Heckerling Musings 2010

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Introduction

The 44th Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 25, 2010. 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. In addition, there are excellent summaries provided by Martin Shenkman on the Leimberg Information Services reports. This is merely a summary of observations of selected items during the week. 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 "repeal" of the estate and GST taxes for 2010 together with the imposition of a modified carryover basis system.

1. Likelihood of Congressional Action Regarding Estate, Gift, GST Taxes and Carryover Basis

a. House-Permanent Extension of 2009 System. The House of Representatives passed H.R. 4154 to permanently extend the 2009 system ($3.5 million exemption, 45% rate) on December 3, 2009. The permanent extension passed the House without a single Republican vote — the Republicans are holding out for a larger exemption and lower rates; one proposal is for a $5 million exemption and a 35% rate.

b. Representative Bills Under Consideration. The wide differences in opinion as to the structure of future estate and gift tax legislation are reflected in some of the bills that have been introduced in 2009. These include:

> H.R. 3905 – Proposal for $5.0 million exemption (indexed after 2019) and 35% rate. The exemption increase and rate decrease is phased in over 10 years through 2019. The state death tax deduction is phased out over the same period. The bill has bipartisan support.
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> "Lincoln-Kyl Amendment" to 2009 Budget – Room in the budget for $5 million estate tax exemption, indexed for inflation, and 35% rate, with unification of the gift tax and portability of the estate exemption between spouses. This amendment passed the Senate 51-48, but it applied only if the "legislation would not increase the deficit" over a five or ten year period.
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> S. 2784 - $3.5 million indexed estate and GST exemption; unification of the gift and estate tax exemptions; 45% rate; and portability of the estate and gift exemptions. (Introduced November 17, 2009; almost identical to the transfer tax provisions of S. 722 introduced in March 2009 by Senators Baucus, Rockefeller and Schumer.)

c. Senate Action — 60 Votes Required? Many believe that at some point, Congress will act on the estate and GST tax in 2010, but there is certainly the significant possibility that 60 Senators will never be able to agree on a single approach, and that 2010 will pass without further legislation. (Only 51 votes would be required to pass the legislation if it is included as part of a Budget Reconciliation Act. However, the "Byrd rule" could be invoked if it impacted the budget beyond a ten-year window, in which event 60 votes would be required; therefore "permanent" adoption of a transfer tax system that would have decreased revenues as compared to the pre-2001 system may require 60 votes even in a Reconciliation Act.)

d. Senate Action. The Senate on January 20 completed the procedural steps necessary for placing HR 4154 (discussed above) directly on the Senate calendar, bypassing the Senate Finance Committee. The Senate on January 28, 2010 passed its version of the PAY GO rules (60-40, with no Republican votes in favor), which includes a two-year (not permanent like the House version) exception for extension of the 2009 transfer tax and alternative minimum tax systems. Perhaps that reflects a greater likelihood that the Senate might vote to extend the 2009 system for up to two years.

e. Retroactive Legislation? There have been varying indications as to whether legislation would be retroactive to January 1. Retroactivity could be viewed as very unfair to people who have died in the interim (and even more unfair for people who make gifts thinking they are subject to a 35% gift tax rate rather than a 45% or even higher gift tax rate) and could be politically difficult to get through Congress in an election year. The longer it takes to pass legislation, the more likely it is that the legislation will not be retroactive.

If the legislation is imposed retroactively, there will probably be constitutional attacks, but it is likely that the restorative legislation would be upheld. U.S. v. Carlton, 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). The court observed that "the amendment at issue here certainly is not properly characterized as a "wholly new tax," and its period of retroactive effect is limited." The estate, and GST tax would appear not to be a "wholly new tax" despite its current uncertainty and the maximum possible retroactivity, 12 months, is less than the 14 months involved in Carlton.

Similarly, retroactive increase of the gift tax rate from 35% to 45% is probably valid. Quarty v. United States, 83 AFTR2d ¶ 99-597 (9th Cir. 1999)(increase in gift and estate tax rates from 50% to 53% and 55% in OBRA, signed on August 10, 1993, retroactive to January 1, 1993, was constitutional where the decedent died on January 12, 1993 having made taxable gifts earlier in that year).

An approach that has been discussed in formal discussions with some legislative staffers is to continue the 2009 system retroactively, with the right to elect which regime (estate tax or modified carryover basis) would apply. A similar election would likely not be extended to persons who make gifts before the legislation is passed.

f. Numbers Affected. Many estates that are below the $3.5 million estate tax exemption amount in 2009 will be impacted by carryover basis, which allows only a $1.3 million basis adjustment (assuming there is no surviving spouse to utilize the $3.0 million spousal adjustment). Some have estimated that the estate tax would impact 6,000 estates, but carryover basis could affect 60,000-70,000 decedents in 2010.

2. Planning In the Shadow of 2010 Estate and Gift Tax "Repeal" and Modified Carryover Basis

a. Overview of Highlights of 2010 Law.

(i) Estate and GST Taxes. There is commonplace discussion of the estate and GST taxes being "repealed" in 2010. However, under §2664, chapter 11 "shall not apply" to estates of decedents dying after 12/31/09 and chapter 13 "shall not apply to generation skipping transfers" after 12/31/09.

(ii) Gift Tax. A 35% rate applies to gifts made after 12/31/09.

(iii) Section 2511(c) Regarding Transfers to Non-Grantor Trusts. Section 2511(c) applies to gifts after December 31, 2009. It provides that except as provided in regulations, a transfer in trust is treated as a transfer by gift unless the trust is a wholly owned grantor trust as to the donor or the donor's spouse. Questions have been raised whether this means that transfers to grantor trusts are not treated as gift transfers. The statute does not say that and such an interpretation would leave the possibility of making trust transfers that are not taxable gifts and the trusts would not be included in the donor's estate at the donor's death. The IRS will no doubt interpret the statute to avoid that possibility. On February 2, 2010, the IRS issued Notice 2010-19 indicating that the IRS intends to issue guidance regarding §2511(c). The Notice clarifies that gifts to wholly grantor trusts will be governed by the normal gift tax rules under chapter 12. Another concern is that §2511(c) literally may be interpreted to require that the full amount contributed to a charitable remainder trust, except for the value of the charity's remainder interest, would be treated as a taxable gift, including (1) the donor's retained annuity or unitrust interest and (2) the interest of any successor noncharitable annuity or unitrust beneficiary (even though the donor has reserved the right to revoke the successor beneficiary's interest).

(iv) Modified Carryover Basis. For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). There are two exceptions from the carryover basis provisions: (1) The executor can allocate up to $1.3 million (increased by certain unused losses and loss carryovers) to increase the basis of assets; and (2) the executor can also allocate up to $3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a trust very similar to a QTIP trust. IRD does not qualify for any basis adjustment. Gifts from the surviving spouse to the decedent spouse qualify for the adjustments, but gifts to the decedent from any one else within three years of the decedent's death do not. The decedent's one-half interest in the community property and the surviving spouse's interest in the community property are both eligible for the $1.3 and $3.0 million basis adjustments. A report is due by the due date of the decedent's final income tax return listing, among other things, the fair market value and basis of each asset and the basis adjustments made by the executor.

If an asset has liabilities in excess of the basis, there is no gain at death, but when the estate of beneficiary disposes of the asset there will be gain recognition and the tax liability may exceed the net equity value of the asset.

If a pecuniary bequest is satisfied with appreciated property, gain is realized only with respect to the post-death appreciation amount. The beneficiary's basis is the carryover basis plus the gain recognized on funding (i.e., the post-death appreciation).

b. Sunset Provision in 2011. Section 901(a) of EGTRRA says the act does not apply to decedents dying, gifts made, or generation skipping transfers after 12/31/2010. Section 901(b) says the Code shall be applied to "years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted." (This has been called the "Bobby Ewing provision," by reference to the full year of shows on the old "Dallas" television series that we found never happened but were all a dream of Bobby's.)

Read literally, Section 901(b) of EGTRAA raises a host of surprising results. The uncertainty revolves around two possible ways of interpreting that provision. (1) Does the phrase mean that after 2010, we assume that the EGTRAA provisions were never in effect in 2001-2010? (2) Alternatively, does it mean that going forward from January 1, 2011, we apply the Code to future gifts and estate transfers as if everything added in EGTRAA were not there. This raises the most uncertainty in the GST area. For example, will GST exemption that was automatically allocated during 2001-2009 still be given effect, or is it ignored because it would not have been available if EGTRRA had never been enacted?

Carol Harrington observes that many say the courts won't interpret it that way because it's just too crazy. Carol agrees it is crazy, but the statute says that. She concludes, "Oh dear."

c. <u>Testamentary Planning Considerations</u>. Various alternative planning approaches are described.

(i) <u>Notify Clients</u>. Notify clients of the changes. Many attorneys have not yet sent general notices (partly because they are trying to determine what to do when clients respond). Some attorneys are applying a triage approach — first contacting more elderly clients, clients with larger estates, etc. However, the law changes can have dramatic and unintended effects on some estate plans. This is generally only a problem for the decedents who die in 2010. It is likely that a large number of clients will not respond to these notices at all, and will take the risk that they will not die during 2010.

(ii) <u>Review Will to Determine Effect; Explore Client's Intent</u>. Standard bypass trust provisions typically will leave the entire estate to the credit shelter trust when there is no estate tax, but this can be affected by the words used in the formula. Ambiguities may lead to the need for construction suits. Even if the will language is clear, state courts may construe the will in a manner to carry out the decedent's intent if the formula would lead to an unintended result.

The client's intent cannot be assumed. For example, one attorney discussed a will with a formula charitable lead trust, leaving the residue to a dynasty trust. In that situation, the attorney thought the client might want to leave the entire estate to a dynasty trust, if that could be done with no estate taxes, but the client emphasized that his wanted to leave some substantial assets to his private foundation.

Interpretation issues will also be paramount if there is retroactive legislation. **As a** judge, Carol Harrington would say that a decedent with tax formulas designed to achieve a tax result intended retroactive tax law to apply at his death, including retroactive changes. There may be significant construction litigation if there is retroactive legislation.

(iii) <u>Retain "Standard" Credit Shelter Trust/Marital Trust Plan</u>. For many families, leaving most if not all of the estate to the credit shelter trust is satisfactory, and clients may not want to revise wills having that result. A concern is that the full amount of the $3.0 million spousal basis adjustment may not be available, because it only applies to bequests to spouses or QTIP trusts.

(iv) <u>Simple Codicil Fix</u>. A simple codicil may be sufficient to clarify any ambiguity. Alternatives would be to apply the 2009 law or to make clear that the maximum amount possible should pass to the credit shelter trust, even if the entire estate passes to it under the formula clause.

Example: "If no federal estate tax applies with respect to transfers under my Will when I die and if no federal estate tax is subsequently and validly reinstated with an effective date prior to my date of death, it is my intention that the Family Trust will hold the entire residuary estate."

Observe, in referring to whether there is an estate tax, do not refer to whether the estate tax is "repealed," but to whether the estate tax is "applicable," because that is how the statute is worded for decedents dying in 2010.

(v) <u>One-Year Term Insurance to Keep Simple Approach</u>. One downside of the "all to credit shelter trust" approach is that the full $3.0 million spousal basis adjustment may not be utilized. One alternative would be to purchase a one-year term life insurance policy for about $600,000 ($3.0 million times an approximate 20% capital gains rate) on the spouses' lives to make up for this loss. The cost of the insurance may be less than the cost of other more complex planning alternatives.

(vi) <u>More Sophisticated Approaches to Leave Desired Amount to Credit Shelter Trust AND Take Advantage of $3.0 Million Spousal Basis Adjustment</u>. There are two main approaches to coordinate leaving the desired amount to the credit shelter trust and taking full advantage of the $3.0 million spousal basis adjustment. (1) Leave all of the estate to a QTIP trust, and rely on QTIP elections, and basis adjustments to cause the QTIP trust either to avoid estate inclusion in the surviving spouse's estate or to qualify for the marital deduction if the estate tax is reinstated, and to rely on disclaimers to cause assets that do not need to remain in the QTIP trust for tax purposes (such as qualifying for the $3.0 million spousal basis adjustment) to pass to a trust with more flexible terms for the spouse and the family. This approach is simpler from a drafting perspective than using complicated formula clauses, but relying on disclaimers has several significant disadvantages. (2) Use formulas to leave the desired amounts to the credit shelter trust and the QTIP trust (or to the spouse outright).

(vii) <u>Use QTIP Trust Bequest</u>. A key to maximizing planning flexibility during this time of uncertainty is to use a QTIP bequest for the spousal bequest (rather than an estate-type trust or outright bequest to the surviving spouse). This is true for two major reasons.

First, assets in a QTIP trust for which an estate tax marital deduction is not allowed at the first spouse's death are not includible in the surviving spouse's estate under § 2044. Second, assets passing to the QTIP trust qualify for the $3.0 million spousal basis adjustment.

A disadvantage is that the QTIP trust must include only the spouse as beneficiary and require mandatory income distributions. The client would often like to have more flexible provisions (for example including descendants as discretionary beneficiaries) to the extent that assets do not need to be in the QTIP trust for tax reasons. A "Clayton" provision is not available, providing that the portion for which a QTIP election is not made would pass to the credit shelter trust, because there is no election of the QTIP trust for purposes of the spousal basis adjustment. However, a disclaimer could be used, so that assets in excess of the amount needed to qualify for the full $3.0 million spousal basis adjustment could be disclaimed and pass to the credit shelter trust. Disadvantages of the disclaimer approach are

(1) the spouse may not disclaim, (2) the disclaimant cannot have a limited power of appointment over the disclaimed assets, and (3) the spouse may inadvertently accept benefits from the trust making a disclaimer impossible.

(viii) Formula Based Approaches. The alternative is to use formula bequests to describe the amounts passing to the credit shelter trust and QTIP trust to assure leaving as much as possible to the more flexible credit shelter trust and to assure full utilization of the $1.3 and $3.0 million basis adjustments (to the extent needed to adjust the basis to full fair market value). This is complicated by the fact that the basis adjustments are not asset values but the formulas must describe an amount of assets with inherent gain in the amount of the respective basis adjustments.

One possibility would first be to make a bequest to the credit shelter trust of the maximum value to which the $1.3 million basis adjustment could be allocated. (That might represent the entire estate, which would mean that the entire estate (other than IRD) would have a basis equal to the fair market value at the date of death.) Next, of the remaining assets, leave the minimum value possible to fully utilize the $3.0 million spousal basis adjustment to the QTIP trust. Any remaining assets would pass to the credit shelter trust.

State death taxes will further complicate this planning. If the state allows a QTIP election for state law purposes, the formulas may leave amounts in excess of the state exemption to a QTIP trust, and the QTIP election would be made for state tax purposes only. If a separate state QTIP election is not permitted, the client will need to decide whether to pay state estate tax in order to fully fund the credit shelter trust with as much value as possible.

d. Transfer Planning.

(i) General Gift Tax Effects. Clients who plan to make large gifts anyway should consider doing it early in 2010, when there is a chance that they may pay a 35% gift tax rate rather than the 45% top rate that might be reinstated and the 55% top rate that will apply beginning in 2011.

