a guaranteed payment of $x amount each year. There is an exception in §2701 for guaranteed payments — they are not treated as preferred interests that are valued at zero under the §2701 rules. Richard would have an appraiser value the guaranteed payment, which would be an offset in determining the value for gift tax purposes of the profits interest that is transferred to young family members.

o. Corporation. If the business is a corporation rather than a partnership or LLC, the corporation (whether it is an S corporation or a C corporation) could contribute its assets to an LLC or partnership, and the profits interest could be issued from the LLC or partnership.

p. Examples of Uses. Richard described various different situations in which he has used profits interests.

- A restaurant owner wished to transfer ownership interests to managers in three different locations. The restaurant was in an S corp. The corporation dropped the three locations into three separate LLCs and gave the managers a 50% profits interest in each respective LLC.
- An auto dealership had three locations and gave a profits interest to the general manager of each location by using separate LLCs for each location.
- The father of a printing shop wanted to retire and allow his son to take over the business. Dad wanted some cash flow each year. He dropped the business from a corporation into a partnership. The corporation kept a 1% partnership interest, and a guaranteed payment (to pay cash flow to dad, and the son received a 99% profits interest for running the business.

q. Legislation May Impact Profits Interests.

Taxing Hedge Fund Owners. Hedge fund owners make their money largely through carried interests, generating capital gains. There have been various proposals to treat people in Greenwich, running hedge funds "the same as the rest of the country."

Proposed Legislation May Impact Most Partnerships. The proposed legislation is aimed at hedge fund managers who receive huge profits with capital gain treatment even though the profits represent compensation for their services. Various bills have been introduced in Congress, some of which treat any partnership interest that is an "investment services partnership interest" in a special way. For such partnerships, all K-1 pass-through income is ordinary income (even if the K-1 would otherwise show capital gain income); furthermore it is treated as self employment income subject to the self employment tax. Also, a sale of the partnership interest generates ordinary income, not capital gains. If there is a distribution of property, the partnership recognizes gain and a partner has ordinary income on receipt of the property. Under one proposal, an "investment services partnership interest" is a partnership interest if the partner provides substantial services to the partnership in connection with advising on securities, commodities, real estate and certain other assets. In one bill, services must be provided to third parties, but in another bill, there is no requirement of providing services to a third party. Under that approach, if a family limited partnership invested marketable securities, and the parent provides advice as to the sale of securities (or for a real estate partnership, the parent provides services regarding real estate investments) those partnerships could be within a broad definition of an "investment services partnership interest."

If that result were to occur, the effective date of legislation would be vitally important. There may be a need to liquidate partnerships before the effective date to avoid the ordinary income treatment.

30. Planning With Carried Interests For Private Equity Fund and Hedge Fund Owners

Jonathan Rikoon presented this topic, together with Alan Halperin and David Handler in a workshop. They all have been deeply involved in estate planning issues for owners of private equity funds and hedge funds. General descriptions below of the structure of the funds are taken (often quoted directly) from Jonathan's excellent outline.

a. Primary Observation: Extremely Complicated. My primary overall observation from the discussion is that there can be huge transfer tax advantages of making transfers of "carried interests" owned by the managers of private equity funds or hedge funds that have a relatively low current value (because of the uncertainties of raising capital for the fund and of the fund's success) but may have huge appreciation potential. However, the issues are exceedingly complex. Planners must be willing to devote an enormous amount of time to understand the issues to practice in this area. I will make no attempt to describe all of the many complexities involved, but will merely provide an overview of the issues, particularly in light of the fact that relatively very few estate planners represent private equity fund or hedge fund owners.

b. Economic Benefits of Principals and Legal Structure of Private Equity Funds. "Principals" who play a key ongoing role in the organization and operation of the fund typically have various types of interests in the fund.

   (i) Committed Capital. The owners contribute a certain significant amount of capital to the fund, both for tax reasons and to reassure outside investors that the owners have "skin in the game."

   (ii) Carried Interest. This is a share of future profits (typically through the fund's general partner). The carried interest receives 20% of profits AFTER capital contributions have been returned to the investors, a hurdle rate of return (e.g. 8%) has been met, and a corresponding make-up amount of the 8% hurdle has been allocated to the general partner so that the investors and general partner are in proportionate sharing ratios.

(iii) Compensation. Salary and bonus compensation is typically provided for principals, often from a separate management company, which receives management fees (typically up to 2% of the capital committed, not including capital reserves awaiting deployment) from the fund.

(iv) Synthetic Capital. The recent trend is to include an additional component of profit interest calculated as if the general partner had made an additional capital contribution to the fund beyond its actually contributions. Economically, the capital deemed contributed on behalf of the general partner is actually contributed or advanced by the limited partners. Management fees in funds with synthetic capital may be lower than in those without synthetic capital.

(v) Distributions Waterfall. Distributions are often made deal by deal as portfolio companies are sold, and most funds do not reinvest profits. Distributions are typically first applied as a return of capital to investors (and for this purpose, synthetic capital is treated as an actual investment). Next, distributions are made to investors to satisfy the hurdle rate of return. Next, there is typically a make-up distribution to the general partner corresponding to its proportionate share of the hurdle rate return. Finally, any additional profits are allocated 20% to the carried interest holders and 80% to the investors (counting synthetic capital). There may be a clawback or reimbursement required of the general partner, to preserve the hurdle and the overall 80/20 allocation of profits, if there are subsequent dispositions at a loss. Clawbacks are typically on an after-tax basis of the net carry that the principals have received.

(vi) Legal Structure. The fund may be structured as a limited partnership with an LLC as the general partner (having the founders and principals as members of the LLC). Alternatively, the general partner may be another limited partnership with an LLC as the 1% general partner. (This is used to minimize state income taxes in states that treat LLCs as corporate entities for state income tax purposes.) There is typically a separate management company that contracts with the general partner to provide management services.

In addition, the principals sometimes invest a large portion of their capital commitment outside the fund in a "side-by-side" investment vehicle that co-invests with the fund in each portfolio company investment. (This is often used to avoid §2701.)

It is important to understand the legal structure and the various economic interests because transfers to family members often have to be a "vertical slice" of all ownership interests of the principal (but arguably not in separate "side-by-side" investment vehicles) in order to satisfy §2701 and other tax concerns.

c. Economic Benefits of Principals and Legal Structures of Hedge Funds. Hedge funds typically do not have all the various "bells and whistles" of private equity funds and may be easier to satisfy some of the various tax complexities involved in making estate planning transfers of the carried interests.

(i) Actual Capital. Principals typically contribute between 1% - 3% or more of the fund's capital.

(ii) Performance Fee. The performance fee is typically equal to 20% of the net profit (based on the net increase in net asset value) of the hedge fund and is allocated to the general partner (or investment manager). Generally, the fund must reach a "high water" mark before the general partner receives a performance fee for the year, meaning that the general partner only receives performance fees on the value of the fund that exceeds the highest net asset value it has previously achieved.

(iii) Compensation. There is typically a management fee paid to a separate management company that compensates the managers who are running the fund.

(iv) Legal Structure. The simplest "stand-alone" hedge fund structure (not often used) is a limited partnership with another limited partnership as the GP that has an LLC as its 1% general partner. There is typically a separate management company that provides services to the general partner. A "parallel funds structure" is often used where there are foreign investors or tax-exempt entity investors, in order to avoid taxing "effectively connected income" of a U.S. trade or business to foreign investors. There is an offshore fund (for investments by foreign individuals and tax-exempt entities) and an onshore fund (for U.S. investors) that typically share mangers and the investments of the two funds are coordinated.

d. Advantage of Transferring Carried Interest; Need to Transfer Vertical Slice of All Interests; Arrangements to Reduce Gift Amount With Vertical Slice Gifts. The carried interest may be valued rather low because of a wide variety of uncertainties. The optimal plan would be to transfer the carried interest, but not the capital interest that would have a much higher current value. However, there are concerns that §2701 would apply if the parent gives the carried interest and retains the capital interest, which could result in a large upfront gift. Many planners conclude that the only safe way to proceed is to give a "vertical slice" of all interests that the client owns in order to avoid §2701. That is not a problem if the client just owns a 1% capital interest, but may be problematic if the client has had to make a substantial capital investment. However, other planners suggest various alternatives to avoid having to give a vertical slice of all interests. One approach is to have the principals invest almost all of the significant capital (that outside investors want the principals to have at risk) in a side-by-side entity that co-invests in all individual portfolio companies in which the fund invests. The primary fund would then have a very small capital investment and it would be much easier to give a vertical slice of the principal's interest in the primary fund. Some planners suggest doing something similar with derivatives to keep the actual capital invested in the primary fund very low so that a vertical slice of all interests in the primary fund would still result in a relatively low gift.

e. Estate Planning Vehicle for Transferring Interests. A family limited partnership is typically used to receive the interests that are transferred from the private equity fund or hedge fund. The fund probably will not want to deal with a number of individual trusts, different trustees, or pressure to make distributions based on when distributions are required from trusts. In addition, the family limited partnership affords substantial flexibility to manage cash flow.

Interests in the FLP are typically transferred by gift or by sales to grantor trusts. GRATs are not workable because of the timing of required distributions form the GRAT.

f. Section 2701 Issues.

- Section 2701 does not apply if the client wishes to transfer interests to unrelated persons (such as a domestic partner).
- Does the client have "control" (which is a requirement for §2701 to apply) if the client merely has a small ownership interest in an LLC which is the general partner of the primary limited partnership? (Being a general partner is enough to constitute control of a limited partnership, but the regulations do not address what happens if the client is not a direct partner but owns an interest in an entity that is the general partner.) The answer is unclear.
- The junior interest exception and same class exception do not provide certainty that §2701 can be avoided. Section 2701 does not apply if the donor gives the preferred interest and retains a junior interest. This does not help for private equity funds, because the retained capital interest gets the initial allocations of income until the initial investment and hurdle rate amounts are repaid, so the capital interest is preferred in that regard (even though it is junior to the carried interest at later times). However, hedge funds typically do not allocate anything preferentially to the capital interest owner, but just allocates all profits on an 80/20 ratio from the outset, and it is possible that hedge funds would not be subject to §2701 if just the performance fee interest is transferred. However, there is no certainty.
- Even if the client just owns a small 1% capital interest, if parents or the client's spouse also owns capital interests, the same class test is applied taking into consideration all applicable retained interests held by all applicable family members (i.e., ascendants or the client's spouse) — which might require substantial capital transfers by those other family members.
- Sometimes there are fee waivers of capital call waivers for principals — the call is waived and there is an adjustment later when profits are allocated. If that occurs, there would be a waiver as to the vertical slice that was transferred and questions could arise as to whether that waiver constitutes a gift. It is preferable to avoid such waivers if there have been transfers to family members.
- Interests in the separate management company should not be subject to §2701 because it has a contractual right and not an equity interest in the fund itself.

g. Assignment of Income. Will the allocation of profits distributions to the transferee estate planning vehicle be respected under assignment of income principles? The safe harbor in §704(e) may apply. It requires that capital be a material income producing factor, but the total capital of the fund can be considered so this test can be met. The §704(e) regulations also have a number of other subjective factors to determine if the donor has ceased dominion and control over the transferred interest. However, transfers are often made to grantor trusts, and in that situation assignment of income is not important — the grantor is paying all income taxes in any event.

31. Severances Under GST Final Regulations

Lloyd Leva Plaine addressed GST severance issues.

a. Significance of Severances. Prior to the adoption of the qualified severance rules under §2642(g) in EGTRAA in 2001, "downstream splits" were not possible. With limited exceptions, even though a single trust was later split into separate trusts under the trust instrument or state law, the resulting trusts were collectively treated as one trust for GST purposes (meaning, among other things, that they all had the same inclusion ratio as the prior single trust). As a general rule, trusts resulting from qualified severances (and in some other situations) are now treated separately for GST purposes. This has various advantages, including (i) GST exemption can be allocated to the trusts separately (or all to one and none to another), (ii) a trust that is partially GST exempt can be split into separate exempt and non-exempt trusts, (iii) additions to and distributions from the separate trusts are treated separately and not treated as pro rata additions and distributions to or from all of the trusts, (iv) a "reverse QTIP" election can be made for one but not all of the trusts, and (v) taxable terminations and distributions will be treated separately from the trusts (which may have the effect of accelerating a GST tax because the GST transfer cannot be deferred until there has been a taxable termination of all of the resulting trusts.)

As should be clear from this discussion, the ability to sever trusts for GST purposes is vitally important. Unfortunately, §2642 is one of the many provisions in EGGTRA that will sunset in 2011 unless it is extended. Thus far, the many estate and gift tax bills that have been proposed do not address the sunsetting of this provision. Hopefully that will be corrected before 2011.

b. Final Regulations, July 31, 2008. Final regulations to the qualified severance provisions of §2642 were issued on August 2, 2007 and on July 31, 2008. The regulations to §2654, which recognizes "non-qualified" severances in several situations, were revised on July 31, 2008.

c. Qualified Severance Regulations Under §2642 No Longer Supplant the §2654 Regulations. Various commentators criticized the position in the §2642 prior regulations that they supplanted the §2654 regulations. The final regulations continue the position in the proposed regulations to change that result, and they recognize and make some liberalizing revisions to the §2654 regulations.

d. Qualified Severance May Result in More Than Two Trusts. Final regulations make clear that a qualified severance may result in more than two trusts as long as the resulting trusts are either fully exempt or non-exempt. That is broader than the statute and provides helpful flexibility.

e. Funding of Severed Trusts. Trusts created by a qualified severance under §2642 must be divided into two or more separate trusts that are fully exempt or non-exempt. The funding can be pro rata or non pro rata. For a non pro rata funding, the assets must be valued on the severance date (the severance dated selected by the trustee or the date specified in a court order) and the separate trusts must be funded within a reasonable time (but not more than 90 days) after the selected severance date. The final regulations retain the highly criticized provision in the proposed regulations that assets must be valued without considering "any discount or premium arising from the severance." Despite the potential unfairness and potential fiduciary concerns, the IRS opted to retain a bright line rule.

Nonqualified severances under §2654 must be funded in accordance with the provisions in the prior regulations for §2654 divisions. (Those provisions do not include the restriction on applying discounts; they just specify that non-pro rata funding must be "based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding." Reg. §26.2654-1(b)(1)(ii)C)(1).)

f. <u>Nonqualified Severances Under §2654.</u> Severances under §2654 are now permitted for three categories of trusts. The provisions in the prior regulations are continued to allow severances to reflect (1) "substantially separate and independent shares" and (2) contributions from multiple transferors. A significant new third category has been added for mandatory severances.

The regulations previously required that a severance with respect to substantially separate and independent shares was permitted only if such shares exist from and at all times after the creation of the trust, and a trust is treated as created at the death of the grantor if the trust is included in its entirety in the grantor's gross estate. These types of trusts are sometimes referred to as "included trusts."

The final regulations add a new category for mandatory severances where the governing instrument requires a division of the trust upon the future occurrence of a particular event [which could be long after the trust was created or after the death of the grantor] not within the discretion of the trustee or any other person, and if the separate severed trusts are recognized as separate trusts under state law. For a nonqualified severance of a trust that is partially exempt, the resulting trusts will all have the same inclusion ratio as that of the divided trust. (The final regulations add an example making clear that a subsequent qualified severance could further divide one or more such trusts into fully exempt and non-exempt trusts. Reg. §26-2642-6(j), Ex. 13.) A new detailed example is added to clarify that trusts that are divided pursuant to the terms of the instrument are recognized as separate trusts for GST purposes. Reg. §26.2654-1(a) (5), Ex. 8.

If there is no necessity of changing the inclusion ratio, there is little difference in effect whether the severance is a qualified severance under §2642 or a nonqualified severance under §2654. Qualified severances under §2642 must meet seven general requirements listed in Regulation §26.2642-6(d), whereas severances under §2654 do not have as many requirements, and it may be easier in some circumstances to qualify under the §2654 regulations. The regulations provide that severances of trusts that are included in the transferor's gross estate under Regulation §26.2654-1(b) (i.e., "included trusts") are not qualified severances even if they meet all of the requirements for qualified severances. (Commentators observe that this is appropriate because severances of included trusts are effective as of the date of death whereas qualified severances are effective as of the date of the severance.) However, other severances that would be allowed under §2654 could also be qualified severances if they also meet all the requirements for qualified severances.

One difference between qualified and non-qualified severances, however, is that the safe harbor against gain recognition, discussed in the following paragraph, applies only for qualified severances under §2642 that are authorized by state statute (but not other state law) or the governing instrument and for nonqualified severances of trusts fully included in the grantor gross estate.

g. <u>Safe Harbor Against Gain Recognition for Certain Severances</u>. Final regulations issued effective August 2, 2007 add a safe harbor against gain recognition under <u>Cottage Savings</u> for certain severances that are authorized by the applicable state statute [not just applicable state law] or the governing instrument, as long as any non-pro rata funding is authorized by the applicable statue statute or the governing instrument. Reg. §1.1001-1(h)(1). The safe harbor applies only to qualified severances under §2642 and nonqualified severances under §2654 of trusts included in the gross estate of the grantor that also meet the requirements in the prior sentence. (Other types of nonqualified severances under §2654, including the new category of mandatory severances, do not fall within this safe harbor.) The preamble to the final regulations adds that "no inference should be drawn with respect to the income tax consequences under section 1001 of any severance not described in §1.1001-1(h)(1)."

h. Planning Strategy for ILITs; Six Month Delay Period If Child Predeceases. An ILIT that is distributed to the grantor's descendants at his or her death will likely not have GST exemption allocated to the trust, because it is likely that the trust will be distributed to the grantor's children. If a child of the grantor predeceases the grantor, however, leaving surviving children, a taxable termination will occur on the grantor's death. To avoid that result, consider providing in the ILIT that the termination date will be delayed for a specified period (say six months) after the grantor's death if a child predeceases the grantor with surviving children, during which time the descendants (including other surviving children) would be discretionary spray beneficiaries. This will allow time to allocate GST exemption to the trust during the six month period. The trust could then be divided in a qualified severance and the trust for the benefit of children of the deceased child would have an inclusion ratio of zero and the trust for children would have an inclusion ratio of one.

32. GST Exemption Late Allocations

Section 2642(g)(1), included as a part of EGTTRA in 2001, gives the IRS the discretion to grant extensions of time for filing GST exemption allocations that are effective as of the date of the original transfer in trust. Proposed Regulation 26.2642-7 generally provides new procedures for making late GST exemption allocations pursuant to Code §2642(g)(1). (It also provides extended timeframes for electing in or out of the automatic allocation rules.) The new system will replace Regulation §301.9100-3. Some of the highlights of the new system include the following.

a. General Requirements for Relief. Requests for relief under §2642(g)(1) will be granted when the taxpayer provides evidence (including affidavits of the transferor or executor and all advisors) to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. Prop. Reg. §26.2642-7(d)(1). The regulations list a number of nonexclusive factors that will be considered in determining if the good faith and "no prejudice" requirements are met.

b. Effect of Relief. If an extension of time is granted, the exemption allocation will be considered effective as of the date of the transfer and the value of the property for gift and estate tax purposes will determine the amount of GST exemption allocated. (There are also rules for the effect of granting relief to elect in or out of automatic allocation.) Prop. Reg. §26.2642-7(b).

c. Limitation on Relief. The amount of GST exemption that may be allocated under these late filing procedures is limited to the amount of the transferor's unused GST exemption at the date of the transfer. Any increased GST exemption prior to the date for making the late allocation may not be applied. Prop. Reg. §26.2642-7(c).

d. Situations In Which Standards Are Not Met. The regulation gives four situations that do not meet the good faith and no prejudice to the government's interests standards:

(i) The transferor or executor made an allocation of GST exemption on a timely filed return and the relief requested would decrease or revoke that allocation or election;

(ii) The transferor or executor delayed in requesting relief in order to preclude the IRS, as a practical matter, from challenging the identity of the transferor, the value of the transferred interest on the gift or estate tax return, or any other relevant aspect of the transaction;

(iii) The failure to act after being accurately informed; and

(iv) The IRS determines that the request is an attempt to benefit from hindsight; for example, an extension will not be granted if the effect is to shift GST exemption from one trust to another (unless the beneficiaries and their interests are the same), or if there is evidence that the transferor or executor waited to see which of various trusts would have the greatest asset appreciation before selecting the trust that should have a zero inclusion ratio.

e. Expiration of Statute of Limitations and Valuation Discounts. Very important exceptions are given in the section listing factors regarding when the government's interests are prejudiced:

> "The fact that any period of limitations on the assessment or collection of transfer taxes has expired prior to the filing of a request for relief under this section, however, will not by itself prohibit a grant of relief under this section. Similarly, the combination of the expiration of any such period of limitations with the fact that the asset or interest was valued for transfer tax purposes with the use of a valuation discount will not by itself prohibit a grant of relief under this section." Prop. Reg. §26.2642-7(d)(3)(ii).

On the other hand, there is no explicit statement that such factors could not be considered together with other factors to determine that the government's position would be prejudiced if the relief were granted. Some commentators make the point that the legislative history says that the decision is to be made without regard to statute of limitations, and that whether the statute of limitations on assessment of additional gift taxes with respect to the original transfer has expired and whether the interest was valued with a valuation discount should not be factors considered at all in the decision.

f. Request Does Not Extend Statute of Limitations. A request for authority to file late under these provisions does not reopen, suspend or extend the statute of limitations on any estate, gift or GST tax. The IRS may request that the taxpayer consent to an extension of the period of limitations, but the transferor or executor may refuse to extend the period of limitations or limit the extension to particular issues. Prop. Reg. §26.2642-7(f). There does not appear to be anything in the regulations that would prevent the IRS from refusing to grant an extension of time merely because the taxpayer refuses to extend the statute of limitations for gift, estate, or GST purposes on the original transfer.

g. No Refunds. No refunds will be paid, based on the effect of a late allocation under these provisions if the statute of limitations on refunds has expired. Prop. Reg. §26.2642-7(g).

h. Simplified Method Under Rev. Proc. 2004-46 Still Available. The preamble to the proposed regulation makes clear that the alternate simplified method to obtain an extension, as described in Revenue Procedure 2004-46, 2004-2 C.B. 142, is still available. That method is available for inter vivos transfers to a trust where all of the following conditions are met: (1) the transfer qualified for the annual exclusion; (2) The sum of the amount of the transfer and all other gifts by the transferor to the donee in the same year did not exceed the applicable annual exclusion amount for that year; (3) no GST exemption was allocated to the transfer; (4) the taxpayer has unused GST exemption to allocate to the transfer as of the filing of the request for relief; and (5) no taxable distributions or taxable terminations have occurred as of the filing of the request for relief.

i. Effective Date. The proposed regulations apply to requests for relief filed on or after the date that the regulations are finalized.

j. Intent to Reflect IRS Approach in Practice. Cathy Hughes, with the Treasury Department, has indicated that the standards in the proposed regulations may seem to be tougher standards than those required under the 9100 relief system. However, her understanding is that the provisions in the proposed regulations are very close to how the IRS has been addressing 9100 relief for GST exemption allocation extensions. The IRS does not view this as a shift. However, the new procedures seem more onerous in various respects with respect to the detailed mechanics in making the request.

33. GST Planning Issues

a. GST Planning to Use Increased $3.5 Million Exemption. The GST exemption is now $3.5 million (and it may possibly decrease under future legislation), but the gift exemption is just $1.0 million. How can clients take advantage of the full $3.5 million amount without paying gift tax?