There is a concern that Congress may retroactively impose a 45% rate after a gift is made. One strategy to reduce the impact of such a change is to make net gifts, so that the additional tax would itself reduce the gift amount. Another approach is to make a gift by formula, limited to amounts for which a 35% gift tax rate is applicable.

The main concern that will arise from the 2010 system is for clients who die in 2010. However there are also concerns about missed opportunities especially if the gap remains for some time and it appears less likely that there will be a retroactive change. This is what concerns Bruce Stone the most — missing an opportunity that is available during a very limited period of time. It is probably not a liability issue for the attorney, but there is a concern that clients may lose out on the opportunity.

The 35% rate does not create an opportunity to "game the system" when the post-1976 gifts are included in the estate of the decedent as adjusted taxable gifts for purposes of calculating the estate tax. The tentative tax on the taxable estate plus adjusted taxable gifts is calculated at the current rate at the date of death and the tax on the adjusted taxable gifts alone, using the same rate, is subtracted. The effect is just to tax at the highest estate tax bracket, taking into consideration prior gifts. (It is not totally clear what gift exemption will be applied in calculating the amount of the tax on the adjusted taxable gifts, because of the "had never been enacted rule.") A possible estate tax advantage of making gifts with a 35% gift tax rate is that if the client dies within three years of the gift, the actual amount of gift tax paid is grossed up. There is an opportunity to lock in a 35% possible gross up amount if the client dies within three years.

(ii) Inter Vivos QTIP Trusts. Using an inter vivos QTIP trust may allow a person to make a transfer and postpone the time of deciding whether to treat the transfer as a completed gift (for example, to take advantage of the 35% gift tax rate if the gift tax rate is not increased retroactively, especially if the assets appreciate substantially in value after the time of the transfer). While this planning strategy is not new, it takes on new importance in light of the favorable low 35% gift tax rate, which translates to 25.9% tax inclusive equivalent rate, and the possibility of retroactive legislation taking away the benefit of that low rate. The decision of whether to make the gift tax QTIP election can be delayed until October 15, 2011 (assuming the income and gift tax returns are extended to October 15). Alternatively, the spouse could disclaim within the first nine months if the parties decided that paying gift tax on the transfer would be desirable.

(iii) Disclaimers. Disclaimers may also afford a way to hedge against a retroactive rate change. A disclaimer of an outright gift generally reverts to the donor, but there is the question of how to make delivery of an outright gift without constituting acceptance that would bar a disclaimer. 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.

(iv) Rescission. A Third Circuit 1999 unpublished opinion, Neil v. U.S. (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.

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

(vi) Contingent Gifts. Consider making gifts contingent on the fact that laws that now apply a certain maximum rate or that 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.

e. GST Planning Considerations.

(i) Testamentary Transfers. It is possible that testamentary transfers to trusts in 2010 will not be subject to GST tax in the future, because the "transferor" is the person subject to a transfer tax, and decedents who die in 2010 are not subject to estate tax. The definitions of skip persons and non-skip persons are tied to the definition of transferors. Non-skip persons are everyone other than skip persons, and if skip persons cannot be identified because of the lack of a transferor, perhaps the whole world constitutes non-skip persons, If so, future transfers from the trust would not be subject to GST tax. Inter vivos gifts are not subject to this same possible interpretation because donors are subject to gift taxes in 2010.

(ii) Direct Skip Gifts. Direct skip gifts in 2010 will be subject to the gift, but will not be subject to the GST tax (unless, of course, the tax is imposed retroactively). Direct skip gifts generally should be made outright to grandchildren (or other skip persons). If gifts are made in trust, distributions from the trust in later years may be taxable distributions or taxable terminations subject to the GST tax. (Chapter 13 does not apply to GSTs this year so the "drop down" rule under §2653(a) for trusts generally and the special zero inclusion ratio rule under §2642(c) for transfers to single beneficiary vested trusts that qualify for the annual exclusion would not apply. Transfers to custodianships would likely have this same problem because the GST regulations treat them as trust equivalents. An alternative is to make gifts of LLC or FLP interests directly to the grandchildren, and the LLC/FLPs would provide management and restrictions on the ability of the grandchild to squander the gift.)

However, panelists said that as a practical matter, annual exclusion gifts will still be made to custodianships and to some "annual exclusion vested GST exempt" trusts. We hope that §901(b) will operate to treat the trust as having a zero inclusion ratio after this year. (The argument is that if the 2001 Tax Act "had never been enacted," §2664 would not apply in 2010 to provide that Chapter 13 does not apply to GSTs.) It is better for a client to run that risk than to lose the ability to make annual exclusion gifts to the grandchild.

For large direct skip gifts, though, avoid gifts to trusts or custodianships. In golf terms, "if you're going to lay up, lay-up," meaning to be sure that you are successful in the conservative approach. If the client is going to make **large gifts** to avoid GST tax in this gap period, use an LLC for management capability. But for annual exclusion gifts, it does not make sense to set up an LLC for the smaller gifts.

Another strategy is to makes large transfers to a "HEET" trust that includes non-skip beneficiaries. Because there are non-skip persons in the trust, there will not be GST issues even if there is retroactive legislation.

(iii) Gifts to Long Term Trusts. A downside to making gifts to long-term trusts this year is that there is no GST exemption available in 2010. (The GST exemption is equal to the estate tax applicable credit amount and in § 2010(c), the table for the applicable credit amount ends with 2009; there is nothing listed for 2010 or beyond.)

(iv) Additional Premium Payments to ILITs. The concern is that no GST exemption allocation can be made in 2010. If the plan is to make late allocations, that should not be a problem. (Observe that no late allocations can be made in 2010 for transfers to ILITs in prior years.)

If the client has used less than $1,340,000 of GST exemption previously, and it is a GST trust, the "as if had never been enacted rule" should act automatically to allocate part of that GST exemption in 2011, but no one knows for sure. The safest approach is not to waste the ability to use annual exclusion amounts, but to make the gifts in a way so that when the uncertainty over, the gifts can be added to the insurance trout. Step 1. Create a new ILIT, the beneficiary of which is the old ILIT. Step 2. To pay the premiums, client lends money to the original ILIT trust to make the payments. Step 3. Once the legislative uncertainty is over, if there is available GST exemption, the trustee of the new trust can contribute the assets to old trust, and it can then repay the debt.

(iv) Planning Opportunities for Existing Non-Exempt Trusts. No GST tax will be imposed on taxable distributions or taxable terminations from non-exempt trusts in 2010. However, making transfers or terminations of these trusts in 2010 could accelerate payment of the GST tax if the GST tax system is imposed retroactively, so this strategy might be appropriate only for non-exempt trusts that will likely terminate in the next several years in any event.

(v) Planning Opportunities for Existing Exempt Trusts. The "had never been enacted" sunset rule may be applied to treat any exemption allocations in excess of the $1.0 million exemption amount (indexed after 1997) or any automatic allocations as having never been made. Distributions from such trusts in 2010 might be considered, as discussed above for non-exempt trusts.

(v) Formula Clause. Formula clauses may be used to make the transfers described above only to the extent they do not generate a GST tax, taking into consideration any retroactive legislation. Various speakers said that such clauses should not be subject to a public policy attack under Procter because they are based on Congressional action, not IRS action and are not designed to discourage IRS audits.

f. Charitable Planning.

(i) Better to Get Income Tax Deduction. This is highlighted in 2010 when there is no estate tax, but it is always better to make lifetime charitable gifts to get an income tax deduction. Similarly, make bequests to children and let them make charitable gifts rather than making direct charitable bequests (assuming children can be trusted to make the charitable contribution).

(ii) Charitable Remainder Trusts. A technical problem exists in creating testamentary CRATs in 2010 because the regulations require that a deduction be allowed in creating the trust for it to be an exempt trust, and no deduction applies this year to testamentary CRTs.

(iii) Charitable Lead Trusts. If a client has made a large bequest to a "zeroed out" CLAT, confirm that the client still wants to make the large bequest to the CLT in 2010 when no estate tax applies. Some clients may want to cut down on the size of the CLT bequest.

(iv) Political Action Committees. Gifts and bequests to political action committees (and other § 501(c)(4) organizations) are not deductible for gift or estate tax purposes. This is not a concern for testamentary bequests to political action committees in 2010 when the estate tax does not apply.

g. Pre-Mortem and Post-Mortem Planning Issues.

(i) Pre-Mortem Harvesting Losses. Depreciation that would be recognized as deductible under §165 if the asset had been sold before death is added to the $1.3 million basis adjustment. However, if there are not enough gains to offset losses, capital losses are only deductible to the extent of $3,000 per year. Furthermore, there is no tacking allowed (under §1223(11)) for depreciated assets where the basis is the date of death value and is not determined by reference to the decedent's basis. Also, there is the possibility of retroactive reenactment of pre-2010 law, and under prior law it always made sense to harvest losses before death to avoid the step down in basis.

(ii) Pre-Mortem Transfer From Spouse to Dying Spouse to Use Basis Adjustments. Assets received from a spouse can qualify for the basis adjustments, regardless when made. (There is a three-year rule requirement for assets received from anyone other than the spouse.)

(iii) Set Expectations Regarding Distributions. Beneficiaries of an estate have two questions: What do I get and when do I get it? Set expectations that distributions will be minimized in 2010. There is substantial uncertainty in light of the possibility of retroactive legislation. Current distributions could lock in planning flexibilities. (An exception to that may be in funding pecuniary legacies. As under current law, post-death appreciation will be treated as gain recognition on funding.) Also, retroactive legislation may change the persons entitled to formula bequests. There should be no distributions under wills with formula bequests until we know "the rest of the story." (Dennis Belcher points out that is another reason why it will harder to impose the estate tax retroactively if Congress waits until late in the year to react.)

(iv) Delay Sales. Consider delaying sales until 2011, because there is the possibility (probably remote) that carryover basis only applies if the assets from the 2010 estate is actually sold in 2010. If the estate tax is reinstituted retroactively, presumably the IRS will be lenient in allowing estate tax payment extensions.

(v) Retain Reserve or Use Refunding Agreements In Case of Law Change. If distributions are made currently, retain a reserve or require refunding agreements to satisfy estate taxes in case the estate tax is enacted retroactively. However, it appears that the executor cannot have liability to the IRS for making distributions at a time that the estate tax does not apply, even if the estate tax is imposed retroactively.

(v) Fiduciary Investment Concerns. Executors will have the tension of fiduciary concerns with holding on to concentrated positions vs. paying income taxes when selling appreciated assets under a carryover basis system. Hedging strategies may be a possibility for some marketable securities.

(v) Compliance. No estate tax returns will be due for 2010 decedents and the carryover basis report under § 6018 will not be due until the due date of the decedent's final income tax return (which could be extended to October 15, 2011). Defer reporting until we have a better idea of how all of this will work out.

(vi) Disclaimers. Disclaimers may be a way to "undo" some unintended bequests under formula clauses in 2010. Jeff Pennell says that "the most common reason disclaimers fail is from inadvertent acceptance. So counsel clients early and often not to accept benefits."

(vii) Elective Share. If the bulk of the estate passes to a non-marital trust, leaving the surviving spouse with few assets, the elective share may be very important as a way of getting assets to the surviving spouse. Counsel should advise the spouse to learn about the elective share. That may also be a way of getting assets to the surviving spouse to qualify for the $3.0 million spousal basis adjustment.

(viii) Carefully Plan Regarding State Estate Taxes. The best strategy, if available, is to make a state permitted QTIP election. Otherwise make calculations of the amount of state estate tax for funding various possible amounts into the credit shelter trust so the client can make the decision of how much to fund to the credit shelter trust (assuming there are strategies to get the remaining assets to pass to the surviving spouse by disclaimers, construction suits, elective share, etc.)

3. Treasury Priority Guidance Plan 2009-2010

Only two new items are on the 2009-2010 Plan: (1) Guidance on whether a nonfiduciary substitution power will cause life insurance policies in the trust to be includible in the grantor's gross estate under §2042; and (2) Guidance under §2801 (as provided in the Heroes Earnings Assistance and Relief Tax Act of 2008 [referred to as the "HEART Act"]) regarding the tax imposed on U.S. citizens and residents who a "covered gift or bequest" from a "covered expatriate."

Treasury officials have informally indicated that items on the current plan likely to be released sooner than other items include: (1) CLT ordering rules, (2) §67(e) regulations, and (3) relief for late GST exemption allocation requests.

a. Little Action in 2009. Jeff Pennell concludes that "the Treasury did virtually nothing last year [on estate and gift tax projects]. I don't fault them for that."

a. CLT Ordering Rules; Adjustments to CLT Sample Forms, §664. The CLT ordering regulations are apparently in the last stages of being finalized. (The IRS may issue some revisions to the CLT Sample Forms. 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.)

b. Does Nonfiduciary Substitution Power Trigger §2042? Jeff Pennell indicates that this is a closer question than the §2036 issue addressed in Rev. Rul. 2008-22, but he thinks the result will be that §2042 is not triggered. There may be a number of caveats imposed, but "don't spin out of control on caveats." Rev. Rul. 84-179 required various caveats regarding a decedent holding incidents of ownership as a fiduciary, but the IRS has never raised them.

c. Protective Claims for Refund; Notice 2009-84. More detail will be provided about the details for filing and perfecting protective claims for refund. Protective Claims for Refund are discussed below.

d. Effect of Guaranties and Present Value Concepts. There will be new guidance regarding the effect of personal guaranties under §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 that result. Cathy Hughes said "that is a fair reading of what we might be looking at."

<u>Graegin Notes</u>. 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."

4. Contingent Claims Against Estates, Final Regulations Under §2503

Final regulations (effective for decedents dying after October 19, 2009) continue the general concept in the proposed regulations of allowing an estate tax deduction under §2053 for nonascertainable or contingent claims only when they are actually paid. Some of the major changes made in the final regulations include: (1) Exceptions are allowed for contingent claims against an estate to offset the value of other assets that comprise at least 10% of the gross estate and for the deduction of contingent claims totaling no more than $500,000 (although these exceptions may not be widely used); (2) Settlements do not have to be proven to be within the reasonable range of settlement outcomes to be recognized; (3) There is no affirmative duty for the executor to report when claimed expenses or claims are not actually paid; (4) Marital or charitable deductions do not have to be reduced on the return by contingent expenses or claims that may be paid out of amounts that would otherwise pass to a spouse or charity if a protective claim for refund is filed regarding that contingent expense or claim; (5) The rebuttable presumption that claims by family members, related entities or beneficiaries are not legitimate and bona fide has been deleted and a non-exclusive list of factors is provided for determining whether a claim by such a person is bona fide; and (6) The concept of allowing only the present value of recurring noncontingent claims has been dropped, but a regulation project considering how present value concepts should be applied to §2053 administration expenses and claims is continuing. In addition, Notice 2009-84 issued in conjunction with the regulations clarifies that the IRS will review only evidence related to a §2053 expense or claim in considering a protective claim for refund under §2053 if the claim for refund "ripens" after the three-year period for assessment of additional estate taxes has run.