(i) Allocate GST Exemption to Old Trusts. A late allocation can be made for gifts made before 2008, and values at the time of allocation would apply. That might be desirable in light of the market decline in 2008. If there is not enough GST exemption to cover the entire trust, do a qualified severance after making the allocation.

(ii) Late Allocations to Gifts in 2008. For gifts made in early 2008, a late allocation may be preferable to be able to allocate based on current values — after the market meltdown. However, a late allocation can only be made on a late return; that is not elective. The client would have to wait until after the filing date (including the extended date if the income tax return is extended to October 15) to make a late allocation. Will the market rebound by then so that the allocation based on the current low values would not be available at that time?

(iii) Inter Vivos QTIP With Reverse QTIP Election. One spouse might make a gift to an inter vivos QTIP for the other spouse, make the reverse QTIP election (so that the donor is treated as the sole transferor to the trust for GST purposes), and allocate GST exemption to the trust. That could be done without paying any current gift taxes.

Is gift splitting possible with a reverse QTIP trust? The answer is unclear. For gifts to trusts that give a mandatory income interest to a spouse, other than to QTIP trusts, it appears that gift splitting is possible. If a gift is made to a trust, gift splitting is possible with respect to the interest transferred to a third party if the interest of the spouse in the trust is ascertainable and hence severable from the interest that is transferred to a third party. However, for GST purposes, the gift splitting seems to apply to the entire trust (not just the interest transferred to a third party if the spouse is also a beneficiary of the trust.) Reg. 26.2652-1(a)(4).

Pam Schneider secured PLR 200218001 to that effect (though some in the IRS disagreed with that approach). It is unclear if making the QTIP election or the reverse QTIP election changes that analysis in any way.

(iv) (iv) GRAT. Contribute assets to a GRAT and allocate GST exemption to the assets at the end of the GRAT term. This permits use of the GST exemption without making a taxable gift.

b. GST Planning; No §2036 Concept. The IRS's primary success in attacking FLP discounts is under §2036. There is no §2036 concept for GST purposes.

(i) Allocating GST Exemption to Trusts With Discounted Assets. If a late GST exemption allocation is made to a trust with discounted assets, there is no concept of arguing that the allocation is ineffective based on §2036 concepts. For example, under Reg. §26.2624-4, if a donor makes a completed gift to a spouse, allocates GST exemption, and the asset for some reason is included in the donor's gross estate, the inclusion does not change.

(ii) Convert to Discounted Assets To Reduce GST Tax At Time of Taxable Termination or Taxable Distribution. If assets in a non-exempt trust are contributed to an FLP, the value may be lower at the time of a taxable termination or taxable distribution. There is no concept of determining if the donor has retained too much control for purposes of applying some type of §2036 problem for GST purposes.

c. GST Tax May Be Preferable to Estate Tax. Trusts are often structured to cause the assets to be subject to estate tax at the death of the first generation rather than the GST tax. That goes back to the days of having different rate brackets for estate tax purposes, when the estate tax rate might be lower than the GST tax which is based on the highest rate bracket. However, there are times when GST taxation would be preferable to estate taxation. Some reasons include: (1) No §2036 analogous issues; (2) No state GST taxes; (3) It is possible to get deferral of the GST tax (as would be available with the marital deduction for estate tax purposes) if the spouse is a beneficiary of the trust — without the requirement of having the spouse as a mandatory income beneficiary, and (4) Basis step up availability.

d. GST Planning: Pecuniary Formula Structure to Limit Downside Risk to GST Exempt Bequest. In a down economy, planners are concerned with market declines depleting pecuniary GST exemption bequests. For a strategy to limit the losses that fall on GST exempt bequests, see Item 9.a of this summary.

34. Tax Court Procedures and "Laro on Valuation"

a. Tax Court Procedures. A panel discussion with Judge Chiechi at the ABA Real Property Trust and Estate Law 2008 Spring Symposium, and with Judge Laro at the ABA Joint Tax and RPTE Section 2008 Fall Meeting and at the 2009 Heckerling Institute highlighted some interesting procedures about the operation of the Tax Court.

The trial judge reviews the court record after trial and prepares a draft opinion. The draft is sent to the office of the Chief Judge of the Tax Court, where it is reviewed for consistency and to another office where it is reviewed for grammar and citations. (These are quality control mechanical procedures.) The Chief Judge decides whether the opinion will be released as a "regular" T.C. opinion or as a memorandum opinion. When the opinion is ready to be released to other judges for review, it is released to the other judges on the Tax Court computer system (and sometimes in paper form as well) about 8:30-9:00 am. If no judge raises an objection, the opinion is released at 3:00 pm THAT afternoon. (Amazingly, the judges have a window of only several hours to see that an opinion is being circulated, to read it, and to raise an objection.)

All 19 of the Tax Court judges and clerks have an opportunity to review the opinion. (Most of the judges have two clerks.) The judges review the opinion with their clerks; sometimes there are informal discussions with other judges in the dining room over lunch. If any judge has concerns, he or she notifies the authoring judge. A judge with concerns and the authoring judge may come to agreement, or the authoring judge may make changes. If there is a substantive change, the change is disclosed to the Chief Judge. If there is no agreement, the judge who wrote the opinion may advise the reporter not to release the opinion at 3:00 pm. If that authoring judge does not do so, any of the judges can ask the Chief Judge to postpone the release, which the Chief Judge can do at his or her discretion. The general practice is that the Chief Judge will postpone release if at least two judges ask for postponing release.

Only the Chief Judge decides what opinions go the entire court for a court reviewed opinion. There is a court conference procedure for reviewed cases. All of the judges meet in a conference room with no clerks or secretaries present (but the Clerk of the Tax Court is also at the conference.) The case is discussed and a vote is taken. If the authoring judge cannot persuade his or her colleagues, the Chief Judge will ask authoring judge whether that judge will change his or her position, or allow the case to be reassigned to another judge who will rewrite the opinion consistent with the majority. Other judges can write concurring or dissenting opinions.

b. "Laro on Valuation." Some of Judge Laro's comments include the following:

(i) Business Purpose. He continues to believe that there must be "business purpose" in order for an FLP to be respected under §2036. However, in response to an informal question after a panel discussion, he said that does not mean that an FLP must have an operating business in order to be respected under §2036.

(ii) Typos and Math Errors. Typos and math errors in an appraisal may significantly impact the reliability and credibility of the appraisal if the error involves the omission of critical facts, or reliance on information that itself is not reliable.

(iii) Reasoning in Appraisals. In reviewing opinions, he looks for how the appraiser "gets from a to b." For example, how does a particular capitalization rate take you to a particular discount amount? How do restricted stock studies get you to the conclusion in the opinion? It is not enough for the appraisal to just say that it is relying on restricted stock studies. Only after carefully reviewing the appraisal and its logic does he look at the bottom line result.

(iv) Practical Reasons That Judges Often Do Not Follow Buffalo Tool and Die Approach of Selecting Valuation Approach of Side That is Most Correct. The approach suggested in Buffalo Tool and Die to look generally at one appraisal or the other, rather than "splitting the baby" generally is not workable. Appraisal reports being issued now typically are complex and rely on many assumptions. What if the judge says agrees with 90% of the report, but cannot agree with the other 10%? The judge often cannot accept any appraisal in its totality. Therefore, the judges are falling back on their own resourcefulness in determining value based on what's in the record. Judge Laro acknowledges that is precarious because judges are not valuation experts, but that is why he believes Buffalo Tool and Die is not practical today.

(v) Effect of Subsequent Events. Many circuits do consider subsequent events. The issue arises as to whether subsequent actual sales should impact the amount of the marketability discount. Judge Laro's position is that he is trying to determine the true value as of the valuation date, the best he can. If he thinks that particular subsequent events are relevant to that determination, he will look at them. However, a purchase by a strategic buyer does not fit the willing buyer-willing seller test, so he would not look at that subsequent event.

(vi) Defined Value Clauses. Judge Laro indicated pretty strongly that he finds the IRS's public policy argument against defined value clauses to be persuasive. These clauses can be used in a way to frustrate the collection efforts of the IRS, and they should be void for public policy. (He dissented in McCord on that basis.) The Fifth Circuit in McCord did not consider the public policy argument, and he thinks that issue is still "on the table." Furthermore, Judge Laro says this goes to the integrity of the tax system. If the planner can do something that frustrates the collection efforts of the IRS, should the planner do so even if it is intellectually permissible?

(vii) Tax Affecting for S Corporations. Tax affecting for S corporations is still an open issue. He has not decided for himself what he thinks about tax effecting.

(viii) No Direct Testimony of Expert Witness. The expert appraisal constitutes his or her direct testimony. (The opposing side may cross examine the expert.)

Appraisers must be careful to include their full analysis in the appraisal report.

(ix) Internal IRS Appraisals. Jude Laro views appraisal prepared by "in-house" IRS engineers and experts as potentially biased. He views that is the same as if IBM had a case involving valuation and brought one of its own employees as the valuation expert.

(x) Marketability Discounts. The lack of marketability discount is in need of resolution. Judge Laro recently hosted a panel of appraisers and asked them to show how they would calculate a marketability discount in a particular fact scenario. There were at least five different ways to do it, with different results. Restricted stock studies are sometimes old and have problems. In LBO studies, there are compensation issues. Judge Laro will host a similar symposium in September 2009. He says that the discrepancies raise questions as to whether any of these methods are acceptable or should be admissible.

35. Planning for the Next Generation

Jeff Pennell discussed how planning patterns need to change in light of changing attitudes on people in our society as compared to 50 years ago. A panel discussion with practitioners explored decisions that different attorneys are making in their practices.

a. Jeff's Thesis. We need to rethink "traditional" dispositive patterns. Current drafting is much the same as 35 years ago for the GI Generation, and that planning may not be appropriate for the Silent Generation or Baby Boomer generations.

For example, the non-marital trust that most attorneys draft is what Jeff's father's generation wanted for his mother's generations for surviving spouses. (He uses those genders because in those days, the husband was typically the bread winner and most assets were in his name.) Estate planning was drafted for H to provide for W. The general philosophy behind the approach was that husbands didn't trust surviving wives with control over wealth.

Maybe that was appropriate for Jeff's mother's generation. But he wonders if it is still appropriate. (Furthermore, many more surviving spouses in the future will be husbands.) Jeff thinks that perhaps attorneys are still drafting as a holdover of planning that was done for the GI Generation. Our assumptions of what is appropriate may need to be changed.

b. Generations. The GI Generation was born before 1927. The "Silent Generation" was born between 1927-1945 (during the depression and war years). (They are referred to as the "Silent Generation" because there is no identifying cause.) The Baby Boomers were born between 1946-1964. (Baby Boomers are really different from their parents.)

We now generally represent the Silent Generation. Are they more like Jeff's parents or more like Baby Boomers? According to census data, there are not many married couples still in the GI Generation. Most men have died. Surviving widows are now dying off. Only about 25% of the Baby Boomer generation has yet become an orphan — and traditionally children only receive assets from parents after the surviving spouse's death.

This year, the oldest Baby Boomers became old enough to retire and receive Social Security. Jeff thinks there will be a wave of estate planning over the next several years.

Perhaps our planning boxes haven't changed yet because our primary client base is the Silent Generation and they may be are more like the GI Generation than the Baby Boomers.

c. We Bring Our Own Preconceptions. Planners come to this endeavor with our own preconceptions. We are good at asking the question that will evoke the answer that we want. "You do want per stripes distribution don't you — that is standard for most people."

d. The New Biology. So far, there have been five cases, which are remarkably similar. (The latest case is *Khabaaz v. Commissioner of Social Security Services*, 930 A.2d 1180 out of New Hampshire.) This is the general scenario: H is diagnosed with cancer. If H survives, he will be left sterile. They were hoping to have a family, so H banks sperm. H dies, and within a year, the surviving widow decides that she wants to have a legacy of her predeceased husband. So she goes to sperm bank and "gets out the turkey baster." (In many of these cases, she ends up having twins.)

Are the DNA offspring of the deceased H, that were conceived and born post mortem, treated as descendants of H for the purpose of receiving social security survivor benefits? The federal court remands the case to the state level, because the issue turns on state law — are the DNA offspring considered heirs of the decedent, even though they were conceived and born posthumously. In three of four cases with this scenario, the state court said yes. (That is not remarkable — the entitlement is coming from the federal government so why would a state court stand in the way?) Bigger factor: The decedent made a conscious decision to bank his sperm and DNA. (The recent *Khabaaz* case did not follow that approach.)

The much harder case is *In Re Martin B*. Grandfather created a trust for C, with remainder to C's descendants. The surviving widow produces more "little Jeffries." The issue is whether H's wife can make more beneficiaries of H's father's trust. Jeff puts this on a personal note: Would Jeff's father want Jeff's surviving spouse to have the ability to make more beneficiaries of dad's plan after Jeff is dead?

One study shows that less than 7% of estate plans that were reviewed addressed this issue. Jeff does not know what the answer is. This is not something that is susceptible of a Uniform Law.

Estate planning attorneys should explore this issue with clients. To put it bluntly — "Are the client's children going to leave stuff in the freezer and how do we know that as planners?" Estate planning attorneys should ask clients: 1) If your son died leaving sperm in the bank and your daughter-in-law wants to produce more offspring, would you want them to be included? Jeff thinks the majority of clients would say yes. 2) If your daughter was to die having left eggs and your son-in law wanted to find a surrogate mother to incubate the baby, would you want your son-in law be able to produce more descendants of your daughter? Jeff thinks the favorable response would be lower.

e. <u>Drafting the Non Marital Trust</u>. Jeff thinks this is more controversial. We tend to draft the non-marital trust to provide for the surviving spouse and descendants, in the discretion of a third party as trustee (the spouse may be a co-trustee, but to avoid tax issues, distribution decisions are typically made by an independent trustee).

For a $3.5 million estate, the entire estate will be held in a trust like this under a traditional formula bypass trust format. How many surviving spouses would find this palatable? Jeff thinks most surviving spouses are far less passive about their entitlement to "our wealth" than was Jeff's mother. Jeff strongly believes that we will need to address the terms of non-marital trusts to make them more palatable to spouses.

Possible alternatives: 1) Make the spouse a co-trustee. But will Baby Boomer spouses be satisfied with that or will they push back? If so, what planning is appropriate? 2) Do not change the non-marital trust, but make it more difficult for the surviving spouse to elect the elective share. 3) We may see more "outright to spouse" plans. 4) Many spouses are happy to have a trust and to be sole trustees with an ascertainable standard, and perhaps also a "5 or 5" withdrawal power. Jeff agrees with using a "5 or 5" withdrawal power for the non-marital trust because it can result in a bigger previously taxed property credit. 5) The spouse may be the sole trustee with a broad special power of appointment, so if a child complains about how the parent is spending the money, the parent can eliminate the child from the plan which takes away standing of the child in a lawsuit.

From a tax perspective, Jeff likes the non-marital trust to be QTIPable so he would prefer providing a mandatory income interest to the surviving spouse from the non-marital trust. This increases planning flexibility. The trustee can invest in assets that produce little or no income to avoid having to make unwanted mandatory income distributions. Furthermore it is possible to satisfy the mandatory income requirement by just giving the spouse the power to withdraw the income or unitrust amount rather than actually mandating income distributions. Another advantage of having a mandatory income interest in the non-marital trust is to maximize the possible "previously taxed property" credit.

f. <u>Outright Bequest to Spouse; Marital Trust</u>. Will there be a greater inclination to prefer outright gifts to spouses rather than using a QTIP trust? Part of the reason for using QTIP trusts has been control. The general thinking of some is a concern that the wife will get remarried and the gold-digger will get her assets. That is why QTIP trusts are used a lot. Jeff says that when Husband says he is concerned about Wife remarrying and leaving out the kids, he's really saying he might do that. There was a show of hands — in the audience's experience, it is much more common for a widower who remarries to leave assets away from the children of the first marriage than for surviving widows. Jeff's reaction: "That's what husbands do." Keith Bilter interestingly observes that if portability of estate tax exemptions is passed, that will really test "Do you trust your spouse."

A tax efficient plan is to allow flexible distributions from the Marital Trust to permit the surviving spouse to make lifetime gifts to the descendants. How many plans allow that? The issue turns on whether the client trusts the spouse to withdraw from the Marital Trust and turn around and make gifts to whomever he or she wants. Some attorneys do this by giving the spouse a "5 or 5" annual withdrawal power. Another approach previously suggested by Mack Trapp is to split the marital bequest into two shares — a general power of appointment trust share and a QTIP share. The spouse could have broad authority to withdraw funds or appoint assets to others from the general power of appointment trust.

How would clients respond if the attorney asks: "Would you personally trust your spouse with this provision?" Most would probably say yes. But most attorneys do not draft Marital Trusts to give surviving spouses this authority.

Attorneys will typically ask this question in estate planning conferences when both spouses are sitting there. Would there be a different answer if the spouses were asked separately? (Then the attorney would be left with the conundrum of whether to share all relevant secrets. Jeff thinks that a "share all secrets" approach was ok in his father's generation, but he thinks it is corrosive in the Baby Boomer generation and perhaps in the Silent Generation as well.)

The trustee cannot condition the distribution on the spouse making a gift. (That might endanger the marital deduction.) That means the client must really trust the spouse by permitting large distributions to the spouse from the Marital Trust and trusting the spouse to make gifts.

g. <u>Terminating Distributions At Relatively Young Ages</u>. Estate plans typically distribute a share of the estate when a child reaches a specified age of maturity. Many form books say 30 or 35. But most all of us become orphans at 50-65. Jeff thinks the 30-35 ages are kind of goofy, but about 80% of plans are drafted that way. The alternative is to give the beneficiary a power of withdrawal at that age. If the beneficiary is busy with a career or wants investment assistance, why not allow the beneficiary to just leave the assets in the trust? Why do we force the money out rather than using a power of withdrawal?

Giving a right of withdrawal to a child gives up the asset protection that trusts could provide for children. However, for some children (for example children who are professionals and who are concerned about potential liability), it is more appropriate for the planning to take into consideration asset protection issues.

h. <u>Drafting for Spouses of Children</u>. How many attorneys commonly draft trusts for the settlor's son for life, and then for the son's surviving wife for life? Only a dozen hands went up. He finds it bizarre that the case law so far gives the surviving wife a blank check to make more beneficiaries of the parent's estate plan, but the draftsman thinks the parents were not willing to make son's spouse a beneficiary of the estate plan.

Would the thinking be different about providing for a deceased daughter's surviving husband?

A child's spouse may be used to living on the income from the trust when the settlor's child is alive. Yet when child dies, the surviving spouse is cut off, and her (or his) lifestyle would change dramatically. Why do we disinherit the surviving spouse of the child — often the surviving parent of the client's grandchild??

We typically don't want a surviving spouse taking the family assets to a new spouse, but the trust could provide support until death or remarriage or until "shacking up."

Most plans (Jeff said about 80%) provide for outright distributions to children at certain ages. If that is the case, it is not as important to consider spouses of children. Jeff thinks it may be better to use a power of appointment approach and include the child's spouse as a potential appointee (in case the child dies before receiving the distributions). Another possibility is to give a power of appointment to the child to appoint to the child's spouse, but the appointment must be in trust with a corporate trustee. Keith Bilter says that he typically gives children a power of appointment which includes the child's descendants and spouse and spouses of descendants, but usually restricted to allowing only a trust "life estate" for spouses. He sends documents to clients with that provision and tells the client he will change it if the client wishes (but most don't).

i. <u>Equal Distributions to Children At Death</u>. Most clients want assets to pass in equal shares to their children AT DEATH. That's a funny notion. We hardly ever deviate unless there is a black sheep child or a disabled child. But during lifetime, well over 70% of lifetime transfers are not equal. Jeff's dad told him that he'd always treated all three children equally. (Jeff told him, "Dad, you're a communist.") Jeff realized that what his dad meant by that was that he gave to each child what that child needed, but did not necessarily make equal transfers to others. Why do clients default to equal distributions when they die?

Would it be preferable in many cases to use "group trusts" and give the trustee the discretion to make unequal distributions to accommodate varying needs of the beneficiaries, presumably like the parent would have done if alive? Nancy Fax often uses a group trust until the youngest child is 21 or 25, and then divides the trust into separate shares (after all of the children are educated). Keith Bilter said he has been involved in a case with a group trust where one beneficiary had drug problems and the trustee paid $30,000 for legal fees and drug rehabilitation. He has some concern with charging that type of expense to the group without treating it as an advance to the beneficiary with the recurring drug problem. One flexible approach would be to give the trustee the discretion to treat distributions as advancements in that type of situation where the trustee thought there was an unjust result.

j. <u>Other Issues Related to Demographic Changes</u>.

(i) <u>Skipping Child Generation</u>. There is an interesting dichotomy in the consideration of the age at which people are orphaned and the proper age for distribution. If distributions are delayed until the children are orphaned, should you just skip the child's generation? We've discussed this from a tax perspective but not from a demographic perspective.

(ii) Single Parent Households. There has been an extraordinary increase in single parent households. How does that impact planning decisions?

(iii) Supporting Adult Children and Parents. Many clients in the Baby Boomer generation provide at least some support for adult children as well as for their parents. How should that impact planning decisions?

(iv) Divorce. The Silent Generation "stayed for the benefit of the kids and divorced when they became empty nesters." If a spouse remarried, there was a likelihood that the new spouse was much younger. There are now many blended families, many including children who have grown up together. Blended families alter the classic dynamic in dealing with children by prior marriages and addressing children born to the new marriage. We could draft plans that do what the spouses did when alive: Treat all of "our" kids as if they were common to this marriage. (There is still the tension of what is appropriate if one spouse has much more assets than the other.)

(v) Grandparents Raising Grandchildren. There is an increase in grandparents who are raising their grandchildren. How will that change day to day planning?

36. Roth IRAs

Marcia Chadwick Holt discussed planning implications for Roth IRAs. These are important for all clients because (1) the income limits on Roth IRA conversions are lifted beginning in 2010, and (2) many employers have allow "Roth Accounts" for 401(k) plans, which can be a terrific strategy for leaving a tax-free growth legacy to children.

a. Overview of Requirements and Advantages. Contributions to Roth IRAs are permitted only to the extent of compensation income, up to only $5,000 indexed for inflation, with an additional $1,000 if age 50 or older — which amounts can be contributed either to traditional or Roth IRAs. There are no age limits (contributions to a traditional IRAs are not permitted after 70 ½.). Contributions to a traditional IRA are currently deductible but withdrawals are ordinary income. Contributions to a Roth IRA are not currently deductible, but withdrawals are tax-free if the Roth IRA is held at least five years (beginning on January 1 of the year in which the person's first Roth IRA was acquired) and if amounts are withdrawn for certain reasons (i.e., after reaching age 59 ½., death, disability, or first time home purchase up to $10,000). Withdrawals that are not taxable income do not affect the taxability of the owner's social security payments. If withdrawals are not "Qualified Distributions" meeting the requirements for tax-free withdrawals, the withdrawals are subject to income AND there is an additional 10% additional income tax.

The lifetime minimum distribution rules do not apply to Roth IRAs. (After the owner's death, the minimum distribution rules do apply to beneficiaries of the Roth IRA, except that a spouse who elects to treat the deceased spouse's Roth IRA as his or her own Roth IRA will not have required minimum distributions. Reg. §1.408A-6, Q&A-14(b).)