5. Protective Claims for Refund

The IRS is in the process of providing further guidance regarding protective claims for refund.

a. Final § 2053 Regulations, §20.2053-1(d)(5).

(1) Timing. The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax).

(2) Identification of Claims. The protective claim for refund must identify each claim or expense and describe the reasons and contingencies delaying actual payment of the claim. (Amounts do not have to be listed.)

(3) Consideration of Protective Refund Claim. The protective claim for refund is considered after the executor has notified the IRS "within a reasonable period that the contingency has been resolved." While no specific time period is specified beyond "reasonable period," the executor cannot delay raising the protective claim with the IRS indefinitely after the contingency has been resolved.

(4) Further Guidance. The preamble to the final regulations indicates that the IRS will issue further guidance on the process of using protective claims for refund. The preamble also indicates that the IRS is considering amending Form 706 to incorporate a protective claim for refund so that a separate form need not be filed.

b. Notice 2008-84. The Supreme Court has held that the IRS can examine each item on a return to offset the amount of a refund claim, even after the period of limitations on assessment has run. Lewis v. Reynolds, 284 U.S. 281, 283 (1932). However, the IRS in Notice 2009-84 agreed that it would limit the review of protective claims for refund to preserve the ability to claim a deduction under §2053 "to the evidence relating to the deduction under section 2053," and not exercise its authority to examine each item on the return to offset a refund claim. The limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." (Accordingly, there may be an advantage in not having resolved the underlying lawsuit regarding the claim against the estate until after the period on additional assessments has run — to the extent that there may be items on other parts of the estate tax return that the IRS might question if it could.)

c. Chief Counsel Advice 200848045. An email subject to the Freedom of Information Act, CCA 200845045, provides a general overview of protective claims, including the following:

- Reg. § 301.6402-2 does not require that a particular dollar amount be asserted but the claim must "identify and describe the contingencies affecting the claim." This requirement "is interpreted liberally by the Service. So long as the claim is sufficiently clear and definite [to] apprise us of the essential nature of the claim, it will be accepted as having met the requirement." This is important because providing too much detail about what makes the claim contingent may give the other side in the litigation insight into the taxpayer's perceived weaknesses in its case.
- The IRS will delay action until the contingency is resolved, suggesting that the IRS will take no action on the protective claim until is provided further information about facts that resolve the contingency.
- A "general" claim may be amended following the running of the statute of limitations to supply missing information that caused the claim to be "general," but an untimely new claim may not be filed after limitations have expired. The distinction is that the

claim is treated as a time-barred new claim "if it would require the investigation of new matters that would not have been disclosed by the investigation of the original claims" or if it assets a different legal ground for the refund.

- A supplemental submission cannot be an amendment (and therefore it is a time-barred new claim) "if the Service took final action on the original claim by rejecting the original claim or allowing it in whole or in part."

6. State Estate Tax Issues

a. State Death Tax Changes. Five states made state estate tax changes last year. Those include Vermont (reducing the state threshold from $3.5 million to $2.0 million), Delaware (reinstating the state estate tax for estates over $3.5 million), Rhode Island (increasing the state exemption from $675,000 to $850,000 to be indexed in future years), Connecticut (increasing exemption from $2.0 to $3.5 million and reducing the rates), and Illinois (permitting state only QTIP election).

b. State Only QTIP Election. Eleven states currently allow state-only QTIP elections: Connecticut, Indiana, Kentucky, Maine, Maryland, Massachusetts, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington.

c. Impact on State Tax of "Full Funding" of Credit Shelter Trust. In states that do not allow a state only QTIP election, if the client has made the decision in the past to leave the entire federal exemption to the credit shelter trust even though that may mean paying state estate tax, the effects of that decision should be revisited in light of the fact that the entire estate may now pass to the credit shelter trust, depending on the wording of the formula bequest. For example, New York has a $1,000,000 state exclusion amount, and the state tax on leaving $3.5 million to a credit shelter trust is $229,200. The client may be very willing to pay $229,200 of tax to be able to get a full $3.5 million in the bypass trust (representing a 6.5% rate of tax on the $3.5 million). However, if the client has a $25 million estate that would pass entirely to a credit shelter trust, the state tax would increase to $3,446,800 (representing a 13.9% tax on the $25 million). The client may decide to leave some, but not all, of the excess of the estate over the $3.5 million amount if the client dies in 2010 when the federal estate tax does not apply.

Currently, 29 states have no state estate tax. In 2001, every state had a state estate or inheritance tax that at least picked up the federal state death tax credit.

7. Family Limited Partnership Issues

a. 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). These regulations have been on the Priority Guidance Plan six years, leading Jeff Pennell to believe that the regulations may be more aggressive than §2704 currently permits, so the IRS is holding back on releasing the regulation until further legislation is passed revising §2704.

The Treasury on May 11, 2009 released the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. Section 2704 would be revised to add a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Disregarded restrictions would include limitations on a holder's right to liquidate that are more restrictive than a standard to be identified in regulations, and any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in an entity. For purposes of determining if restrictions can be removed, certain interests (to be identified in regulations) held by charities or others who are not family members would be ignored. (Kerr v. Commissioner held that requiring the approval of a small charitable interest before the partnership could liquidate was not an applicable restriction, and could be considered in valuing the limited partnership interests. 202 F.3d 490 (5th Cir. 2002).) Regulations could create "safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met." There would be "conforming clarifications" regarding the interaction of the valuation discount restrictions with transfer tax marital and charitable deductions. (This provision is estimated to raise $19 billion over 10 years.)

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 has an excellent general summary of valuation discounts, and addresses the §2704 proposal. It suggests that the regulations allow a broader exception to what is treated as an "applicable restriction" than the statute. The statute says that an "applicable restriction" does not include "any restriction imposed, or required to be imposed by any Federal or State law." However, the regulations define an applicable restriction as a "limitation on the right to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restrictor." The Tax Court viewed the regulation as an "expansion of the exception" in Kerr v. Commissioner, 113 T.C. 449, (1999), aff'd on other grounds, 202 F.3d 490 (5th Cir. 2002). The Joint Committee Staff report speculates that the new standard that would be adopted in regulations "is intended in part to address interpretive concerns that have arisen regarding the present-law exception for restrictions that are imposed or required to be imposed under State or Federal law. The proposal, however, does not provide information from which one could determine what such a regulatory standard might include or whether such a standard might also be intended to address other concerns."

The Joint Committee Report observed various possible objections to the proposal: (1) It does not specify or adequately describe the liquidation restrictions that will be disregarded, and leaves the key aspects to future regulations; (2) the IRS already has broad statutory authority to issue new regulations and further legislation is premature and unnecessary; (3) it only targets marketability discounts arising from liquidation restrictions, and a broader approach would be preferable, because "taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions;" and (4) it does not directly address minority discounts and other proposals (e.g., the 2005 Joint Committee Staff proposal and H.R. 436) address "excessive minority discounts more directly through aggregation of certain interests."

The President's Fiscal Year 2011 Budget Proposal contains the same proposal.

There WILL eventually be substantial further tightening of §2704 and the availability of FLP discounts, either by this proposed legislation or by the issuance of regulations pursuant to the broad authority in the current statute (§2704(b)(4)).

Observations from Ron Aucutt at ABA Tax and Real Property, Trust and Estate Law Sections Joint Meeting in September, 2009:

- "Here's what I think: The regs are almost nearly drafted and someone thinks they need more statutory cover for some of the bolder provisions."
- The effective date will be date of enactment. The regulations will be issued very quickly in proposed form and there will be a firestorm of comments. There will be final regulations within 18 months, and under §7805(b)(2) such regulations could be retroactive to the date of enactment.
- Providing conforming adjustments for marital and charitable deductions is a welcome development. Perhaps this will override the harsh "reverse-Chenowith" result.

Cathy Hughes, with the Treasury Department, indicated in the fall of 2008 and in early 2009 that these new regulations will be out soon and that this regulation project is "at the top of the list." However, at the ABA Tax and Real Property, Trust and Estate Law Sections Joint Meeting in September, 2009, Cathy indicated that these regulations will not be released pending possible action on the "Greenbook" proposal to tighten §2704 (which will depend in large part on regulations to provide new standards for judging liquidation restrictions).

Summary of Practical Planning "Takeaways"

- Implement transfer planning now to utilize appropriate discounts. Clients should not anticipate that they will be entitled to substantial estate tax discounts at their subsequent deaths for FLP interests. Future legislation and/or regulations may significantly curtail FLP discounts by the time the client dies.
- There is a window of opportunity for transfer planning with FLP discounts. This conceivably could continue until the fall of 2010 (or even later), depending on how quickly Congress acts with respect to the §2704 proposal in the 2009 and 2010 Greenbooks (i.e., the Fiscal Year 2010 and 2011 Budget Proposals). It is likely that estate and gift tax reform measures (beyond just extending the 2009 system) will not be considered independent of a comprehensive tax package, and that will probably not be considered until late in the year, perhaps even after the November elections. If Congress delays inordinately or refuses to tighten the §2704 statutory scheme, the IRS may at some point issue the regulations they have been working on. However, the inclusion of the §2704 proposal in the 2009 and 2010 Greenbooks has apparently provided a significant additional window of time to implement transfer planning with discounted FLP interests.

b. Section 2036 Cases in 2009.

(i) Estate of Jorgensen, T.C. Memo. 2009-66; Section 2036 Applied to Creation of FLPs; Equitable Recoupment Allowed. Section 2036 applied. While the decedent retained assets for her day-to-day living expenses, other facts were pretty bad — (1) there was no evidence of why one FLP was created but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the decedent had control of the

FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts). Particularly notable aspects of the §2036 analysis include:

- This is yet another case where the court pointed to post-death payments of estate taxes as reflecting an implied agreement of retained enjoyment of partnership assets to trigger §2036;
- In rejecting the "bona fide" transfer defense, the court found "especially significant that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities;" and
- In dictum, the court observed that §2036 applied even as to assets attributable to partnership interests that the decedent gave to her children and grandchildren more than three years prior to her death, reasoning that the decedent "retained the use, benefit, and enjoyment of the assets she transferred to the partnerships." (This is consistent with the results in Bigelow, Korby, and Rosen. As discussed below, this conclusion would not seem proper if the decedent does nothing to suggest that the decedent has an implied agreement to be able to reach assets of the partnership attributable to the partnership interests that have been transferred.)

Jeff Pennell comments that in Jorgenson, the taxpayer was doing everything wrong. "In Murphy [discussed below] I can't understand why the IRS litigated. In Jorgensen, I can't understand why the taxpayer litigated."

In addition, under the equitable recoupment doctrine, the Tax Court allowed an offset in the estate tax liability for the "overpayment" of income taxes, where a refund of the income tax was barred by limitations and where the prior income tax payments did not reflect the increased bases as a result of the increased value included in the decedent's estate under §2036.

(ii) Estate of Miller v. Commissioner, T.C. Memo 2009-119; Taxpayer §2036 Partial Victory Based on Non-Tax Purpose of Providing Active Management of Portfolio; For Additional Contributions Made Days Before Death, Court Looked Primarily to Post-Death Distributions to Pay Estate Taxes as Triggering §2036(a)(1) Inclusion. The bona fide sale for full and adequate consideration exception to §2036 applied to transfers of marketable securities to an FLP made about 13 months prior to the decedent's death. The court concluded that there were legitimate and significant nontax reasons for the contributions to the partnership, finding credible the witnesses' testimony "that the driving force behind decedent's desire to form [the FLP] was to continue the management of family assets in accordance with Mr. Miller's investment strategy." The court emphasized that there was active management of the partnership's assets by the decedent's son as the general partner (even though son worked 40 hours a week, the actual trades were rather small, resulting in a turnover of only about 1% of the partnership's assets each year), that there was a change in the investment activity after formation of the FLP, and that the decedent retained sufficient assets for living expenses. (Apparently, the son was also trustee or co-trustee of his mother's revocable trust.)

The court refused to apply the bona fide sale exception to additional contributions to the FLP made only 13 days before the decedent's death following very serious health problems, finding that "the decline in her health and the decision to reduce her taxable estate were clearly the driving forces" behind the subsequent contribution of assets to the FLP. As to those assets, the court held §2036(a)(1) applied, primarily pointing to pro rata post-death distributions from the partnership 8 months after the date of death, where the estate used its 92% pro rata portion of the distributions to pay estate taxes. The court also observed (after a detailed discussion of the post-death distributions for paying estate taxes) that the additional contribution was almost all of the decedent's assets and that an implication arose that the assets would be made available to her for living expenses if needed.

- Investment Management. There has been a growing trend of cases that look to investment management as a legitimate and significant non-tax purpose. If the purpose is to involve next generation family members in management (examples include Stone and Murphy), be sure to do it.
- Transfer All Assets. The court viewed the transfer of all remaining assets (in the second death-bed transaction) not only to find retained enjoyment but also in determining that there was not a legitimate non-tax reason so the bona fide sale exception did not apply. (Contrast this with Black, below.)
- Post-Death Distributions. John Porter points out that this is the FIRST time the Tax Court has held that, where there were NO distributions during life, the pro rata distribution of assets after death was evidence of a retained right to possession or enjoyment under §2036(a)(1).

(iii) Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009); $40 Million Taxpayer Victory; Partnership Recognized Although Not Formally Funded Before Decedent's Death; 47.5% Discount Allowed For Assignee Interest in Limited Partnership Holding Bond Portfolio; Bona Fide Sale Exception to Sections 2036 and 2038 Applied; Interest on Loan to Borrow Money From Partnership After Death to Pay Estate Taxes and Other Obligations Is Deductible For Estate Tax Purposes. In this estate tax refund case (published about 2 ½ years after a four-day trial), the decedent signed a partnership agreement and expressed the intent to fund the partnership with a specifically identified bond portfolio and cash, but the funding did not formally occur before her death. The decedent died unexpectedly, so the planner put the funding on hold for about a year until one of the planners heard about the Church case, which had recognized a partnership that similarly had not been formally funded at the decedent's death. The planners "sprang into action" and completed the formal funding transfers and the estate filed an estate tax return reporting the partnership interests (without a discount) and reporting about $143 million of estate tax. The estate later filed a claim for refund for about $40 million of estate tax.

- Intent to Fund Constituted Funding. The court concluded that the decedent had expressed the clear intent to fund the partnership with the identified assets, and under Texas law that caused the assets to become partnership assets.
- Non Tax Reason: Divorce Protection and Facilitating Administration. The bona fide sale exception to §§2036 and 2038 applied because the partnership

was genuine, there was a legitimate business purpose for the partnership (protecting family assets from divorce proceedings and facilitating the administration of family assets) and because she retained significant assets outside the partnership.

- 47.5% Discount. The taxpayer's valuation expert's value was accepted, representing a 47.5% discount. (The IRS's expert's opinion was rejected because it violated several of the tenets of the hypothetical buyer and seller standards, including considering the true identities of the buyer and seller, speculating as to future events, and aggregating the interests of the various owners.)
- Interest on Estate Borrowing from FLP Deductible. The estate borrowed $114 million from the partnership to pay estate taxes and other debts. The interest on the 9-year loan was deductible for estate tax purposes because the interest expense was actually and necessarily incurred in the administration of the estate.