Contributory Roth IRAs are not overly important because of the very small annual contribution limits.

b. Conversion From Traditional IRA to Roth IRA. There is a $100,000 income limit on being to convert from a traditional IRA to a Roth IRA in 2009, but the income limit is lifted after 2009 (and there is no age limit on conversions). If amounts in a company retirement plan were converted to an IRA when leaving employment with that employer, a traditional IRA may have a large value that could be converted to a Roth IRA, for many clients beginning next year. Income tax has to be paid on the amount of the conversion, but for conversions in 2010, the taxes can be paid over two years (2011 and 2012). The elimination of the income limit on conversions offers an end around the income limit on contributions to a Roth IRA; a person who earns more than the income limit could contribute to a traditional IRA and convert to a Roth IRA. The conversion should be made to a separate Roth IRA instead of adding it to an existing Roth IRA (if any) if the person is under age 59 ½ (because of complications with the special penalty rules for withdrawals before the five-year period is met).

Does it make sense to convert? It can make sense for someone who wants to accumulate funds and has outside resources to pay the income tax on conversion from assets other than the IRA assets. Therefore, it could work well for young people, who have a lot of time for tax-free appreciation to develop. It can also work well for deathbed planning if someone does not have enough assets outside the IRA to fully fund the bypass trust; converting allows funding the bypass trust with an asset that is not subject to a large inherent eventual income tax.

Marcia concludes: "A Roth IRA is an excellent vehicle for passing on wealth to the next generation free of income tax. If the widow's goal is to leave the largest amount to her children after income tax, the Roth IRA beats the Traditional IRA. The Roth IRA with income tax paid from outside funds beats the Roth IRA with income tax paid from the IRA."

Observe, this may be an even more appealing strategy in 2010 if the market has not recovered by that time, and the conversion can be made at a time when account values are at historically low levels.

Undoing the Roth Conversion. If the asset values go down after conversion, the owner can "recharacterize" back to a traditional IRA as if the conversion never happened (and income tax is not payable) if the recharacterization occurs before the income tax return due date (plus extensions), and there is a special rule permitting recharacterizations in some cases even after the return has been filed. Furthermore, the person can convert back to a Roth IRA at the lower values, as long as the reconversion does not occur until the next taxable year (but the person must wait at least 30 days).

c. Roth Account in 401(k) Plan. A 401(k) or 403(b) plan can be amended to permit nondeductible contributions to a "Roth Account" in the 401(k) plan. About 25% of companies with 401(k) plans offer Roth Accounts. There is no age limit or income limits. The contribution limit is $16,500 plus $5,500 if age 50 or older (unlike "regular" Roth IRAs that are subject to a $5,000 limit plus $1,000 if age 50 or older). Amounts already in a 401(k) plan cannot be converted into a Roth Account; there is merely an election available for new contributions to a 401(k) plan to be made into a Roth Account.

Roth Accounts in 401(k) plans are subject to the required minimum distribution rules (unlike Roth IRAs). But like Roth IRAs, withdrawals are tax-free if they meet certain requirements (similar, but not identical, to the tax-free qualification requirements for withdrawals from Roth IRAs, discussed above; the five year rule applies begins on the first day of the tax year in which the person must makes a contribution to the Roth Account, determined separately for each separate 401(k) plan in which the person has Roth Accounts).

Is It Worth Making Nondeductible Contributions? Many of our clients will face the decision of whether to make their annual 401(k) contributions as nondeductible contributions to a Roth Account. This will appeal most to persons who have sufficient funds to pay the income taxes on the nondeductible contribution, and to younger persons who have many years for tax-free growth before retirement. Withdrawals are not taxable income and therefore do not impact the taxability of social security payments. Persons who will be in a lower bracket after retirement or who will need substantial withdrawals for living expenses that are not qualified tax-free distributions will gain no benefit from paying the income taxes early by making nondeductible contributions.

Perhaps most important, it is a good strategy for someone who wants to leave a tax-free legacy to children. The assets can grow tax free for the entire lifetime of the owner and the owner's spouse (if the Roth Account is converted to a Roth IRA before reaching age 70 ½, as discussed below), and when it passes to children, the tax-free growth can continue in large respect, because the children withdraw the funds over their life expectancy. For example, if a person age 55 makes $22,000 contributions each year for 10 years before retirement at age 65, the assets would grow to $289,977 (assuming annual appreciation of 6%). If the person or his or her spouse lives to age 90, the assets (with no further contributions after retirement) would grow to **$1,244,544**. (If this process begins when someone is 50, making the $22,000 per year contributions until age 65, the assets would grow tax-free to **$2,197,742** by age 90.) This amount could be left to children, which could continue to grow tax-free, subject the minimum distributions over the child's life expectancy. (Of course, estate taxes and GST taxes must be considered.)

d. Rollover of a Roth Account to a Roth IRA; "The Really Great Strategy". The optimal strategy is to withdraw amounts in the Roth Account before the participant reaches age 70 ½ (when required minimum distributions would have to begin from the 401(k) plan, including the Roth Account) and rollover or convert those amounts to a Roth IRA. After age 59 ½, amounts may be withdrawn from the Roth Account without a penalty and can be rolled over to a Roth IRA within 60 days of receipt. (Alternatively, the participant could arrange for a direct rollover or trustee-to-trustee transfer from the Roth Account to the Roth IRA.)

There are special rules that apply for the five-year qualification period to qualify for tax-free withdrawals after rollover to the Roth IRA. If the Roth Account had not been established for at least five years before the withdrawal, and if the amount is rolled over to a Roth IRA that has already been existence for five years, withdrawals will be tax-free. However, if the rollover from the Roth Account (before the five-year period has been met) are made to a new Roth IRA, there will be a new five-year period for the new Roth IRA. (If there are withdrawals from earnings [i.e., exceeding the nondeductible contributions] of the Roth IRA before the end of its five-year qualification period, they will be taxable.) If the Roth Account had been in existence for five years but are rolled over to a new Roth IRA, there is a new five-year qualification period to tax-free withdrawals from the new IRA, but any withdrawals during that five year period are taxable only to the extent that the distributions exceeded the amount rolled into the new IRA at the date of the rollover.

e. Conclusion; Terrific Strategy For Tax-Free Growth Legacy to Children. Marcia concludes: "A rollover of a Roth Account to a Roth IRA can be very very valuable. You don't have to take required minimum distributions from the Roth IRA and if your goal is to pass that Roth IRA to younger generations — and this is what really appeals to me — that Roth

IRA can grow untouched. You can have it as a safety net. If you really need it during your retirement, use it. But if you can let that grow untouched, and pass it on to your children, and they have tax-free growth and tax-free distributions, that is a wonderful gift."

37. Special Needs Planning

Sebastian Grassi had a terrific discussion of concepts that every estate planner should understand about special needs beneficiaries. As opposed to describing the myriad technical details for SSI and Medicaid qualification, for which most planners rely on experts who specialize in this area, he focused on concepts that all planners should understand. The materials include a number of helpful forms.

a. Common; Non-Discriminatory. According to the 2000 Census, about two in every seven families have at least one family member with a disability. Sebastian has a daughter who is a quadriplegic. Every planner's questionnaire should ask if the client has any special needs children or grandchildren. In the past, there has been a stigma associated with having a special needs family member; that is no longer true. Wealthy families have special needs family members the same as poor families.

b. Important Government Programs. (1) Supplemental Security Income (SSI), (2) Medicaid, (3) Social Security, and (4) Medicare.

c. SSI.

Means Tested for Indigents. SSI is a means tested benefit for indigents. For example, in 2009, the SSI amount for a single person is $674 per month, with a **resource limit of $2,000** of non-exempt assets owned by the special needs child. While that low of a resource limit seems unreachable, remember that an 18 year old child is an emancipated adult. For example, Sebastian's daughter qualifies for SSI even though Sebastian is still able to treat her as a dependent for federal income tax purposes.

Significance. SSI provides only a modest monthly stipend, but it is extremely important because receiving even $1 of SSI benefits automatically qualifies the SSI recipient for Medicaid benefits in most states (but not Connecticut, Hawaii, Illinois, Indiana, Minnesota, Missouri, New Hampshire, North Dakota, Ohio, Oklahoma and Virginia), and Medicaid is the portal to health care benefits that provide a multitude of ancillary services. "That is where the money is."

Monitor Continued Qualification. The planner must be careful that the special needs child does not receive resources from inheritances, gifts, (such as graduation gifts) etc. that would disqualify him or her from SSI — that would cut off the very valuable Medicaid benefits. **This is why planners must understand that leaving a trust for a special needs child that has a standard "health, education, support and maintenance" distribution standard could cut off the special needs person from enormously helpful government programs.**

d. Medicaid. It has been said that "Medicaid is the best health 'insurance' that money can not buy." Medicaid pays for medical necessities (not private schools, etc.). Each state has its own Medicaid eligibility and benefits guidelines.

e. Social Security. Social Security provides benefits for people (*or their parents*) who have worked and paid into the system. It is not an indigent based program. When the parent reaches age 65, he or she is entitled to social security benefits, AND the special needs child (who would then be an adult) of that parent will automatically be eligible to receive social security benefits that are larger than the SSI benefits. The receipt of the social security benefits will not disqualify the child for Medicaid benefits under the rules of many states.

f. Medicare. Medicare eligibility follows social security (beginning at age 65).

g. Special Estate Planning Challenges for Families With Special Needs Child. Challenges include: (1) How to provide for all of the family without impacting the special needs child. (2) How to design the plan to supplement government benefits to enhance quality of special need child life. (3) How to provide for other children equitably. (4) How to assure there are sufficient funds available at the parent's death to care for the special needs child. "It is amazing how expensive this can become once the parent is deceased, even though Medicaid does pick up a lot of the tab." For example, Medicaid just pays for medical necessities, not things such as private schools that are very helpful for special needs adults. (5) How to select the right trustee who will care for the child.

h. Consider as Boilerplate for All Families. A family never knows when a family member will become a special needs person (from an accident, etc.) Planners should consider including some "special needs planning" provisions as boilerplate for most plans.

The trust could say that if it is determined at the time of a distribution that the beneficiary is disabled, the trustee has the authority to reform the trust or to have the distribution paid to a third party special needs trust that would not require repayment to the government (or at least have it become a first party SNT that while repaid to the government, would not disqualify the child from qualifying for SSI and Medicaid.) Exhibit 4 in the materials has form language for such provisions.

i. Five Essential Documents for the Special Needs Family. (1) Will, (2) Durable power of attorney, (3) Durable medical power of attorney, (4) Revocable living trust (during the parent's incapacity, the trustee should be able to make discretionary distributions to the special needs child that would not disqualify her from government benefits, (5) Third party created and funded Special Needs Trust ("SNT") (this is a totally discretionary trust that will not be counted as a resource of the child that would disqualify him or her from SSI and Medicaid.)

j. Estate Planning Options. Options include the following.

(1) Outright bequest (that would disqualify the recipient from benefits).

(2) Disinherit the child (that was a typical approach in the past).

(3) Leave assets to a sibling to take care of the special needs child (but the sibling may move, may be divorced, may lose assets to creditors, etc.).

(4) Leave assets in trust with a typical health education support and maintenance (HEMS) standard-**DO NOT DO THAT, it will "100% guaranteed" disqualify the child for SSI and Medicaid.**

(5) Third party special needs trust with totally discretionary standards that will not disqualify the child from SSI and Medicaid.

k. Third Party Discretionary Special Needs Trust. The Special Needs Trust ("SNT") is a discretionary non-support trust with spendthrift provisions. It is both flexible and protective.

Experts recommend establishing an inter-vivos stand alone third-party created and funded SNT because of its benefits and flexibility. (One of the advantages of an inter vivos SNT is that other relatives could also use that same trust for their plans, without having to create their own SNT provisions.). It can also be a testamentary trust.

Some states have their own statutes or rules. A recent Kansas case addressed a trust that did not include special statutory language to say that the trust can only "supplement and not supplant" government benefits.

The special needs child can be any age when the trust is funded. (A first party SNT (discussed below) sometimes must be created when the person is under age 65.)

Include a letter of intent, discussing details of caring for the child.

Discuss tax apportionment provisions, making clear who pays estate taxes attributable to asses in the SNT.

l. No Medicaid Payback Provision For Third Party Trusts. **"If you establish a third party created and funded SNT, never never EVER EVER put in a Medicaid payback provision… You will be calling your carrier… because you will have caused the government to get something to which is not entitled. That's the beauty of the third party created and funded special needs trust — that you don't have to pay back the government for Medicaid benefits for the special needs child. That's why this trust is so effective."**

First Party SNT Must Have Payback Provision. In a "first party SNT" created from the special needs child's own money (such as a damages award from a lawsuit), there must be a payback provision (discussed below).

m. Selecting the Right Trustee. This is a KEY decision. The key is relationship. Who will visit the child and do what is necessary to provide for the needs of the child? Consider integrity and lack of a conflict of interest. It is tempting to just name a sibling, but there may be a conflict of interest and there may be adverse tax consequences.

Not Special Needs Child or Spouse. Neither the special needs child nor his or her spouse should be trustee of a third party SNT or a first party SNT created by the special needs child.

Flexibility to Change. The trust should include provisions to change the trustee or add a co-trustee who can visit the child and provide special attention that is needed.

n. Coordinate With Other Relatives' Estate Plans. Make sure that other relatives do not leave bequests directly to your client's special needs child that would disqualify him or her from benefits. An advantage of creating an inter vivos SNT is that other relatives could leave bequests for the child into that trust.

o. Financial Planning; Life Insurance. This is a very important part of the overall planning process for special needs families. Life insurance is very important to replace the lost income of the parent or caregiver. Unless the disabled child has a short life expectancy, this is a case where permanent insurance (not term insurance) is needed.

p. Child's Own Assets. If the disabled child receives assets, those assets will probably disqualify the child from SSI and Medicaid unless the assets are converted to exempt assets by contributing them to one of two types of trusts: a (1) Medicaid payback trust; or (2) Pooled Account Trust.

Medicaid Payback Trust. The trust provides that when the child dies or the trust terminates, Medicaid gets repaid for what it has spent on the child. These trusts must have very detailed requirements that are different in each state. (They are sometimes referred to a "(d)(4)(A) SNT.")

The child is the grantor and funds the first party trust. It is an irrevocable discretionary trust to assist the child and supplement the child's SSI and Medicaid benefits. Be careful not to make a completed gift by giving the special needs child a testamentary limited power of appointment.

Pooled Account Trust. Assets are contributed to a non-profit association and invested in a pooled account that sets up a separate share for the child. (This is sometimes referred to as a "(d)(4)C) Pooled Account Trust.") When the child dies, the assets will be repaid to the government or possibly remain with the charitable organization to benefit other special needs persons.

These are not recognized in all states. In some states, a Pooled Account Trust cannot be created if the child is over age 65 and there can be no contributions after age 65. Furthermore, Sebastian understands that the SSI rules are being revised to clarify that a transfer on or after age 65 to a Pooled Account Trust may result in a period of ineligibility for SSI benefits.

q. HIPAA Consent. The HIPAA privacy rules can have horrendous implications for the medical care of an adult special needs child. The child (or a guardian if necessary) should sign a consent form or a durable medical power of attorney that includes HIPAA release information and names each parent as a "personal representative" under the HIPAA rules.

r. Power of Attorney to Assist With Daily Living Matters. A power of attorney for the special needs child can prove very helpful in dealing with a variety of daily issues (dealing with banking matters, etc.)

38. Planning for Unmarried Couples

Joshua Rubenstein outlined issues facing planners representing unmarried couples.

a. Subsequent "Divorce". Planners should be careful to deal with a subsequent split-up of unmarried couples. There will be no benefit from state laws that typically automatically revoke bequests or appointments in the event of a divorce of a married couple.

b. Gift Tax Issues For "Inadvertent Gifts" to Partner. The education and medical exclusion applies, so one partner can send the other to college or pay medical expenses without gift tax consequences. What about paying for living expenses, vacations, etc.? Technically, there may be a gift, but Joshua has never seen the IRS get upset over this unless there are egregious transfers. Usually a rule of reason applies, but if the IRS is annoyed for other reasons, the client "could get slammed."

c. Be Especially Careful About Planning To Avoid Will Contests. The families may not be happy with the relationship of the unmarried couple and may be more inclined to contest the wills of either partner than in other situations. For example, don't just send will execution instructions, but insist that the parties come to the office to sign their wills. If there are any questions about capacity issues, have the parties explain generally to the witnesses what they are doing, and why they are leaving the assets to the partner rather than to their family. Two independent witnesses are then available as witnesses in a contest proceeding. If there are any concerns about undue influence, have each of the parties represented by independent counsel, and redo the wills with frequency so that a contestant would have to overturn multiple wills in the event of a contest (because of the dependent relative revocation doctrine).

d. No Springing Powers of Attorney. Springing powers of attorney are not favored in any event, but especially do not use them in a domestic partner situation. A family member who wishes to contest the power of attorney would have another argument — that the "springing" event has not yet occurred.

e. Health Care Documents. The partners have no presumptive or legal rights regarding health care decisions that spouses have. Address visitation rights in a hospital if the "standard form" does not do so. Otherwise, the family may want to camp out in the hospital and deny visitation access to the partner

39. Long Term Care Insurance

Professor Larry Frolik had a very practical discussion of the factors in deciding whether it makes sense to purchase long-term care insurance.

a. Gamble Consider Benefits, Risks, and Whether Unacceptable Losses. The decision of whether to purchase insurance is inherently a gamble. If you knew you would spend 8 years in a nursing home, you would clearly buy the policy. But you must factor in how much benefits are realistically likely, as well as your financial situation. (Bill Gates does not need it, and poor people don't need it-because they have no assets to protect. For middle wealth people, the need for it can be more unclear.)

The decision to purchase any insurance is about protecting against unacceptable losses. You insure against an expense you can't afford to pay.

b. What Risk Is Realistically Being Covered?

(i) Cost of Care. Nursing homes costs $70,000-$100,000 per year. Two years in a high cost area would be $200,000. Assisted living costs about half as much ($40,000 per year.)

Nursing homes are dinosaurs of the past. Most long term care is provided by assisted living and the percentage of care provided by nursing homes will continue to decline. Assisted living homes have dementia units (at about $50,000 per year). Dementia patients can live a long time, and the care could be provided by assisted living. If the person has physical problems, nursing home care might be needed, but the patient likely will not live long enough anyway to be moved to a nursing home (or to be there very long). More than half of people in nursing homes leave within the first 6 months (they go home or die). Interestingly, men go to nursing homes at a much higher rate than women.

A dementia patient who needs five years of care might reasonably be in assisted living for three years (or more) and in a nursing home for two years (or less). The cost would be:

(3 x $40,000) + (2 x $100,000), or $320,000

That must be considered in connection with other factors. For an estate with $10 million, that is a drop in the bucket. For an estate with $100,000, the person is only exposed to $100,000 of losses if he or she goes to a nursing home. In either of those situations, long term care insurance does not make sense.

(ii) Not Being Left on the Street. The decision is not one of getting care or being left to die on the street. It is important to realize that being able to go to a nursing home does not depend on whether one has long term care insurance or the ability to pay for it. A patient that needs nursing home care can go to a nursing home even if he or she cannot pay for it; Medicaid will pay for it if the person qualifies as indigent under the relevant state tests. (Medicaid does not pay for assisted living generally.)Some say the quality of care is much worse for Medicaid patients. Larry does not agree. Nursing homes always have two beds in each room; one patient may be on Medicaid and the other not, but both get the same care. Most nursing homes accept Medicaid; the "gold standard" ones do not, but persons probably cannot afford those even with long term care insurance because the long term care payments would be far less than the costs.

(iii) Coverage Under Policy. Long term care insurance is not like medical insurance, where the patient just sends all bills to the insurance carrier. Long term care insurance just pays a daily rate. For example, a common policy pays $200 per day for three years, five years, or life (more typically, either three or five years). At $200 a day, the policy would pay up to $75,000 per year, and a three year policy would pay up to $225,000; a five-year policy would pay up to $350,000. The typical nursing home costs $250.00 per day and up, so the daily pay rate does not cover all of that.

Illnesses Covered. Some policies exclude mental illness other than for Alzheimer's disease. Some policies exclude other treatments as well, such as for alcoholism, drug addiction, wartime injuries or attempted suicide.

What Triggers Payment of Benefits? Significant disability is required before payments begin, such as significant cognitive problems, inability to perform a specified number of "activities of daily living." Many people will need some degree of assistance before they qualify under these provisions.

Elimination or Waiting Period. Policies typically have a three or six months elimination period, meaning no benefits are paid until the patient has qualified for benefits for that period of time.

Preexisting Conditions. Many policies will not pay for nursing home care that arises from a preexisting condition until the individual has resided in a nursing home for at least six months.

Summary. All of that should be considered. Often the realistic benefits being purchased are far less than expected — and not enough to assure that all long term care needs will be provided from the insurance payments. What is being insured against, the loss of other assets, may happen anyway with a long illness. On the other hand, many people will not live long enough after qualifying for care to use all policy benefits. Even those that max out on benefits are typically just purchasing a $225,000-$350,000 benefit, depending on the years of coverage being purchased.

c. Cost of Coverage. The premium cost obviously is less for younger persons. The premiums are typically set and do not increase unless the insurance company has a general rate increase for all policies in that same group (and most policies have at least one general rate increase.) Age 65 seems to be a good time to buy the policy in terms of premium cost. The cost of premiums escalates dramatically after age 70. A rough estimate of the premium for a 65-year old purchaser for five years of coverage after qualifying with inflation adjusted benefits is $3,500 to $4,500 per year.

Once someone decides to purchase a policy and pay premiums, it should be viewed as a long term obligation. Once someone starts paying premiums, typically he or she will never let the policy lapse, because the policy gets more valuable over time as the person becomes older and is more likely to need the insurance.

d. Insurability. Twenty percent of long term insurance applicants are uninsurable. (The insurance companies see an adverse selection problem; people in poorer health are more likely to apply for the insurance.)

e. Tax Treatment. Premiums can be deducted as a medical expense, up to dollar limits based on the person's age. §213(d)(10). A self employed individual may get an above-the-line deduction for the premiums. Benefits may be excluded from gross income. §7702B(a)(1).

f. Home Care. Most people have a vision of staying in the home and having someone take care of me for life. That is a myth and is not realistic. Many of the reasons that someone needs assistance to stay in the home (doing laundry, cooking, going on walks, etc.) do not trigger the policy benefits. Many policies pay only half as many benefits for home care (even though the cost of home care is even higher than other care).

g. Home. Once the husband goes to a nursing home (husbands go to nursing homes much more than women), the wife should realistically not expect to stay in the house. She may be 80 and trying to take care of a big house. The house should be viewed as a piggy bank to help provide long term care for the couple.

h. Estate Preservation Not a Good Reason. Purchasing long term care insurance to preserve the estate to pass to the children is not a good reason to buy long term care insurance. Larry's view is that children should pay the premiums if they want to insure against losing their inheritance. The better way to preserve an estate for the children is to purchase life insurance. (If a person cannot qualify for long term care insurance, he or she may still qualify for life insurance.)

i. Second or Third Marriages. In late life second or third marriages, each party wants to preserve the estate for their heirs. Husband does not want to pay for Wife's long term care by using Husband's kids' inheritance. Each spouse could get long term care insurance, and prenuptial agreements in late life marriages should address long term care insurance. That is a good reason to purchase long term care insurance.

j. Middle Wealth Family. The purchase decision can be hard for a middle wealth family. Assume a family has an estate of $1.0 million. The onset of dementia could bring on long term care costs. "A couple may not want to accept the possibility of having to pay $200,000 for long term care. That may be approximately 20% of their estate. They might sleep better with the long term care insurance. But once they see the premiums, they may decide to just buy sleeping pills."