Carol Harrington's summary: "The fact she died before all the little details were completed did not keep them from getting a big whopping discount." Jeff Pennell's favorite statement from this opinion: "Although the exact amount of the expenses are not known by the court, the court finds them to be permissible."

(iv) Estate of Malkin v. Commissioner, T.C. Memo. 2009-212; IRS Defeats Aggressive FLP Planning; Issues Involving §2036, Indirect Gifts, and Sham Sales and Loans. The case involves the creation of and sales of interests in two different FLPs to two different sets of trusts for decedent's son and daughter. Decedent was the sole general partner of both FLPs. The decedent contributed about $16.8 million worth of "D&PL" shares to the first FLP ("MFLP"). After the partnership was funded and limited partnership interests were sold to trusts for the children, decedent was diagnosed with pancreatic cancer. About one year after funding the FLP, the partnership pledged almost all of its assets toward a personal debt of decedent, and decedent paid a small fee to the partnership (0.75%) for doing so. Those shares were included in the estate under §2036; the pledging was evidence of an implied agreement of retained enjoyment, and the purported non-tax purposes did not meet the bona fide sale exception to §2036.

Contributions of some D&PL stock and various LLC interests to the second FLP ("CRFLP") were also subjected to transfer tax without a partnership level discount. The D&PL shares were contributed subject to a personal liability of decedent, and that evidenced an implied agreement of retained enjoyment under §2036. Contributions of decedent's interests in the LLCs to CRFLP were treated as indirect gifts of the LLC interests themselves (with no FLP level discount). The trust partners were deemed to be partners before the funding. The court viewed purported sales of limited partnership interests to the trusts as sham transactions and treated the transfers as gifts; therefore the LLC interests were treated as indirect gifts to the trusts. Subsequent contributions to the LLCs (in which the decedent no longer owned a direct interest) were treated as indirect gifts to the decedent's children.

Various cash loans to decedent's children were treated as gifts because there was no expectation of repayment. The estate was insolvent at decedent's death, and deductions were allowed only up to the amount of assets subject to claims. (For purposes of determining the assets subject to claims, the court made clear that there should be no "double inclusion" and that decedent's interest in CRFLP that he retained at his death should be determined without including any of the D&PL stock in that partnership that was included in the estate under §2036.)

(v) Estate of Murphy v. U.S. Case No. 07-CV-1013 (W.D. Ark. El Dorado Division October 2, 2009); Total Taxpayer Victory in FLP Case Involving §2036, Rule 144/Blockage Discounts, FLP Discounts, and Graegin Loan. Among other assets, decedent owned substantial interests in a publicly traded oil company (he served as CEO and Chairman of the Board), a timberland and farmland company, and a bank. Decedent formed an FLP to centralize management and protect against dissipation of those family assets, and transferred his interests in the three companies (worth about $90 million) to the FLP (directly or through the LLC that was the general partner). (The concern about dissipation arose because two of decedent's four children had pledged and sold many of the family assets that had previously been given to them. The other two children shared decedent's philosophy and participated in the FLP planning and operations.) Decedent retained assets worth about $130 million. Decedent, individually and as trustee of several revocable trusts, acquired a 96.75% limited partnership interest. A new LLC, owned 49% by decedent and 51% by two of his children, held a 2.25% general partnership interest. At decedent's death, he owned a 95.25365% limited partnership interest in the FLP, and the LLC owned a 2.28113% general partner interest. John Porter tried this case.

- Preserving Family Legacy Asset. The transfer to the FLP satisfied the bona fide sale exception to §2036; the non-tax purpose was preserving and protecting the important family legacy asset. There was one non pro rata distribution; but it was for the redemption of some of the decedent's stock so it was not nefarious.
- Valuation. The value of the limited partnership interest is calculated by first determining the net asset value of the FLP's assets (including taking into consideration Rule 144 and blockage discounts), and by applying a 41% discount for the limited partnership interests. The value of decedent's 49% interest in the LLC, which is the general partner of the FLP, is determined by applying two levels of tiered discounts, for an overall discount of 52% of the nest asset value.
- Graegin Note Interest Deduction Allowed. The estate is allowed an estate tax deduction for all of the interest on a 9-year Graegin note for amounts borrowed from the FLP and for the interest actually paid on another note, reasoning that the court would not set aside the business judgment of the executor. The proceeds of the loans were used to pay federal and state estate taxes.

The case was tried in a federal district court bench trial, in a courthouse that was one block away from the Murphy business, which was very well known in El Dorado, Arkansas.

(vi) Estate of Black v. Commissioner, 133 T.C. No. 15 (Dec. 14, 2009); FLP Taxpayer Victory: "Buy and Hold" Investment Policy Satisfies Section 2036 Bona Fide Sale Exception. Husband and Wife died within five months of each other, after Husband was the second largest shareholder in a thinly traded public company. Husband had created an FLP eight years earlier. Husband had previously made gifts of some of the company's stock to his son and to revocable trusts for his two grandsons. Husband was concerned about the son or grandsons eventually disposing of the stock and planners advised that they all contribute their stock to an FLP in order to protect Husband's buy and hold investment philosophy with respect to the stock. (John Porter describes the stock as the "goose that laid the golden egg for the family" and that the block of stock was the swing vote between fighting factions of the founder's family.) The IRS argued that §2036 applied to the transfers by Husband to the FLP, causing a pro rata portion of the FLP assets to be included in Husband's gross estate. The IRS argued that the amount of marital deduction available in Husband's estate would be limited to the discounted fair market value of the FLP interests (which apparently were the only assets that could be used to fund the marital bequest). (This is sometimes referred to as the "marital deduction mismatch issue.") There were also disputes about the deemed funding date of the Marital Trust (which was not funded before Wife died), and the availability of administrative expense deductions in Wife's estate. John Porter represented the estates in the tax litigation.

- Trial. John Porter indicates that the case was tried in November 2007. The IRS attorney was the same attorney who tried and lost the similar Schutt case.
- Discounts Settled. John Porter indicates that valuation issues were settled, concluding there was a 12% blockage discount for the stock in the FLP (for thinly traded stock) and a 32% combined lack of control/marketability discount for the limited partnership interest.
- Buy and Hold Investment Philosophy. The Tax Court (in this "regular" Tax Court decision) held that the bona fide sale for adequate consideration exception to §2036 applied, primarily relying on the buy and hold investment philosophy as the nontax reason for creating the FLP.
- Divorce Protection. Another reason, in addition to preserving the family legacy asset, was the concern over divorce of the decedent's son. Some other courts have said that potential divorce concerns and the protection of an FLP in divorce is just theoretical. In this case, the son's divorce attorney testified that having the stock in the FLP helped in the divorce negotiation, and the parties realized they could not get to assets inside the FLP.
- Business Purpose Not Needed. Black (as well as Miller) emphasizes that having an investment purpose is sufficient, and it is not essential to have a "business purpose." (Mil Hatcher puts it: "Judge Laro is retired.") That has been a trend in recent years, and it is nice to see cases explicitly say so.
- Predominant Reason Test? Mil Hatcher is concerned that the IRS argued that the taxpayer must show that the non-tax reason is the "predominant" reason for forming the FLP, not just a "legitimate and significant" reason. (This concern was certainly justified in light of the Shurtz case issued after the

Heckerling Institute in which the court stated explicitly that tax savings cannot be the "predominant motive." See Item 7.b.(vii) below.)

- Not Retaining Assets to Pay Estate Taxes Relevant to Retained Enjoyment Issue But Not A Factor For Bona Fide Sale Exception. Footnote 12 of Black makes clear that whether the decedent retained sufficient assets to pay estate taxes and fund bequests relates to whether there was a retained interest under §2036(a)(1) but is "inapposite to the bona fide sale question." Mil Hatcher views that as a "big takeaway" from Black.
- Marital Deduction Mismatch. Because §2036 did not apply to Husband's estate, the court did not have to address the marital deduction mismatch issue in Husband's estate.
- Gifts Made Within Three Years. The IRS did not raise the potential §2035 issue with respect to gifts of partnership interests within three years of Husband's death. The "bona fide sale for an adequate and full consideration" exception would not have applied to the gifts.
- Deemed Funding of Marital Trust. The stock (and therefore the FLP interest) increased in value in the five months between the two spouses' deaths, and the court agreed with the estate that the Marital Trust would be deemed to have been funded on the date of Wife's death. (Therefore, fewer units were allocated to the Marital Trust than if the trust had been deemed funded at Husband's death.)
- Graegin Note Interest Not Deductible. The $20.3 million of interest on the Graegin note was not deductible; the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly).
- Administration Expenses for Estates in Quick Succession. Only the portion of the selling expenses attributable to funds needed by the estate for paying federal and state estate and income taxes was allowed as an estate tax deduction. Executor fees and legal fees were allocated equally to Husband's and Wife's estate and only the one-half allocated to Wife's estate could be deducted on her estate tax return to offset the substantial estate taxes payable from her estate.

Regarding the Graegin analysis, the court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution. Of course, had it done so, that might have been a factor suggesting the existence of a §2036 retained interest. This raises the issue of the tension that exists between using distributions or redemptions to get liquidity to the estate (raising potential §2036 concerns) or borrowing from the partnership (raising the interest deductibility issue).

(vii) Estate of Shurtz, T.C. Memo. 2010-21; Bona Fide Sale Exception to §2036 Applied Based on Asset Protection and Facilitating Management Concerns; Marital Deduction Mismatch Issue Avoided. Wife and her brother and sister owned undivided interests in family timberland that they contributed to a limited partnership (Timberlands L.P.) in 1993 to facilitate management of the timberland. They were also concerned about "jackpot justice" that existed in Mississippi and an attorney advised that each of them should contribute their limited partnership interests in Timberlands L.P. to their own respective limited partnerships to help assure that if the business were sued they would not lose control of the family business. Wife owned some additional timber interests. She wanted to make gifts of interests in the timberland to her descendants and was concerned about management of undivided interests that would exist if she made gifts of undivided interests in the timberland. In 1996, Wife made a gift of a small undivided interest in the timber to Husband, and Wife and Husband created their own family limited partnership (Doulos L.P., sometimes referred to as "Doulos"). Husband's undivided interest in the timber was valued by an accountant to be equal to a 1% general partnership interest in Doulos. Wife contributed the rest of the land and her 16% limited partnership interest in Timberlands, L.P. to Doulos in return for a 1% general partnership interest and a 98% limited partnership interest. After creating the partnership, Wife made annual exclusion gifts to her children and trusts for her grandchildren. (There were 26 gifts of 0.4% interests — each valued at $19,700 or less— between 1996 and 2000.)

Partnership formalities were not always followed perfectly. Instead of maintaining "books of account," as required by the partnership agreement, the accountant created "work papers like a trial balance" to prepare the partnership's tax returns. There was a four month delay in opening a partnership bank account. Because the partnership bank account was a money market fund with limited checks that could be written each month, Husband and Wife paid some of the partnership expenses and were reimbursed (and amounts that were not reimbursed were added to their capital accounts).

In addition, there were some disproportionate distributions. Distributions were made just to Wife in 1997 and to Husband and Wife in 1999. A disproportionately large distribution was made to Wife in 2000. The partnership made up the missed distributions in subsequent years. (Other than mentioning the formalities discrepancies in the facts, the court did not comment on them further. Apparently, they were not a significant concern to the court.)

The estate plan of Husband and Wife included a bequest to a credit shelter trust and a formula marital deduction bequest at the first spouse's death. Wife died on January 21, 2002. The estate tax return was filed 8 months after the extended due date. (The planners believed no tax was due because of the marital deduction so were not concerned about failure to file penalties.) The major assets in Wife's estate were her 87.6% limited partnership and 1% general partnership interests in Doulos, but there were $1.5 million of other assets. (The opinion does not reflect how much discount was claimed on these interests. The estate may have claimed a dual level "tiered" discount for the Timberlands L.P. interest that was held within Doulos L.P. The estate valued that 16% interest at about $10.0 million and the IRS valued it at about $13.3 million.)

The IRS argued: (1) Section 2036(a)(1) and (a)(2), combined with §2035 (apparently for gifts of limited partnership interests that were made within 3 years of Wife's death) applies to the assets of Doulos; (2) If §2036 applies, the marital deduction is limited to the fair market value of the limited partnership interest; and (3) Failure to file penalties apply under §6651(a)(1).

The court (Judge Jacobs) held that the bona fide sale exception to §2036 applied, so the partnership assets were not includible in the estate under §2036(a)(1) or (a)(2). Therefore, the court did not have to address the "marital deduction mismatch" issue and there were no late filing penalties.

- Bona Fide Sale Requirement. The bona fide sale test was met primarily because of two "legitimate and significant nontax reasons."
  1) Threat of Litigation. Wife and her siblings had a legitimate concern about preserving the family business, their "concern regarding the threat of litigation… went beyond mere speculation," establishing limited partnerships was a "customary response in Mississippi to possible lawsuits," and the partnership agreement was "designed to limit the exposure of partnership interests from seizure and the automatic conversion of general partnership interests to limited partnership interests." This reason was given primarily to justify the need to transfer the Timberland L.P. interests into Doulos. (Presumably, it would also be applicable to the timberland contributed to Doulos.)
  2) Facilitate Management. Having multiple undivided ownership interests in timberland impeded management of the farmlands owned by Wife and her siblings, and it was reasonable for Wife to form Doulos to provide management efficiency with respect to directly owned farmland in which she wanted to give interests to her descendants. Wife and Husband were consulted before any major decisions were made, and "business activities occurred with respect to the timberland." (The court cited cases indicating that providing management is not a recognized nontax reason where there is no need for management. However, it is a recognized reason even though only a portion of the assets need management (the court calculated, based on the IRS's valuation of the assets of Doulos, that the directly owned timberland was 15.8% of the value of Doulos).
  3) Conclusion. "[A]lthough we recognize that reducing estate tax was a motivating factor in establishing Doulos L.P., decedent had valid and significant nontax reasons for establishing the partnership."
- Full and Adequate Consideration. The parties met the tests described in Bongard. (1) Contributors received interests in the partnership proportionate to the assets that each contributed. (2) Contributions were properly credited to capital accounts. (3) Distributions were subtracted from the respective capital accounts. (4) "Fourth, and most importantly, we have found the presence of a legitimate and significant nontax business reason for the establishment of Doulos L.P…"
- Section 2036(a)(1) and (a)(2) Not Considered. Because the exception applied, the court did not have to address whether §§2036(a)(1) and (a)(2) applied. The court does not describe the IRS's arguments for alleging that those sections applied. (Wife's estate tax return listed $1.5 million of assets in addition to the interests in Doulos.)
- Marital Deduction Mismatch Not Addressed. Because §2036 did not apply, the court did not have to address whether large estate taxes would be due at Wife's death because the marital deduction would be limited by the value of the

partnership interests passing to Husband. (The IRS raised this same issue in Black.)