40. Asset Protection

Barry Nelson practices in Florida and focuses on asset protection issues for clients.

a. Plan Before Problems Occur. When doing estate planning, Barry believes it is important for the estate planning attorney to consider some of the asset protection issues; do not wait until a problem occurs. There is a wide spectrum of asset protection planning. At one end is creating a foreign trust on the eve of bankruptcy, but the vast majority of people who practice in this field work with clients before problems occur.

b. Estate Planning Attorneys Should Consider Asset Protection or Exclude From Scope of Duties. "Even though there are no reported cases that establish such a duty [to address asset protection planning], case law suggests that such a duty exists. Accordingly, it is advisable for estate planning lawyers to either counsel their clients on asset protection or to exclude such matters from the scope of their duties." Spero, Asset Protection, ch. 2 (2001).

c. Tier 1: Client With Mega Problem — Existing Judgment. There are basic things that can still be done.

- Potential inheritances should be in totally discretionary spendthrift trusts or bypass the client totally.
- Be careful to maintain the exempt status of currently exempt assets.
- Allow other family members to take advantage of future opportunities.
- If the judgment is against the husband, use the husband's assets for living expenses rather than the wife's assets.

d. Tier 2: Client With Pending Liability But Exposure Is Uncertain.

- Use Tier 1 planning.
- Prepare a solvency analysis to make sure that any conveyances do not cause insolvency.
- In preparing the solvency analysis, consider obtaining an opinion from an attorney or appraiser to document potential exposure and quantify the potential loss and likelihood of success. Also consider getting appraisals to value real estate or other hard to value assets.
- If the client is still solvent, consider Tier 3 planning strategies to the extent that they do not cause insolvency.

e. Tier 3: No Existing or Contingent Claims.

- Use Tier 1 planning.
- Florida married individuals use tenancy by the entireties accounts. This is easy and cheap and effective against creditors' claims.
- Non Florida residents can take advantage of Florida tenancy by the entireties by acquiring Florida real estate as tenancy by the entireties. Several Bankruptcy cases have upheld protection for the Florida tenancy by the entireties real estate. Furthermore, if other Florida tenancy by the entireties accounts are established in Florida and if the person changes domicile to Florida before filing bankruptcy, the tenancy by the entireties protection may extend to such previously established personal property accounts as well (but this is not clear).
- Transfer assets to lifetime trusts for children, using discretionary standards so that beneficiaries have no ability to force distributions from the trust. Barry says that "typically, creditors cannot reach assets held in a spendthrift trust for a beneficiary even if distributions are subject to an ascertainable standard." Barry calls this the "Salvation Army Protection Plan" — to assure that the client's kids are not in front of the Salvation Army asking for food handouts.

- Do not transfer a Florida homestead to an FLP; that will cause loss of the property tax safe harbor limiting the annual increase for local property tax.
- Make sure that the client has a liability umbrella policy, Barry is amazed at the number of wealthy clients who have no umbrella policy. The premiums are very small.

f. Inter Vivos QTIP Trust. This is Barry's favorite estate planning/asset protection planning technique. Husband transfers $3.5 million to an inter vivos QTIP for Wife. This assures that she has a full $3.5 million to fully fund a bypass trust if she predeceases. The corpus is protected from Wife's creditors (if the trust is a spendthrift trust), as long as the spouse does not have a general testamentary power of appointment.

Professor Mitchell Gans, Jonathan Blattmachr, and Diana Zeydel have described this as the "Supercharged Credit Shelter Trust," because if Wife dies first and appoints the property to a "bypass trust" with the husband as a beneficiary, the trust is a grantor trust as to Husband. Reg. §1.671-2(4)(5) says that Husband is treated as the grantor to the trust despite the fact the assets were included in Wife's gross estate under §2044. See Gans, Blattmachr and Zeydel, Supercharged Credit Shelter Trust, 21 PROB. & PROP. 52 (July/August 2007).

Does the trust continue as a spendthrift trust for Husband? The answer is not clear if the client does not live in a state that provides asset protection for self-settled discretionary trusts. The "relation back doctrine" may treat the Husband as the grantor for creditor purposes. However, there have been no relation back cases directly addressing a trust being left back for the original donor by reason of the exercise of a limited power of appointment (as opposed to the exercise of a general power of appointment). Arizona has a statute specifically saying that amounts contributed to a QTIP trust or general power of appointment trust for the spouse, which come back to a trust for the original donor spouse by exercise of a limited or general power of appointment, "are not deemed to have been contributed by the settlor even if the settlor is a beneficiary of the trust following the death of his or her spouse." Arizona Trust Code §14-10505(E) (effective January 1, 2009). Barry is pressing for the passage of similar statutes in Florida and other states.

g. LLC and Limited Partnerships. Barry thinks that Florida has the best limited partnership act for asset protection. Florida statutes say that the exclusive remedy of an individual owner of an LLC or LP is limited to a charging order, which only allows the creditors the rights of an assignee. Furthermore, the Florida statute says specifically that the creditor is not entitled to foreclose with respect to the assignee interest in an LP (but there is not a similar provision in the LLC statute).

Elizabeth Schurig and Amy Jetel suggest that Alaska, Florida and South Dakota are the best three states for LPs, and Alaska, New Jersey and Oklahoma are the best three states for LLCs with respect to protection against claims of creditors against the owners. See Asset Protection Planning Newsletter #122 from Leimberg Information Services, Inc.

41. Gems of Wisdom From Experienced Planners

A panel discussion entitled "If I Knew Then What I Do Now… Practical Solutions to Recurring Estate Planning Problems" was presented by a panel of experienced practitioners (Alan Rothschild, Bob Edge, Jo Ann Engelhardt, and Mal Moore). Some of their pearls of wisdom, some of which are "lessons learned the hard way," are listed.

a. <u>Income Only Trusts</u>. Income only trusts are complex to administer. Perceived advantages are that the settlor does not have to rely on trustee discretion and there is an inherent limit on how much can be distributed. Diversified investments, however, produce relatively low income, particularly now in the current chilly market. Allowing discretionary principal distributions affords much more flexibility.

b. <u>Choice of Trustees</u>. This is one of the most important things to discuss with clients. In the attorney's early career client discussions, that was often left to the end of the conversation, but it is too important for that. The trustee selection decision should come first in the process if the clients are going to use a trust.

As an example, one client had three daughters and a son and the client used trusts for the daughters but not the son. The client asked to use the son as trustee for the daughters and the attorney did that. Experience proved that "it was not a good thing to do." Bob Edge says that "of all the plan designs that may lead to discord between siblings, [having one child serve as Trustee of another child's share] could well be the one most likely to lead to bad feelings." If the client insists, consider allowing the beneficiary to replace the sibling as trustee by appointing a corporate trustee or an individual approved by an objective outsider. The trustee-sibling should have the same "escape hatch" to resign and appoint a corporate trustee.

If a corporate trustee is used, consider bringing in a child as a co-trustee at some time before the trust will terminate so the child can learn about investments.

c. <u>Successor Trustees</u>. Trustee succession documents should include a process for choosing successor trustees, and even a way to change how successors are chosen with long term trusts. The most common subject of reformations (whether under a nonjudicial agreement statute or in a judicial proceeding) is to designate successor trustees where a proper process for naming successors has not been provided.

For dynasty trusts, it makes sense to end up with a corporate trustee.

d. <u>Personal Impact of Estate Plan</u>. How gifts and bequests will impact the beneficiaries personally is the central concern of the clients we are working with. Clients are not all that interested in squeezing the last drop out of tax planning, but they are very concerned about the impact of gifts on their children.

e. <u>Understanding Who Gets What; The Need for Numbers</u>. An attorney has sent a guide to estate planning instruments, and for a long time thought that was sufficient. But for many plans, it is not clear how the numbers will come out and what goes where. After looking at the numbers, the attorney often thinks there should be further discussion with the client. He now gets permission to "run the numbers" as a special project. He tells the client that it increases the bill, but clients often say this tells them more about the estate plan than anything else.

f. <u>What's In the Estate</u>? Do not rely on what clients tell you off the top of their heads about what their assets are or how they're held. Force clients to examine what the assets are and who receives assets that do not pass under the will.

g. <u>Engagement Letters</u>. A good engagement letter for every relationship is very helpful. It can go a long way toward avoiding headaches, disappointed clients and huge write-offs. Address the method for determining the fee and give a fee range. "If the client is expecting $900 and you know it will be $3,500, don't put off that conversation." (Another attorney on the panel said that his firm does not require engagement letters for estate planning clients, and he personally does not like to start an estate planning relationship with a formal engagement letter.)

The attorney never used to use retainers for estate planning clients, but they can make sense for a new client that you do not know.

Bills should be sent periodically. Send them when documents are sent out.

Make clear who the attorney represents in the engagement letter.

Cover that the attorney will bill for being a witness in defending a will if state ethics rules allow that.

h. Aging of Clients and Client Competency. The aging of our clients creates challenges. Clients with diminished capacity are more susceptible to undue influence or financial abuse. Try to maintain contact with clients. As clients age, the attorney does not hear for them as often. Be proactive. One attorney bought boxes of oranges in Orlando, and he will stop on the way home and drop off some oranges to clients, giving him a reason to meet with them and see how they're doing.

Encourage multi-general meetings. As clients age, the children have a stronger self interest in safeguarding parents' money. It is difficult for children to ask parents about their estate planning.

When an 80-year old asks you to prepare a power of attorney, do not just view that as an insignificant add-on. Make sure the power of attorney is current and covers the client's needs.

i. Frugal Entrepreneurs. Business owners often do not have the time or energy to invest in themselves, their marriages, or their children. They come to expect behaviors from spouses and children that are unrealistic. The entrepreneur often lives frugally, living off a quarter of the earnings and plowing the rest back into the business. The client will stay in the Hampton Inn when traveling to meet with the planner. Once the entrepreneur dies, the children have very different ideas about an appropriate lifestyle — and they stay in the fancy resort when coming to visit the planner. Knowing that will occur can help color what the client should realistically consider for provisions in estate planning documents.

j. Deathbed Gifts. Deathbed gifts are important for avoiding state estate taxes. Be sure to consider the loss of step-up in basis. Be sure that powers of attorney allow the agent to make gifts.

k. Gifts from QTIP. If the QTIP has assets to be used for gifts, consider invoking §2519 by assigning an income interest (if there is not a spendthrift clause. If the QTIP trust is larger than the desired gift with that strategy, the trust will first have to be divided, and then make an income assignment just out of the trust with the desired amount.

l. Deferral of Gift Tax Payments. Most attorneys (and IRS agents for that matter) do not realize that §6161 applies to gift taxes as well as estate taxes — to allow a discretionary six-month extension in hardship situations (a stricter hardship test is applied than for estate taxes).

m. Timing of Trust Distributions. If the client is concerned with a beneficiary squandering trust assets after they are distributed, consider using a specified number of years to defer the distribution rather than just using ages. For example, provide that if the beneficiary is at least 25, the trust will terminate as to one-third of trust at the parent's death (or when the person reaches 25), as to one-half of the balance five years later, and as to all of remaining assets 10 years later. That assures that the beneficiary will not receive the trust assets all at once. (Include a discretionary authority to make distributions from the trust in addition to the termination distributions.)

This can be especially helpful if the oldest child is not as mature financially as younger children. The parents want to treat all children equally, and that is a way to do so, without requiring early full termination distributions to the oldest child even though the child has reached an age that the client thinks is appropriate for a younger child.

As children get older, they tend to move back ages for distribution. Using a "number of years" approach accommodates that automatically.

Also consider adding "holdback" provisions if the trustee determines that the beneficiary is not ready to receive the distribution (but do not name one sibling to make that decision for another sibling). Mal Moore's materials include good form language for a holdback provision.

n. Prepare Clients That the Great Idea May Not Work Out as Anticipated. Assets that are given away may decline substantially in value, thus wasting the client's gift exemption. The other end of the unanticipated results spectrum is that the assets given away may increase so dramatically that the children acquire a degree of financial independence that the parents are not happy about later.

Warn clients that tax returns get audited, and the IRS may contest transactions or values. Do not be too much of a one-sided advocate for any of the estate planning strategies.

o. Since You Did My Parents' Wills, Why Do We Have To Pay So Much Estate Tax? The deceased client's children may unrealistically think the estate planner failed in the representation of the parents' estate — without realizing how difficult it was just to get the parents to do basic planning. Attorneys suggest discussing, at least in general terms, strategies that could result in tax savings. If the client is not interested, prepare a follow-up letter: "I'm glad you got the basics done. Recall our discussion about tax savings strategies. When you are ready to have that conversation, let me know because I think it's very important to your family."

p. Develop Consistent Document Assembly Systems. Use an assembly system comfortable to the planner. Document assembly systems are much more efficient and less error prone. Young attorneys should understand every question in the form system and should understand every provision in the document.

q. Conference Memo. Prepare a memo summarizing client discussions. Despite the time it takes, it is much more efficient in the long run and less error prone than trusting the assistant to decipher the attorney's handwritten notes. To the extent feasible, confirm client decisions in writing with the client.

r. Signing Table Changes. When the client wants changes made just before signing documents, there are likely to be problems. Tell the client that the attorney will look at the document closely after the meeting to make sure everything is coordinated. If there are problems, the clients will need to come back in and re-sign.

s. Spelling of Names. Misspelling names is one of the most embarrassing things the attorney can do. Attorneys have seen firms fired over that.

t. Learning to Say "No" and "I Made a Mistake". Sometimes a client is not right for your firm or law practice, wanting something you can't provide. Sometimes there is no way your fee will cover time lost and the mental anguish of dealing with the client and responding to unreasonable requests at all hours. Say “No” to that client.

If you’ve made a mistake, acknowledge it. If done properly, the client relationship is deeper and more trusted. There is a proper way to do it. Talk to senior people in the office and get their insights and thoughts. Plan the conversation with the client. Don’t sound defensive. Be willing to discuss options to fix the problem. Then be willing to shut up and let the client vent.

u. Providing for Children’s Spouses. Spouses of children are typically not included in estate plans, even if they are considered as part of the family. If the client wants to provide for the possibility of the child predeceasing, leaving his or her surviving spouse, consider giving the child a testamentary limited power of appointment to include the spouse, either outright or perhaps limited to trust provisions, or perhaps limited to some but not all of the property. Some clients view that as the child’s problem, and it should be up to the child to get insurance to guard against that possibility. (If that’s the plan, the client should understand that the child will likely be coming to the trustee after the parents have died requesting distributions to permit the child to purchase life insurance.)

v. Preparing Clients For Estate Administration. Clients have no idea of the complexity of an estate administration and problems that an individual named as executor will have. If a corporate fiduciary is used, have the clients meet with the corporate fiduciary to understand what will happen.

w. Vacation Homes. Help the client understand how leaving the beach house to the children is fraught with causing huge problems for them. It is like putting the children in a row boat that can only go in one direction at a given time and they must agree what direction that is. The children often end up not speaking to each other over the vacation home.

Consider creating a side fund to pay maintenance expenses. There is often a “poor” child that can’t afford to contribute to upkeep.

The parents may set out rules of joint ownership. Another alternative is to provide that the beach house will not be delivered to the children until they enter into a joint ownership agreement to agree in advance about how to handle various difficult issues.

x. Confront Difficult Issues. Attorneys report that it takes a long time to gain the confidence to address difficult family issues with clients. For example, if children do not get along while the parents are alive, they won’t get along after the parents have died either when the “glue” of the parents is gone. It is difficult and embarrassing to talk to people who are a lot older than the attorney about some of these difficult issues, such as what kind of bequests they want to leave to their spouses to qualify for the marital deduction.

y. Distribution of Tangible Personalty. Some of the bitterest estate administrations center on the distribution of tangible personal property. One attorney tells clients that if there are important sentimental items, they should be dealt with in the will. Make it an important part of the thinking — because it will be important to the beneficiaries after the client dies.

z. Location of Documents. Encourage clients to tell the attorney where the estate planning documents will be located. “We might not like to recognize just how many of out clients do not even recall where they put their original wills. We should help our clients avoid a hunting expedition when the original will is needed for probate.”

42. Interesting Quotations

a. IRD Deduction for Retirement Benefits. "This is the most overlooked deduction." —Natalie Choate

b. Complication of Retirement Benefits Taxation. "I'll never be out of business, they keep it so complicated." — Natalie Choate

c. Taxpayers Getting Excused If Get Professional Advice (But It's Wrong). "I'm considering a new marketing plan. 'Let us handle your rollover for you. You know it will get screwed up anyway. Let us screw it up for you, then you can get a waiver from the IRS.' I'm still working on that marketing plan." — Natalie Choate

d. Dwelling on the Past. "It's no good to just look back, driving down the road and looking out the rear view window." — Dennis Belcher

e. Investment Advisors' Predictions. "I listen to various investment advisors. One-third say things will get worse. One-third says things will go sideways. One-third say the market will come back strong. That happens to be my personal financial advisor, who has predicted three bottoms of the market since Sept 30." — Dennis Belcher

f. Market Meltdown. "I have one client with a capital gain in 2008." — Dennis Belcher

g. Fear of Retroactive Legislation. "Can Congress make changes retroactive? Do I have to rush out and do it last year?" — Dennis Belcher

h. Time Lag in Learning About Legislation. "There is always at least a one day lag before I find out about it." — Pam Schneider

i. Sons-in Law. "The one thing that is heartening for attorneys to hear from clients — that will keep us in business for a long time — is 'son-in-law.'" — Dennis Belcher

j. Pervasive Impact of Madoff Scandal. "How many in the audience personally knew someone affected by the Bernie Madoff Ponzi scheme?" About 20% of hands went up

k. Primary Advice to Estate Planning Attorneys Regarding Madoff and Other Financial Scandals. "If planners take anything away from the Heckerling Institute they should remember this: If you have anyone that had dealings with Madoff, check the statute of limitations and file whatever claims for refund you can think of to keep the statute open. We fear that the IRS may not come out with guidance on this until after the statute has run on 706s, 1065s, 1040s, or 1041s. You don't want to be calling your carrier after you miss something like this." — Dennis Belcher

l. Lessons Learned From the Economic Crisis. Pam Schneider's conclusions:

- If you're a lawyer, you're not an investment advisor and do not pretend to be.
- Diversity means not only diversity as to assets and investment classes, but also as to investment advisors.
- Beware of conflicts of interest.
- Do your due diligence.
- If it sounds too good to be true, it probably isn't true.

m. Do They Just Want My Money? The grandfather was sitting in his favorite chair nodding off. Grandson: "Grandpa, make a noise like a frog." Grandfather: "Why would I want to do that?" Grandson: "Because Mom says when you croak we're going to Disney World." — Dennis Belcher

n. Success. "You know you are a success when you have your children's lifestyle." — Stacy Eastland

o. IRS's Statutory Construction Skills. In discussing the IRS's interpretation that the power to "reacquire" assets includes third party substitution powers: "The IRS believes the 'RE' letters are irrelevant. They have never been a literate group, and I'm comfortable with it now." — Howard Zaritsky

p. Clients Not Paying Attention. In discussing the advantage of clients doing exchanges with grantor trusts before death to get appreciated assets back in the client's estate to get a stepped basis at death: "But a lot of clients do not call you the day before they die. Again, clients can be difficult." — Howard Zaritsky

q. Do You Really Understand? "The client who actually understands what will happen with a grantor trust will ask 'Can turn off having to pay the trust's income taxes if I want to?' If the client doesn't ask that, keep explaining how a grantor trust works. They don't understand yet." — Howard Zaritsky

r. Jonathan's View of Golf. "Do I play golf? Actually, no. I'm still sexually active." — Jonathan Blattmachr

s. Cynical View of Trust Drafting. "'Trust protector' sounds ominous to clients, so I'm toying with calling it: 'Meaningless Grantor Trust Power Provision That I'm Sticking in the Way Back of this Document.' But I don't have enough courage to do that yet." — Lou Harrison

t. Clients Zoning Out With Tax Planning. Client meetings tend to focus primarily on estate taxes and complicated planning. The attorney goes to whiteboards and draws charts and arrows. Three-fourths of the meeting is about tax planning before getting around to children trust provisions. Lou Harrison worries about clients eyes glazing over during the conference and clients doing the Star Trek thing: "Scotty beam me up. There's no intelligent life form on this planet." — Lou Harrison

u. Doctors. "We can't expect clients to be brilliant in estate planning—unless they are doctors." — Lou Harrison

v. Building Value in Trust Rather Than in a Person's Estate Directly. W.C. Fields said "I don't want to be a millionaire. I just want to live like one." — Stacy Eastland

w. Avoiding 2036 By Making Lifetime Gifts. "There's no section 2536 in the Internal Revenue Code." — Stacy Eastland

x. Willingness to Pay in the Midst of a Crisis, But Not So Much Afterward. "Summoned to remove a fish bone agonizingly stuck in a rich man's throat, British surgeon Joseph Lister did so. When the grateful patient asked the charge for his service, Lister replied: 'Suppose we settle for half of what you would be willing to give me if the bone were still lodged in your throat." — George Will

y. Attorneys Fees. "A lawyer is a learned gentleman who rescues your estate from your enemies and keeps it for himself."

z. Special Needs Trust; HEMs Standard. "Planners must understand that leaving a trust for a special needs child that has a standard 'health, education, support and maintenance' distribution standard could cut off the special needs person from enormously helpful government programs." — Sebastian Grassi

aa. Special Needs Trusts; Payback Provisions. "If you establish a third party created and funded special needs trust, never never EVER EVER put in a Medicaid payback provision… You will be calling your carrier …because you will have caused the government to get something to which is not entitled. That's the beauty of the third party created and funded special needs trust — that you don't have to pay back the government for Medicaid benefits for the special needs child. That's why this trust is so effective." — Sebastian Grassi

bb. Roth Account in 401(k) Plan and Rollover to Roth IRA Before Age 70 ½ as a Terrific Strategy for Passing Wealth to Next Generation. "A rollover of a Roth Account to a Roth IRA can be very very valuable. You don't have to take required minimum distributions from the Roth IRA and if your goal is to pass that Roth IRA to younger generations — and this is what really appeals to me — that Roth IRA can grow untouched. You can have it as a safety net. If you really need it during your retirement, use it. But if you can let that grow untouched, and pass it on to your children, and they have tax-free growth and tax-free distributions, that is a wonderful gift." — Marcia Chadwick Holt

cc. Videotaping. "Unless you are Steven Spielberg, home videos are atrocious. It makes the healthiest of people look deathly sick. The lighting is bad. People come out gray and ashen. Not only is the quality of the tape bad, but people know they're being taped so… people stiffen up; they try to act. They say I… AM… DOING… THIS… OF… MY… OWN… FREE… WILL. You're just much better off on oral testimony of people who were there rather than trying to record it." — Joshua Rubenstein

dd. Rabbis. Everyone feels differently about wills vs. revocable trusts. "I feel like a Rabbi about it. You're right. You're right. Everybody's right!" — Joshua Rubenstein

ee. Interesting Side Effect of Estate Tax Exemption Portability. In discussing why many clients prefer using QTIP trusts over outright spousal bequests for control purposes, Keith Bilter interestingly observes that if portability of estate tax exemptions is passed, that will really test "Do you trust your spouse."

ff. Long Term Care Insurance. "A couple may not want to accept the possibility of having to pay for 200,000 for long term care. That may be approximately 20% of their estate. They might sleep better with the long term care insurance. But once they see the premiums, they may decide to just buy sleeping pills." — Larry Frolick

gg. Recession. "The definition of a recession is when people live within their means."

hh. Scandals and Weaknesses Being Exposed by a Poor Economy. "You don't know who's swimming naked until the tide goes out." — Warren Buffet