- No Penalties. Because no tax was due, there were no failure to file penalties.
- Observations.
  - 9th Circuit. The case is appealable to 9th Circuit Court of Appeals.
  - Tell a Good Story. This is another winning case for taxpayers where the estate had a "good story" to tell of missionaries who lived modestly and donated almost $1.0 million to charity between 1989-2001.
  - Formalities. Litigators indicate that the IRS scours partnership agreements to see if all formalities under the agreement are followed. Apparently that happened here, and the IRS complained that the partnership kept "work papers" instead of "books of account," waited four months to set up a bank account, and allowed the spouses to pay some partnership expenses for which they were later reimbursed or had adjustments to their capital accounts. The court did not seem concerned about these minor "glitches." Be aware that the IRS looks for glitches and will point them out.
  - Non Pro Rata Distributions. Some non pro rata distributions were made to Wife in several years and to Husband and Wife in one year. However, the partnership "made up the missed distributions in subsequent years." If possible, avoid non pro rata distributions. If they are necessary, make up the missed distributions as soon as possible.
  - Arm's Length Requirement. The case very clearly states that to meet the bona fide test, not only must there be "legitimate and significant nontax reasons" and proportional interests received with capital accounts but there must be "an arm's length transaction." The court says (quoting Bongard) that means the transaction is "carried out in the way that the ordinary parties to a business transaction would deal with each other." Despite stating that there is a separate arm's length requirement, observe that in this case there were *not* significant contributions by others. Wife made a small undivided interest in farmland gift to Husband, just because of the requirement of having multiple partners to create a partnership. Husband contributed that undivided interest for a 1% general partnership interest. Therefore, the court's statement of a separate arm's length requirement should not be interpreted to require having significant contributions to the partnership by other partners. Indeed, the court summarized at the end of its analysis of the exception to §2036 that the partnership was formed in the way ordinary parties to a business transaction would deal with each other. According to this court, that is what the "arm's length transaction" requirement means.
  - Nontax Reason Is Predominant Reason. The IRS argues that the nontax reason must not only be a legitimate and significant reason, but must be the "predominant" reason for creating the partnership. (It made this same argument in Black.) The court explicitly agreed with that argument, stating directly that "[a] finding that the transferor sought to save estate taxes does not preclude a finding of a bona fide sale *so long as saving estate taxes is not the predominant motive.*" The case cites Mirowski and Schutt. (Neither

of those cases directly stated that the tax reason must not be the predominant reason.) This suggests that if there are nontax reasons that represent 49% of the reasons for creating a partnership but tax reasons represent 51% of the reasons, the bona fide sale exception would not be satisfied. *This is a new development, and is an extension of the Tax Court's nontax reason test in Bongard and all prior §2036 cases.*

- Bona Fide and Full Consideration Tests are Interrelated. This case continues the approach of other cases in saying that the bona fide test and full consideration tests are interrelated, citing Bigelow (9th Circuit). The bona fide test requires that proportionate interests be received for contributions in addition to having a legitimate and significant nontax reason, and the full consideration test requires "most importantly" the presence of a legitimate and significant nontax business reason" in addition to the partners receiving proportionate interests and having properly maintained capital accounts. This is merely a matter of semantics; as a practical matter there must be both legitimate and significant nontax reasons (as well as, according to this case and some others, an arm's length transaction) and proportionate interests with properly maintained capital accounts to satisfy both legs of the exception. (In addition, according to this case and some others, there must be an arm's length transaction.)
- Active Business Not Required. Like the recent Black case and various other cases, the court went out of its way to point out (in footnote 11) that an FLP may be recognized "even if it does not conduct an active trade or business."
- Convey an Interest to Persons Involved in Management. As a planning pointer, the court observed that Husband was involved in management and he acquired an ownership interest in the business. It cited Kimbell as a situation where giving the son, who managed the business, an ownership interest "was a factor in finding that a bona fide sale occurred."
- Facilitating Transfers. Some cases have stated that facilitating transfers can never be a legitimate and significant nontax reason. For example, the 9th Circuit Court of Appeals reasoned:

  > "The Estate also argues that consolidation of the real property, with its fractionalized interests and absentee ownership, into an FLP facilitated management of the Padaro Lane property and enhanced the ease of gifting interests to decedent's children and grandchildren. The Tax Court correctly rejected this claim. First, gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification." Estate of Bigelow, 503 F.2d 955 (9th Cir. 2007), aff'g same reasoning in, T.C. Memo. 2005-65.

- This is a case (like some others) where a prime reason was to facilitate management, but this was in light of Wife's desire to make gifts of undivided interests in the timber to her children and grandchildren. But for those gifts, Wife would have continued to own all of the timberland that she owned directly, and no management concerns over having undivided interests would have existed for her lifetime. Even though it was not stated explicitly, the concern over management was really a concern for management to facilitate gifts. (The estate in Keller listed making it easier to pass assets from generation to generation as one of the purposes of the partnership, in addition to divorce protection concerns.)

- Never a Good Idea to File Late. This case is a good example of why it is never a good idea to file the estate tax return late intentionally, thinking that there is no tax due so no penalties could apply. If the IRS had been successful in its §2036 and marital deduction mismatch argument, there would have been large failure to file penalties.
- Tiered Discounts. While the court does not explicitly address whether tiered discounts were allowed, the facts hint that they were. This is similar to Murphy and Astleford which also allowed tiered discounts where an FLP owned an interest in another partnership or LLC.
- Annual Exclusions Not Contested. Even though there were 26 annual exclusion gifts of limited partnership interests over five years, the IRS did not contest the availability of the annual exclusion. We can anticipate that the IRS will be looking more closely at annual exclusions for gifts of limited partnership interests in light of the Price case.

c. Indirect Gift/Step Transaction Cases in 2008-2009.

(i) 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 interests, and they made gifts of most of their limited partnership units six days later. The court's primary test was there is a "real economic risk of a change in value" of the Dell stock (and the value of the limited partnership interests) between the time of funding and the time of the transfer.

(ii) Gross, T.C. Memo 2008-221. The same judge who wrote Holman again rejected the IRS's indirect gift argument where the gift was made at least 11 days after various publicly traded stocks were contributed to the partnership. The court concluded that was long enough where the contributions to the partnership consisted of a portfolio of "heavily traded, relatively volatile" stocks.

(iii) Linton v. U.S., 104 AFTR2d 2009-5176 (W.D. Washington July 1, 2009); Contributions of Property to LLC and Gifts of LLC Interests on the Same Day Treated as Indirect Gifts and as Step Transactions to Eliminate Any Discounts for Gift Tax Purposes. The court found factually that undeveloped real property, cash, and municipal bonds were contributed to an LLC on the same day that gifts of LLC interests were made to a trust (also created on that same day for the donor's children). (Despite factual testimony as to the intended dates of the gifts, the trust agreement itself stated that the gifts of LLC interests to the trust were made "[a]t the time of signing of this Agreement" and the trust agreement was signed on the same date as the date of the contributions.) In a gift tax refund action, the court upheld the government's motion for summary judgment, finding that no discount should be allowed with respect to the LLC interests. The gifts constituted indirect gifts of the underlying assets (the facts are particularly similar to those in Senda where the contribution and gift occurred on the same day and the facts did not make clear which occurred first).

The most significant impact of this case is its analysis of how the step transaction doctrine applies to gifts of partnership or LLC interests. Although not necessary to grant the government's motion for summary judgment, the court also added that the step transaction would apply. The court repeated all three of the alternative tests for the step transaction doctrine from income tax cases that were mentioned in Holman and Gross and concluded that all three tests would apply. The court's reasoning regarding especially the last two tests was very broad and might leave open an argument by the IRS in future cases that the step transaction doctrine could apply to gifts of partnership or LLC interests made long after the time that the entities are funded. (For example, the court concluded that the "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result," is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability.") The court distinguished Holman and Gross because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. The court specifically observed that the assets involved in this case (real property, cash, and municipal bonds) were not as volatile as the assets involved in Holman and Gross.

(iv) Heckerman v. U.S., 104 AFTR2d 2009-5551 (W.D. Washington July 27, 2009); Indirect Gifts and Step Transaction. This gift tax refund case is very similar to the Linton case decided in the same federal district court (though by a different judge). Not surprisingly, the Heckerman case reaches a very similar result, holding that the indirect gift and step transaction principles applied.

Non-Tax Purpose. The Heckerman case specifically addressed the importance of the non-tax purpose element to balance between "tax avoidance" and "tax evasion," depending on whether there is an "independent purpose or effect" in addition to the tax savings. While the §2036 cases invariably focus on whether there are "legitimate and significant non-tax purposes" for transferring assets to an FLP or LLC, that issue has not been applied previously to the gift tax arena.

(v) Summary From Linton/Heckerman. Jeff Pennell concludes that Linton and Heckerman are merely articulating an equitable doctrine, and applying a sense of justice to reach the right result. He thinks that applying a detailed analysis of the three tests from the income tax step transaction cases is not helpful. As a planning matter, he says, it does not help to do thinking about how to avoid any of those three tests. What is important is that there be a delay between the creation/funding and transfers of ownership interests, and that a delay of as little as 15 days is probably safe. "That's all I take out of these cases." [I hope that is all that future courts take out of these cases as well, because the reasoning is outrageously overly broad.]

(vi) Planning Observations. Carefully document that assets are transferred to the entity before transferring interests in the entity. How long to wait? Mil Hatcher has always thought 30 days is appropriate. That may be more than is required for volatile stocks. He suggests that other things can be done besides just building in a delay. (1) Do not finalize what gifts will be made until after the partnership is funded. (2) Wait on drafting documents that will receive assignments of partnership interests until after the funding is completed. (3) John Porter suggests attaching a schedule of assets to the partnership agreement when it is signed. Those become partnership assets even before they are legally transferred, although John prefers to have all legal titles transferred before making transfers of partnership interests. Lee Schwemer (Supervisory Attorney, Estate Tax, Internal Revenue Service) believes that the IRS's focus on indirect gifts will be cases where there is no separation between the funding of the partnership and making gifts of interests. After that case law develops we will see cases where there is some separation.

d. <u>Annual Exclusion Case; Price v. Commissioner, T.C. Memo. 2010-2</u>. Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts that will qualify for the gift tax annual exclusion. There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term reasonable rate of return. Perhaps most interesting is that the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the Hackl, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002. Clearly, the annual exclusion issue is "in play" and the availability of the annual exclusion for limited partnership interest transfers cannot be assumed.

Several drafting suggestions will assist in countering the court's objections. Alternatives include:

(1) Do not include a prohibition on transfers but provide that any transferee will be subject to a right of first refusal, with reasonable time limits;

(2) Do not explicitly favor reinvestments over distributions in the partnership agreement;

(3) Make distributions every year and "regularize" distributions (although this may make §2036(a)(1) inclusion more likely if the parent retains interests in the partnership or LLC);

(4) Mandate distributions of "net cash flow" (although the IRS may also argue that this is an indication of an implied agreement of retained enjoyment under §2036(a)(1));

(5) Specify that the general partner/manager owes fiduciary duties to the other partners/members;

(6) Give donees a Crummey withdrawal power with respect to gifts of limited partnership interests that would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift (this is obviously an unusual provision to be in a partnership agreement); and

(7) Give donee-partners a limited period of time to sell the interest to the partnership for its fair market value, determined without regard to the existence of the put right; this provision could be included in a conditional assignment that is subject to the transferee being allowed to require the donor or the partnership to substitute income producing property equal in value to the value of the donated partnership interest. If the put option is used, some panelists prefer giving the partnership the obligation to purchase the interest, but that would require that the partnership be a party to the assignment agreement if the put option is placed in the assignment. (The provision could also say that the partnership would have the first option to purchase the partnership interest but if it did not exercise the option, the donor would have to buy the interest.)

Jeff Pennell says that he once asked an IRS field agent why agents go after annual exclusions when truck loads of value pass out of estates through discounts. The response: "These are the cases we can win."

e. <u>"Scorecard" of §2036 FLP Cases (11-19, With 2 on Both Sides)</u>. Of the various FLP cases that the IRS has chosen to litigate, eleven have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — <u>Church</u> (preserve family ranching enterprise, consolidate undivided ranch interests); <u>Stone</u> (partnerships to settle family hostilities); <u>Kimbell</u> ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); <u>Bongard</u> (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); <u>Schutt</u> (maintaining buy and hold investment philosophy for family du Pont stock); <u>Mirowski</u> (joint management and keeping a single pool of assets for investment opportunities); <u>Miller</u> (continue investment philosophy and special stock charting methodology); <u>Keller</u> (protect family assets from depletion in divorces); <u>Murphy</u> (centralized management and prevent dissipation of family "legacy assets"), <u>Black</u> (maintaining buy and hold investment philosophy for closely held stock), and <u>Shurtz</u> (asset protection and management of timberland following gifts of undivided interests). In every FLP case resulting in taxpayer successes against a §2036 attack the court relied on the bona fide sale exception to §2036.

Interestingly, four of those eleven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the <u>Miller</u> case and authored the Tax Court's opinion in <u>Bongard</u>. Judge Chiechi decided both <u>Stone</u> and <u>Mirowski</u>. (Judge Wherry decided Schutt Judge Halpern decided <u>Black</u>, Judge Jacobs decided <u>Shurtz</u>, and <u>Church</u> and <u>Kimbell</u> were federal district court opinions ultimately resolved by the 5th Circuit. <u>Keller</u> and <u>Murphy</u> are federal district court cases.)

Including the partial inclusion of FLP assets in <u>Miller</u> and <u>Bongard</u>, 19 cases have applied §2036 to FLP or LLC situations: <u>Schauerhamer</u>, <u>Reichardt</u>, <u>Harper</u>, <u>Thompson</u>, <u>Strangi</u>, <u>Abraham</u>, <u>Hillgren</u>, <u>Bongard</u> (as to an LLC but not as to a separate FLP), <u>Bigelow</u>, <u>Edna Korby</u>, <u>Austin Korby</u>, <u>Rosen</u>, <u>Erickson</u>, <u>Gore</u>, <u>Rector</u>, <u>Hurford</u>, <u>Jorgenson</u>, <u>Miller</u> (as to transfers made 13 days before death but not as to prior transfers) and <u>Malkin</u>. In addition, the district court applied §2036 in <u>Kimbell</u>, but the 5th Circuit reversed.

f. <u>IRS Red Flags</u>. Lee Schwemer (Supervisory Attorney, Estate Tax, Internal Revenue Service) points out that the IRS is hiring additional estate tax agents. The IRS hired 14 new estate tax attorneys last year and plans to hire 10 more in March of this year. Lee listed factors that agents look at in determining whether an FLP is a "wounded animal" case with particularly bad §2036 facts. He emphasized that this is not an exclusive list of factors that agents look for, but it includes some of the "red flags."

- Near death creation of the FLP
- Decedent retained no assets for living expenses
- No contributions by other partners
- Nature of assets (personal use assets)
- Failure to observe partnership formalities (an advantage of near-death partnerships is they are not around long enough for failure to follow formalities to occur)
- Non pro rata distributions if the decedent is the only person receiving distributions
- Commingling of personal and partnership assets (worst case if the decedent is using the partnership bank account as a personal account)
- No real business or investment purpose or creditor protection purpose
- Post-death distributions or borrowing from the FLP (Graegin loans from the FLP are red flags of a §2036 issue)
- Achieving discounts seems to be the real reason for creating the FLP

g. Section 2036(a)(1) Arguments Being Made In Litigation by IRS. The IRS's arguments in its brief in the Black case are interesting.

(i) Mandatory Net Cashflow and "Tax Distributions" Requirement in Partnership Agreement. The IRS's brief argued that §2036(a)(1) applied in part because of an express agreement, in light of the mandatory "net cashflow" distribution requirement and because of the "tax distributions" requirement in the partnership agreement. When Husband was managing partner, he could determine in his sole discretion what cash had to be retained to cover projected expenses, and even after he was no longer the managing partner, the mandatory "net cashflow" distributions constituted retained enjoyment. Furthermore, the partnership agreement required minimum distributions to cover the tax liabilities attributable to the partners' interests. "Thus, although there was no guarantee that Sam Black would receive the full amount of the dividends earned on the Erie stock he contributed, he nevertheless retained an express right to receive at least a significant portion of those dividends through the mandatory cash distribution provision contained in the partnership agreement."

(ii) Substantial Actual Distributions. In addition, the IRS argued that there was an implied agreement that Husband's allocable share of the Erie stock dividends would be distributed to him, evidenced by the fact that 92% of the Erie dividends received by the partnership were distributed to the partners on a pro rata basis.

(iii) Failure to Retain Assets to Pay Estate Taxes. In addition, an implied agreement existed because of Husband's failure to retain sufficient liquid assets to fund a charitable endowment and to pay the federal and state transfer taxes attributable to the stock. The fact that the transfer of partnership assets to pay the estate's taxes was structured as a loan, as opposed to a partnership distribution, should make no difference in the analysis, according to the IRS. "[T]his Court's prior holdings regarding the post-death use of partnership assets to pay estate obligations cannot be circumvented by simply distributing partnership assets in the form of a loan that has little economic consequence to the parties involved, and that the parties are essentially dealing with themselves."

The facts of this case raise interesting questions regarding retaining assets for making estate tax payments. When one spouse transfers assets to an FLP and contemplates that there will be no estate taxes at that spouse's death because of the marital deduction, is the failure to retain sufficient assets to pay estate taxes that will be due at the surviving spouse's subsequent death relevant? Section 2036 would not be applicable at the other spouse's subsequent death because he or she did not make any contributions to the partnership. In that situation, particularly if the contributing spouse dies first, is the failure to retain enough assets to pay estate taxes that will be incurred by the other spouse's estate on the full *undiscounted* value of the partnership assets a retained enjoyment of benefits that can trigger §2036(a)(1)? Furthermore, is the failure to retain enough assets to pay estate taxes that will be incurred by the other spouse's estate on the full *discounted* value of the partnership assets a retained enjoyment of benefits that can trigger §2036(a)(1)?

h. Section 2036(a)(2) Arguments Being Made in Litigation by IRS. The IRS's brief in the Black case made the argument suggested by Judge Cohen in the lower court Strangi opinion that the decedent's power, "in conjunction with others" triggered §2036(a)(2). In Black, the decedent was the 1% general partner and his son was a 0.5% general partner. The decedent held 77% of the limited partner interests at his death. The brief argued that the FLP could be dissolved and liquidated on the approval of all partners, and the decedent, "in conjunction" with the other partners could have amended the partnership agreement or simply dissolved the partnership and accelerated the enjoyment of the partnership's assets. Furthermore, the decedent, acting alone as the holder of a majority of limited partnership interests, retained the right to approve transactions not in the ordinary course of business.

> "Each of these rights conferred by the BILP agreement constitutes the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred assets or the income therefrom during the decedent's lifetime for purposes of §2036(a)(2). . . And none of these rights were circumscribed by any meaningful fiduciary duty [citing a provision in the agreement that the managing partner will be indemnified for all claims except those based on gross negligence, fraud, deceit or wrongful taking]… Stated another way, on these facts, the existence of limited fiduciary duties is not a meaningful constraint on the powers conferred under the BILP agreement."

i. Growing Body of Cases Relying on Maintaining Buy and Hold Philosophy for Family Assets. Schutt based its determination that the bona fide sale exception applied based primarily on the intent of the donor of maintaining his buy and hold investment philosophy over family legacy assets (du Pont and Exxon stock). Two additional recent cases (Murphy and Black) have similarly treated the desire to maintain family legacy assets as a legitimate and significant nontax purpose that satisfied the bona fide sale exception to §2036. (Both Murphy and Black involved companies in which the family held a relatively high percentage ownership interest and in which the family had been intimately involved with the operation of the company.)

j. 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. Commentators argue that §2036 should not apply to post-death uses of partnership assets (John Porter points out that §2036 talks about retained interests by the "decedent," not the "decedent's estate"), but the clear trend of the cases is to consider post-death uses of partnership property for paying estate taxes for purposes of §2036. Seven cases have viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). Those cases are <u>Rosen</u>, <u>Korby</u>, <u>Thompson</u>, <u>Erickson</u>, <u>Jorgensen</u>, and <u>Miller</u> (Tax Court cases) and the <u>Strangi</u> Fifth Circuit Court of Appeals case. <u>Miller</u> and <u>Erickson</u> are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In <u>Erickson</u>, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in <u>Mirowski</u>. However, many judges clearly now do take that position.

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 make a loan using only the partnership interest as collateral. The bank may want a guarantee by the partnership. If so, partnerships should be paid a guarantee fee. There is a legitimate reason for the FLP giving a guarantee, because there will be an IRS lien against the partnership, and the partnership will not want the bank to foreclose on a partnership interest.
- 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. <u>Erickson</u> 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 distributions 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.

k. Graegin Loans From FLP.

(i) 2009 Cases Allowing Interest Deduction. In Murphy and Keller, the court allowed interest deductions for amounts borrowed from partnerships (both 9-year notes). Both cases concluded that the borrowing was necessary for the estate administration.

(ii) Black Refused Interest Deduction. An interest deduction for a Graegin loan from the FLP was denied in Black. The court held that the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). The court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution.

(iii) Tension of §2036 vs. Interest Deduction. A distribution from an FLP to allow the estate to pay estate taxes may be a factor suggesting the existence of a §2036 retained interest. On the other hand, a loan from the partnership raises the issue of whether the interest is deductible. A Graegin loan from an FLP runs the risk of the estate not being able to deduct the interest and also the risk of flagging that there is a §2036 issue. Mil Hatcher has thought for years that this would be an issue, but it has only recently appeared in the cases. Lee Schwemer also confirms that a Graegin loan is a §2036 red flag for IRS agents.

(iii) Business Judgment. Cases generally have been lenient in not questioning the business judgment of executors as to whether borrowing by the estate is necessary. However, Black reasoned that the borrowing was unnecessary because there could have been a partial redemption of the estate's partnership interest. John Porter points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in Black substituted its business judgment for that of the executor.

l. Administrative Errors. Lee Schwemer indicates that isolated instances of administrative errors are not a red flag. John Porter indicates that administrative mistakes should be corrected as soon as possible, rather than waiting until after the client dies.

m. Purposes in Partnership Agreement. Mil Hatcher observes that the partnership agreement is the ideal place to lay out nontax purposes. Be aware though that IRS will closely review the purposes in the partnership agreement, and if another nontax purpose is alleged, the IRS will argue that was not really a purpose or else it would have been in the agreement.

n. Boilerplate. John Porter points out that the IRS looks at boilerplate. If the parties have not complied with the boilerplate in the agreement, the IRS may argue that the partnership is not bona fide.

o. Trust Could Be Used Instead of FLP. Jeff Pennell said the only useful thing to take away from the Jorgenson case is the court's discussion that the FLP was not needed in that case for investment management reasons because a trust could have been used for that purpose. The rationale was also noted by the 9th Circuit Court of Appeals in Estate of Bigelow, 503 F.3d 955 (9th Cir. 2007)("There was no convincing evidence before the Tax Court that

Bigelow could not efficiently manage the property as trustee of decedent's trust, as he had done between 1991 and 1994").

Several 2009 cases (Keller and Miller) have not applied that approach. Responses to this argument that a trust could have been used instead of an FLP are: (1) taxpayers are not directed to use a particular strategy when various strategies are available to achieve a goal; and (2) trusts are much more inflexible — they cannot be amended and there is a higher fiduciary duty in a trust as compared to a partnership.

p. Marital Deduction Mismatch Issue. The IRS argued in Black and Schurtz 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. This issue was not addressed by the court, because §2036 did not apply. The net effect, if the IRS succeeds in arguing that §2036 applies at the death of the first-decedent spouse, is that there could be significant estate taxes owing at the first spouse's death, even where the spouse is left a formula marital deduction bequest, if the partnership interest constitutes about the only assets available to fund the surviving spouse's bequest.

The IRS's brief in Black argued:

> "[A]s of the date of death, only a 77.0876% BILP limited partnership interest remained in the trust, which was the only property available to fund the marital bequest... Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be in includable in the spouse's gross estate under I.R.C. §2044."

To avoid this argument, some planners suggest leaving voting and non-voting stock of an LLC to the surviving spouse at the first spouse's death, so there is little or 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).

q. Partnership Interests Transferred More Than Three Years Before Decedent's Death. If an individual relinquishes within three years of death an interest or power that would cause estate inclusion under the "string" statutes, the assets are still included in the gross estate under §2035. Conversely, if an interest or power that causes estate inclusion under the string statutes is relinquished more than three years before death, §2035 does not apply. It is understandable that if a decedent retains control over partnership assets that causes estate inclusion under §2036(a)(2) or 2038, the three-year rule should not come into play, because the decedent still actually has that degree of control at his or her death. However, it would seem that the answer would be different if §2036(a)(1) is being considered, because it depends on retained enjoyment of assets, and under state law a partner is not entitled to assets attributable to partnership interests that the decedent does not own. In fact, distributions of partnership assets that cannot be attributed to the decedent's interest in the partnership would be theft or an illegal diversion of property from the rightful owners. Nevertheless, a troublesome number of courts have now concluded that a decedent retained personal enjoyment of all partnership assets, even those attributable to interests that were transferred more than three years prior to the decedent's death. The court's analysis of this issue in Jorgensen is dictum; nevertheless, the court makes clear that it would have found that the decedent retained enjoyment of all partnership assets attributable to her original contributions, even though there were apparently never any distributions for the decedent's benefit in excess of her pro rata value of the partnership assets.

Other examples where the decedent was found to have retained personal enjoyment of the FLP assets even after limited partnership interests had been given away were the Estate of Korby and Estate of Rosen cases, Even though the gifts in the Korby cases may have been made more than three years before death, that apparently was irrelevant because the court found the existence of an implied agreement to retain enjoyment of all of the income of the partnership even after the limited partnership interests had been given away. 471 F.3d 848 (8th Cir. 2006). Similarly, the Rosen case held that all partnership assets were included even though the decedent had given away substantial partnership interests more than three years before her death. She was the only partner to receive cash flow from the partnership, and the court concluded very simply that §2035 was not relevant because "Decedent continued to possess and enjoy the transferred assts up until her death." T.C. Memo. 2006-115. See also Estate of Bigelow, 503 F.3d 955 (9th Cir. 2007), aff'g, T.C. Memo 2005-65 (all FLP assets included under §2036 even though decedent made gifts of over 50% of the limited partnership interests by the time of his death).

The obvious planning implication is that following gifts of partnership interests, only proportionate distributions should be made, and nothing should be done to create any implication that the decedent will receive any distributions of partnership assets attributable to previously transferred partnership interests. Furthermore, in light of the inherent §2036(a)(1) uncertainty that can arise by mere implied agreement based on the court's interpretation of the facts, planners may want to consider advising clients who have successfully transferred substantial interests in an FLP to terminate the FLP to remove any possible taint of retained enjoyment of partnership assets that are attributable to transferred partnership interests. If the court would find the existence of a retained enjoyment in all partnership assets, the client would have to live three years after the partnership termination to avoid §2035, but at least the three-year period could begin running to close the books on the possible application of §2036 to the prior successful transfers. (Of course, the termination of the partnership would be inconsistent with the nontax purposes of the partnership; a reasonable reply would seem to be that the family hates giving up the nontax benefits of the FLP, but it is forced to do so because of the possible tax disadvantages of continuing the FLP.)

r. Death or Transfer of Interests May Trigger Reduction of Inside Basis If Partnership Has Built-In Losses Over $250,000. Under amendments to §743(b) in 2004, the death of a partner or a transfer of an interest in the partnership after October 22, 2004 can result in a reduction of the partnership's inside basis in its assets if the partnership has built-in losses over $250,000, even if the partnership does not have a §754 election in effect. The amount of the basis reduction may be even greater if interests are transferred at a discount to pro rata fair market value of the partnership's assets.

For example, assume the fair market value of partnership assets is $4 million and the adjusted basis of the assets in the partnership is $4.3 million. The partnership has a substantial built-in loss because the adjusted basis of partnership property exceeds the fair market value property of partnership property by more than $250,000. Assume that A sells a 25% partnership interest for its fair market value of $1 million. That would result in reducing the basis of the partnership's assets by $75,000, which is the excess of A's $1,075,000 pro rata share of the basis of the partnership's assets (25% of $4,300,000) over the sale price ($1,000,000). However, if the 25% interest is sold at a 30% discount for $700,000, the basis reduction is $375,000 ($1,075,000 [A's pro rata share of the basis of partnership assets] less $700,000 [the sale price]). See IRS Notice 2005-32; Rosenberg, AJCA Imposes New Burdens for Partnership Basis Adjustments Under Section 734 and 743, 101 J. TAX'N 334 (December 2004).

This change to §743(b) largely eliminates a strategy that had previously been available to avoid a step down in basis of depreciated assets at death. Under prior law, a contribution to a partnership of property with basis in excess of its fair market value 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, §743(b) now requires a §754 election to adjust the inside basis if there is a contribution of assets with a "substantial built in loss" of more than $250,000.

8. Single Member Disregarded Entity Transfers

In a case of first impression, the Tax Court held that discounts are not automatically disallowed for federal gift tax purposes when the interests in a single-member LLC are transferred. Pierre v. Commissioner, 133 T.C. No. 2 (2009). Gifts and sales of interests in a single-member LLC to two trusts (12 days after the LLC was created) are treated for federal gift tax purposes as transfers of interests in the entity (with the possibility of discounts) rather than as transfers of proportionate shares of the underlying assets owned by the LLC. This result applies even though the single-member LLC is treated as a disregarded entity pursuant to the check-the-box regulations. This conclusion came from a rather divided Tax Court (with 10 judges joining the majority and 6 judges dissenting).

Regulation §301.7701-3(a) provides that "[w]hether an organization is an entity separate from its owners *for federal tax purposes* is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." (emphasis added) The court reasoned that the regulation was intended to cover the classification of an entity for Federal tax purposes, and does not upset traditional gift tax valuation principles. The dissent pointed to Rev. Rul. 99-5, which treated a sale by the owner of a single-member entity of a 50% ownership interest in the entity as converting the entity to a partnership and treated the purchaser as purchasing a 50% interest in each of the LLC's assets, "which are treated as held directly by [the original single-member owner] for federal tax purposes."

Jeff Pennell concludes that this is an important development. It is a reviewed Tax Court opinion. If taxpayers do not pay tax and seek a refund, cases regarding this issue will be in the Tax Court, and this opinion establishes the law of the land unless it is reversed on appeal. Jeff believes that the same result will apply for estate tax purposes.

9. Defined Value Clauses

a. Estate of Christiansen v. Commissioner, 104 AFTR 2d 2009-7352 (8th Cir. 2009). The Eighth Circuit upheld a formula disclaimer against the IRS's public policy argument, primarily on the grounds that there are other enforcement mechanisms besides just IRS audits. In addition, the court reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws."

b. Estate of Petter v, Commissioner, T.C. Memo 2009-280. Petter involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes. The court reasoned that (1) general public policy encourages charitable gifts, (2) there are other potential sources of enforcement, and (3) the existence of other sanctioned formula clauses suggests that there is no general public policy against formula causes.

c. IRS Agents' Reactions. Lee Schwemer and Marty Basson gave their observations. Lee's conclusion is that "the IRS is behind by a couple of touchdowns." These clauses do discourage examinations, and the IRS is nowhere close to throwing in the towel. Several more cases will have to come down before the IRS would consider an acquiescence. Marty pointed out that if a charity receives assets under a defined value, it is under a fiduciary duty to make sure it receives the proper value. The IRS agent should review any charity sales to make sure they are based on the same valuation approach that the estate or donor used.

d. Formula Allocation Approach Preferred. There are two general types of defined value clauses.

(i) A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula).

(ii) A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord case used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two recent cases have both involved clauses that were based on finally determined estate (Christiansen) or gift (Petter) tax values.

"Formula transfer clauses" are simpler to administer and do not require involving a third party. However, "formula allocation clauses" more squarely fall within the rationale of both Christiansen and Petter for rejecting the public policy argument, including having a third party with a fiduciary duty to police the valuation.

e. Impact of Charity as "Pourover" Recipient. Christiansen and Petter both address formula clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. Some of the other enforcement mechanisms mentioned in Petter could apply whenever a fiduciary is involved to make sure that its entity is receiving the appropriate amount under the formula clause. Accordingly, it is not critical that a charity be involved to come within the rationale of the cases, but using a charity follows the facts of the cases more closely, and all of the rationales given by those cases would apply, whereas some of the reasons given in those cases would not apply if charities are not involved. Of course, the donor must have charitable intent and recognize that significant assets may pass to the charities under a formula allocation clause with the excess passing to charity.

f. Structure "Formula Allocation Clauses" to Require Fiduciary Review of Value Determination. The Christiansen and Petter opinions emphasize that there are other mechanisms to enforce the valuation determination, specifically emphasizing the fiduciary duties of the parties involved. To come within the scope of this rationale, a formula allocation clause should allocate the excess over the formula amount to a charitable foundation or to a trust where there are parties with fiduciary duties that have an obligation to assure that the entity is receiving its appropriate share under the formula transfer. Furthermore, someone other than the donor should serve as trustee of that entity.

g. Use Professional Appraiser. As in Petter, use a reputable professional appraiser to prepare the appraisal for purposes of making the original allocation under the formula assignment. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in Petter) "shady dealing" by a "tax-dodging donor."

h. John Porter Suggestions. Provide the charity with a copy of the appraisal. It has to enforce its rights for the clause to be effective. Be careful when reporting the transaction to consistently treat it as a formula transfer. (Knight rejected a defined value transfer where it was not reported on the gift tax return as a defined value transfer.)

10. Net Gift Strategy As Alternative to Installment Sale to Grantor Trust or Other Planning Strategies

David Handler presented an intriguing idea of using net gifts in place of installment sales in appropriate circumstances. The general idea is that the donor makes a net gift and agrees to finance the donee's gift tax liability. The gift tax is about 31% of the gross value transferred (with a 45% rate), so the note back to the donor is 31% of the transferred value rather than 90% as it would be in the traditional gift/sale to grantor trust transaction. (Under the 35% gift tax rate that applies in 2010, the effective net gift tax rate is 26%.)

a. Net Gift Basics. "Gift tax paid by the donee may be deducted from the value of transferred property where it is expressly shown or implied that payment of tax by the donee or from the property itself is a condition of the transfer." Rev. Rul. 75-26. The donees agree to pay any gift tax, including gift tax resulting from a gift tax audit. The gift could be outright to donees or to a grantor trust (David typically uses grantor trusts as the donees).

The formula for determining the net gift tax rate is Tentative tax/(1 + Rate of tax). For a 45% gift tax rate, the effective net gift rate is .45/1.45, or .310344. (Check it: The gift is .689655, so the gift tax is .689655 x .45, or .310344.) For a 35% gift tax rate that applies in 2010 (unless the rate is changed retroactively), the effective net gift rate is .35/1.35, or .259259.

b. Financed Net Gift. The donor may agree to loan funds to the donee to pay the gift tax. The loan could be made at the AFR. For example, in February, 2010 the mid-term rate is 2.82%, so the note could be financed with a 9-year 2.82% note.

c. Installment Sale to Grantor Trust. Possible disadvantages of the sale to grantor trust approach include the following.

(1) Seeding Required. The grantor trust must have a "sufficient" amount of equity under debt-to-equity concepts. Traditionally, 10% seeding is used. This may require a gift of the about 11.1% of the amount to be sold (so the debt to equity ratio will be 9 to 1).

(2) Potential 2036 Inclusion. Is the overall transaction really a transfer with a retained interest? The IRS has not been successful in making that argument. However, if the payment on the note is equal to the income, it may look like a transfer with a retained income interest.

(3) Cash Flow. Most planners recommend that at least the interest be paid each year, and there may not be enough cash flow to make even the interest payment. If an FLP interest is sold, making an in-kind payment is difficult.

(4) Leveraged Investment Risk. The biggest risk is the investment risk that is amplified by leverage. If there is 90% leverage, a decline of only 10% of the value of the transferred asset wipes out the trust. "In today's world, that can happen in a weekend." If the trust loses 10% in value, it must grow by 11.1% to get back to even. Leverage amplifies gains, but it also amplifies losses.

(5) Rest of Estate; Large Note Still in Estate. An installment sale is a classic freezing transaction. The value at the time of the transfer is still in the estate. The large note value is still subject to estate tax. The sale does not shrink the estate.

d. Advantages of Financed Net Gift Compared to Sale.

(1) Simplicity. The transaction can be as simple as giving stock to children and having them sign an agreement that they will pay the gift tax, and then having a simple note to document the loan from parent to children to pay the gift tax.

(2) Tax Exclusive Gift Tax Rate. The effective gift tax rate is 31% (assuming a 45% federal gift tax rate) compared to the estate tax rate of 45%, if the donor lives at least three years after making the gift.

(3) Shrinks Estate Value. The entire estate value of the transferred property is no longer subject to estate tax. (The note from the donee is included in the estate, but that is offset by the decrease in value of the cash the donor transferred to the donee to pay the gift tax.) If the state does not have a state gift tax (most don't), the state tax is avoided entirely. Another way of stating this is that the net gift transaction shrinks the estate value; it does not just freeze the value. The value of transferred assets actually reduces the estate subject to estate tax by that amount — at a current gift tax cost to the family of a 31% rate. A sale transaction is simply a

freezing transaction. The current value of the estate, represented by the note, is still in the estate.

(4) Less Cash Flow Required. The note amount is only 31% of the value transferred, not 90% of the value transferred. The annual interest is obviously about a third as much, making it more likely that cash flow from the asset will be sufficient to pay all interest as well principal on the note to the donor.

(5) Principal Balance Much Lower. The principal balance of the note (which will be included in the donor's estate) is about a third of the principal balance of the note in a typical sale to grantor trust transaction.

(6) Debt to Equity Ratio. If the gift is made outright to donees, there is no debt to equity limit. If the gift is made to a grantor trust, the trust will by the nature of the transaction have sufficient seeding; the debt will only be about 45% of the trust's equity value (i.e., for a financed net gift of $100, the trust will have $100 less $31 gift tax, or $69 of assets and will owe a note for $31.) This is far different than the sale to grantor trust transaction where the note amount is typically 90% of the value of assets in the trust.

(7) Smaller §2702 and 2036 Risks. Because the debt is much smaller, it is much harder for the IRS to argue this is a transfer with a retained interest. Indeed, nothing is retained. Any loan to pay gift tax would not be made until several months or possibly more than a year later.

(8) Flexibility. Until the gift tax return is filed, the donor could decide to pay the gift tax.

(9) Decreased Leverage Means Less Risk. It would take a huge decline in the asset value to wipe out the transfer, as compared to a mere 10% decline that wipes out a sale to grantor trust transaction.

(10) Valuation Risk on Audit Is Reduced. With a sale to grantor trust, every dollar of increased value results in an additional $0.45 gift tax. For the net gift transaction, every dollar of increased value increases the gift tax by $0.31. (For gifts in 2010 the comparable amounts are $0.35 and $0.26, respectively.)

The legal issue raised is whether the additional gift tax on audit can also be subject to net gift treatment. Armstrong v. United States, 277 F.3d 490 (4th Cir. 2001), suggests perhaps not. However, the facts in that case were unusual — the donees did not agree to pay all gift tax, but just the increased tax on audit. Furthermore, the donees did not actually pay the tax later, so the court understandably held that the arrangement was illusory. The McCord case addressed a case where the donees agreed to pay any additional gift tax and estate tax if the donor died within three years. The court agreed that was not speculative and reduced the gift value by the three year risk element.

(11) Gift Tax Portion of Net Gift Can Be Discounted. "If all of the net gift consists of assets subject to valuation discounts, such as stock in a closely held company or limited partnership interests, the benefit of a net gift is even greater. The 31% of the assets transferred to cover the gift tax are valued at a discount and not subject to gift tax, although the trust will pay the tax using cash borrowed from the donor." Assume a transfer of LP units representing underlying value of $1,000,000, but valued with a 35% discount at $650,000. The net gift is $448,000

and the gift tax is $202,000. Therefore, 31% of the $650,000 is to cover the gift tax and is not a gift. The undiscounted value of 31% of the units, is $310,000, so the trust receives an additional $310,000-202,000, or $108,000 that is not subject to gift tax.

e. Disadvantages of Net Gift Approach.

(1) The Obvious: Payment of Gift Tax. The gift tax must be paid in cash by April 15 of the following year.

(2) Possible Income Tax. Unless the net gift is made to a grantor trust, the donor will recognize capital gain to the extent the gift tax liability exceeds the donor's adjusted basis in the property transferred. Diedrich v. Comm'r, 112 S. Ct. 2414 (1982). This can be avoided with gifts to grantor trusts; David Handler usually does these transactions with grantor trusts.

(3) Legislative Change. There is the risk that the estate tax will be repealed (either actually or effectively for the client if increased exemptions exceed the client's estate).

(4) Three Year Rule. If the donor dies within three years of making the gift, the gift tax paid is brought back into the estate under §2035(b). (This is not actually a disadvantage. This would just remove the advantage of being able to use the tax exclusive gift tax rate for the transfer.) The three-year rule applies even if the donees pay the tax — because they are merely paying the donor's gift tax liability. The Estate of Samuel and Estate of Sachs Tax Court cases confirm that result.

Possible planning strategies to deal with the three-year risk: (1) buy a three-year term policy to insure against the risk; or (2) loan money to the trust in the form of a SCIN. (If the donor dies within three years, the note is cancelled. The gift tax is brought back in the estate, but the note in that same amount is cancelled; so there is a complete offset. The downside of a SCIN is having to pay a premium interest rate over the AFR. However, for a three-year note, the actuarial risk of dying within that short time frame is very low (unless the donor is very old), so the interest rate bump is small. Furthermore, the rate is currently so low (the short term AFR in February 2010 is 0.72%), that even if the rate is doubled or tripled it is still extremely low.

f. Trust Can Be ESBT. One of the requirements for an ESBT is that no interest in the trust can have been acquired by purchase. The regulations were clarified to say that if *beneficiaries* of the trust pay the gift tax, an interest in the trust has been acquired by purchase, but if the *trustee* pays the tax, no *interest in the trust* has been acquired by purchase.

g. Example Actual Client Situations.

(1) Especially Suited for Surviving Spouses. This strategy is particularly persuasive to a surviving spouse. The estate tax is more imminent (because if both spouses are alive, the estate tax is not due until both spouses have died).

(2) Client Who Has Had Sales "Fail" in Past. David has a surviving spouse with $300 million who made a $100 million net gift. The couple had done sales in the past, but the spouse did not want to be "nowhere" in five years, having transferred nothing, if the values did not appreciate.

(3) Hedge Fund Managers. Two 45-year-old partners ran a hedge fund and trading firm. After discussing GRATs, sales and net gifts, the clients did the math in their heads before David could discuss it. They came to the conclusion this is the only strategy that makes sense. They are doing a $10 million net gift. By the time they die, there will likely be $80 million in their trusts. They believe they don't need to do anything else for their families; they can leave the rest of their estates to charity.

11. Mending Wayward GRATs and Sales to Grantor Trusts; Planning Issues With GRATs and Sales to Grantor Trusts

John Bergner presented a number of creative ideas for dealing with changed conditions for GRATs and installment sale transactions. In addition, some of the comments below are from an outstanding panel discussion with John, Mil Hatcher, and Richard Robinson. In addition, there are some comments from other seminars.

a. Five Ways That Plans Go Awry. (1) Bad design; (2) economic changes; (3) mortality changes; (4) changed client wishes; and (5) bad administration.

b. GRATs — Bad Design Issues.

(i) Incorrect Annuity Percentage. Incorrect annuity percentages can appear as a result of misusing software or transposing numbers. Possible planning considerations include: (1) state law may allow a modification to correct the scrivener's error, but under Bosch the IRS is not bound unless it is a finding of the highest court of the state; or (2) a construction suit. Prevention measures include: (1) have a second person run annuity calculations; and (2) use a savings clause to override automatically various annuity percentages (example: "minimum percentage necessary to produce a remainder interest as close as possible to, but not greater than, $___").

(ii) Omission of Required Provisions. Possible corrective measures include: (1) amendment if the instrument gives a third-party power to amend for the purposes of ensuring that the trust qualifies under §2702(b); and (2) judicial modification to clarify an ambiguity. Preventive measures include: (1) carefully scrutinize GRAT forms; (2) use a savings clause; (3) include a third-party power to amend, as discussed above; and (4) compare a "red-lined" version of the instrument with a recognized form.

(iii) Funding With Problem Assets.

Assets Subject to §2701. Assets subject to the §2701 valuation rules might have a gift tax value considerably more than fair market value. Solutions include: (1) make elections under §2701 to give as much value as possible to the preferred interests; (2) avoid §2701 by contributing a "vertical slice" of the asset; and (3) provide that if the gift value exceeds the current market value, the annuity will be a greater percentage of fair market value, but be careful not to violate the "exhaustion rule."

Insider Stock. If the grantor is an insider of a publicly-held company, the grantor will be subject to the "short-swing profits" rule under Section 16(b) of the Securities Exchange Act. Profits must be disgorged if any sales and purchases occur within six months of each other. A contribution to a GRAT is arguably a "sale," and a distribution of insider stock in satisfaction of the annuity payment is arguably a "purchase" by the grantor. A No-Action Letter from the SEC concluded that the transfer of securities by an insider to a GRAT and the transfer of the securities back to the grantor in satisfaction of the annuity payments are only a change in the form of ownership and are not subject to Section 16(b). Peter J. Kight, SEC No-Action Letter, 1997 SEC No-Act. (October 16, 1997). However, cases have held that the substitution of insider stock and an unauthorized transfer from a GRAT of insider stock for the benefit of insiders constituted purchases for purposes of Section 16(b). Morales v. Quintiles Transnational Corp. 25 F. Supp.2d 369 (S.D.N.Y. 1998) (substitution); Dreiling v. Kellett, 281 F. Supp.2d 1215, 1244 (W.D. Wash. 2003).

Mil Hatcher advises that the estate planner must work with securities attorneys in making these decisions. Next, the estate planner would have to go through the company's inside counsel and its outside counsel. A particular problem is that receiving insider stock in satisfaction of the annuity payment and rolling the stock into a new GRAT may be treated as a purchase and sale within six months. "If three securities attorneys look at it, I assure you there will be at least two different answers." The securities attorney may not be willing to opine that the distribution of insider stock in satisfaction of an annuity payment is definitely not a Section 16(b) transaction. Mil says that "securities lawyers will have all kinds of problems. It's nice to know that someone is more paranoid than we are."

Potential solutions (some of these suggestions are designed to reduce discretion to minimize appearances of distributions being treated as a purchase by the grantor): (1) reduce trustee discretion with respect to insider stock; (2) do not include a swap power over insider stock; (3) include an ordering rule so that distributions are made first from insider stock, then cash, then other assets in satisfying annuity payments in order to eliminate discretion; (4) do not include any grace period for making annuity payments. Mil Hatcher also suggests interposing "hurdles" between the insider stock and the grantor: (1) contribute the insider stock to an LLC and be careful to have no purchases for six months and a day; later, the grantor may decide to contribute some of the LLC interests to a GRAT; and (2) have the insider make a contribution of all annuity payments from the original GRAT to a "Gap GRAT" (discussed below regarding economic changes and burned out GRATs), so the annuity payments are not distributed to the grantor but to another GRAT. In one situation, the securities attorneys blessed that approach.

Section 2036(b) Stock. If the grantor serves as trustee, retention of the voting power over stock of a controlled corporation may be subject to §2036(b). Solutions: (1) recapitalize so the stock is no longer voting stock; (2) have the grantor resign as trustee; (3) eliminate the grantor's power to remove and replace the trustee. Each of those steps will likely result in application of the special three-year rule under §2036(b)(2).

In addition, if the grantor has a nonfiduciary substitution power over stock of a controlled corporation, that may also trigger §2036(b). If the grantor has a swap power and there is concern about the three-year rule, the grantor may substitute other assets into the GRAT and take back the §2036(b) stock. If there is no swap power and there is concern about the three-year rule, the trustee might sell the controlled corporation stock back to the grantor.

Stock Options. The IRS takes the position that the transfer of a non-vested nonqualified stock option is not a completed gift until vesting occurs. Rev. Rul. 98-21; Rev. Proc. 98-34. If the client wants to contribute non-vested nonqualified options to a GRAT and take the position that is a completed gift up front, Form 8275 must be filed with the gift tax return to report that the taxpayer is taking a position adverse to the IRS position, and realize that this will likely draw a gift tax audit. In addition, because of the SOGRAT patent, be careful in transferring non-vested options to a GRAT.

Community Property. Avoid making contributions of community property to a GRAT. If a husband transfers community property assets to a GRAT and retains an annuity, arguably the wife has made a gift and it is possibly a terminable interest that does not qualify for the marital deduction. Also, the trust is only a partial grantor trust. If there are sale transactions between husband's and wife's portion of the grantor trust, there would be no gain recognition on the sale (under §1041), but interest on the note would be taxable. See Gibbs v. Comm'r, T.C. Memo 1997-196. Furthermore, there is significant uncertainty regarding the effect of a subsequent divorce or death of a spouse. (Separate property, rather than community property, should be used to fund GRATs.)

c. GRATs — Economic Changes.

(i) Burned Out GRAT. The regulations provide that commutation of the grantor's annuity is not allowed. One possible solution is for the grantor to swap assets under a non-fiduciary substitution power and have the grantor re-GRAT the volatile asset. The valuation of the assets becomes very important. The grantor is concerned that if the value is too low, the deficiency will be treated as a prohibited additional contribution to the GRAT; the trustee wants to make sure that the value is at least equal to the fair market value so the swap does not result in reducing the value of the trust assets. It is likely that an appraisal will be needed. Most planners think that a promissory note can be used for that swap. An AFR interest rate should be satisfactory, because §7872 applies for gift tax purposes; however a market rate may be used to assure that the note is full value. (The interest rate is really meaningless; it will not result in taxable income and the grantor will receive back all of the interest payments in any event.) Is collateral required? Some panelists are comfortable having an unsecured note if the grantor is creditworthy. That is not workable, however, if the grantor is financially troubled and trying to bail assets out of the GRAT. Other possible solutions include: (1) sell trust assets to the grantor (which the grantor could re-GRAT at their lower value); or (2) have the grantor assign his or her rights to the remaining annuity payments to a "Gap GRAT." The annuity payments will be valued taking into account the substantially lower value in the GRAT. Mil Hatcher is "imminently comfortable" that the value of the annuity payments cannot exceed the value of assets in the original GRAT, based on the exhaustion requirement in the §7520 regulations.

Drafting solutions with respect to this problem include: (1) insert a grantor swap power (except for insider stock or §2036(b) stock); (2) do not include a spendthrift clause; and (3) do not include a prohibition on self-dealing.

(ii) “Home Run GRAT.” The values may have appreciated so much that the grantor wants to lock in the gain to assure a wealth shift. Solutions include: (1) swap assets so that the grantor can contribute nonvolatile assets into a new GRAT; (2) sell the volatile assets to the grantor for cash, nonvolatile assets, or a note; (3) sell the assets on the open market; (4) have a trust purchase a collar or otherwise hedge the asset; or (5) have the trustee immediately pay the annuity in kind as soon as possible and do not use the 105-day grace period.

(iii) “Grand Slam Home Run GRAT” — Exceeding Client’s Intent. The wealth shift may exceed the client’s intent. Indeed, the client may need to borrow from the GRAT in order to pay the trust's income taxes. Solutions include: (1) exercise a swap power so the grantor can get back the highly appreciating asset to avoid shifting the additional appreciation; (2) purchase the appreciating asset; (3) add or change beneficiaries if the trust agreement permits; (4) turn off grantor trust status; and (5) pay annuity amounts as early as possible. From a drafting standpoint: (1) include a swap power; (2) avoid prohibitions against the self-dealing so the grantor can purchase trust assets; and most importantly, (3) include a “waterfall” provision so that assets over a specified value would be returned to the client or to other specified beneficiaries.

(iv) Illiquid Assets. The client may anticipate a liquidity event within the first 12-15 months before the first annuity payment is due, but the liquidity event may not occur. Another problem scenario is that oil and gas assets may be contributed to a 6 or 7-year GRAT on the assumption that cash flow can satisfy the annuity payments, but oil and gas prices drop so that cash flow no longer is sufficient to satisfy annuity payments. Another scenario is that illiquid assets were contributed to the GRAT, realizing that in-kind distributions would be required for making annuity payments.

Solutions: (1) in-kind distributions, but discounts may be required and an appraisal will likely be required; or (2) the trust may borrow from a third party to pay the annuity. In that case, the lender will probably want a guarantee. A guarantee by somebody other than the grantor would be preferable (perhaps a QTIP trust or another trust), but a guarantee by the grantor should also be permissible. An annual guarantee fee should be paid. The amount of the guarantee fee depends upon the nature of the transaction. If the transaction is “heading south” a much larger guarantee fee will be required than if the asset is doing very well with little volatility.

Planning suggestion: Fund the trust with some cash in addition to the (hopefully) appreciating asset. The cash can be used for making early annuity payments in case cash flow is insufficient. One panelist indicates that he typically uses longer-term GRATs for illiquid assets, so that there is the possibility of funding annuity payments out of cash flow. A short-term GRAT with illiquid assets will almost necessarily involve in-kind distributions, which would require appraisals. “Clients don’t like appraisals.” To justify annual appraisals, there would need to be very large values being contributed to the GRAT.

Another solution is to use a defined-value clause for distributions. If it does not work, the client is in no worse a situation than if the trust had made a direct assignment without a formula clause. Some firms typically use formula distributions, distributing units equal in value to the annuity amount.

Another trust may purchase the asset; however, if no other funded grantor trust exists, that would require "seeding" a new grantor trust. The Malkin case ignored a deathbed installment sale transaction where the grantor "seeded" the trust immediately before the sale. An "old and cold" trust is preferable.

d. GRAT — Mortality Risk of Shortened Life Expectancy. If the client dies during the GRAT term, most if not all of the assets will be brought back into the estate. Potential solutions: (1) the grantor could purchase a remainder interest for its actuarial value (see paragraph k below); (2) another grantor trust could purchase the remainder interest for a self-canceling note based on the grantor's life; if the grantor has a life expectancy of greater than one year and the Treasury actuarial tables can be used; a relatively small interest rate increase would be required for the added mortality risk for a short-term note.

e. GRAT — Changed Client Wishes. (1) The grantor may desire to shift fewer assets. Solutions include exercising a swap or sale to reclaim the appreciating asset, and turning off grantor trust status. (2) The grantor may need more cash flow; the trust could loan cash to the grantor. (3) The objects of the bounty of the grantor may change; again, the grantor could exercise a swap power or purchase assets to reclaim the highly appreciating assets.

f. GRAT — Bad Administration.

(i) Failure to Make Timely Annuity Payments. By analogy to the Atkinson case, dealing with the failure to make annuity payments from a charitable remainder annuity trust, the IRS may argue that the GRAT is disqualified from the outset. In that situation, pay the annuity as soon as possible with interest, accruing from the anniversary date. However there are no guarantees that this will be successful. Drafting suggestion: include an agency provision providing that the trustee is the agent for the grantor with respect to any undistributed annuity. Do not depend on the clause, but it is a "safety valve." Richard Robinson points out that the Bollinger U.S. Supreme Court case (108 S. Ct. 1173 (1988)) dealt with holding property as a nominee. It suggested two requirements: (1) a written nominee agreement (which the trust agreement would satisfy); and (2) the agent must hold itself out as agent to third parties with respect to the property.

Planning suggestions: One panelist sends a notice to clients 30 days before annuity payment due dates, advising them of the due date and the 105-day grace period, but does not follow up if the client does not respond. Another panelist "tickles" his calendar with the 105-day grace period and works closely with his clients regarding payment of the annuity payments. One panelist has had to rely on the agency provision in the trust agreement, and he strongly endorses it as a "safety valve." Mil says "there's nothing worse than sending out the notice, and having the client call 106 days later and ask –when is the due date?" He would never do a GRAT without that provision included in the agreement.

(ii) Funding on Multiple Dates. Regulations provide that the trust agreement must prohibit additional contributions. If funding of the initial GRAT happens over several days, the IRS may contend that assets funded after the initial day constitute prohibited additional contributions. Possible solutions: (1) treat the subsequent contribution as passing to a new GRAT; (2) return the subsequent contributions to the grantor; and (3) treat any subsequent cash transferred to the GRAT as a loan rather than a contribution. Drafting suggestions: (1) include a provision allowing the grantor to revoke the trust, and the grantor would release the revocation power after the full funding has occurred; and (2) state in the instrument that if the grantor transfers any additional asset after the initial funding, the trustee will treat the additional asset as a loan or as property in a second GRAT.

(iii) Funding After Rate Change. The GRAT may be funded in a month after the trust agreement was drafted, and the §2720 rate may have changed, so that the present value of the annuity payments no longer equals the value of the contributed asset. There may be no viable solution. Possibly a modification action to correct the scrivener's error would be recognized. Drafting suggestion: include a savings clause to provide that the annuity will be designed to leave a specified value of the remainder.

(iv) Grantor Pays Expenses that Should be Paid by GRAT. If the grantor pays expenses that should be borne by the GRAT, the payment may be treated as a prohibited additional contribution. Solutions: (1) the trust should repay the grantor or (2) the trustee should give the grantor a promissory note for the amount of the expenses, with interest. Drafting suggestion: add a provision stating that the grantor's payment of any expenses allocable to the GRAT will be considered a loan to be repaid, with interest, upon termination of the GRAT.

g. GRATs With Discounted Assets. One panelist contributes securities or closely-held stock to an FLP or LLC before contributing FLP or LLC interests to the GRAT. Substantial discounts on contribution may be permitted. Distributions from the entity typically would be made for making annuity payments. (Other advantages of using the entity are that it solves the multiple contribution problem, and there is more flexibility for contributing additional assets to the entity in exchange for interests in the entity.) Other panelists do not use the approach of contributing an interest in an entity to the GRAT and making distributions from the entity to make annuity payments. The same discount must be used for in-kind distributions as was used for valuing the initial contribution. Using discounted assets for dividend-paying stock can be very advantageous (if the cash dividends can satisfy much or all of the annuity payments). Alternatively, there may be a huge blockage discount available for the large block of stock contributed to GRAT but not with respect to each year's annuity payment. The worst result would be to contribute a majority interest undiscounted but take out discounted assets in the annuity payments, resulting in reverse leverage. A possible planning consideration is to delay making distributions from the entity to assist in making annuity payments until after the statute of limitations has run on the initial funding of the GRAT.

h. GRAT — Due Diligence Requirement for Transactions With GRAT. For swap transactions under a nonjudicial substitution power, the grantor should provide an appraisal for hard-to-value assets. Mil Hatcher observes: "One thing about GRATs. I've never found an easy-to-value asset." The trustee's due diligence concern is much less with a substitution than with a sale. If the grantor holds a swap power, the trustee has no discretion in whether to make the exchange; the only issue is whether "equivalent" value is being substituted.

i. 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. This would require having the instrument express the annuity percentages by a formula (example: "minimum percentage necessary to produce a remainder interest as close as possible to, but not greater than, $___").

j. 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.)

Using 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 equal only 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 interest 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.

k. 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 remainder beneficiaries 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 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 remainder beneficiaries 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 remainder beneficiaries 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 transferors 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 transferor 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 remainder beneficiary 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.

l. Installment Sales — Generally. Many of the solutions discussed above for problem areas relating to GRATs will also apply to installment sales to grantor trusts.

(1) 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 $1/9^{th}$ or 11.111% of the sale amount.) In Petter, Judge Holmes observed in a footnote that a 10% seed money gift is traditionally used in sales to grantor trust transactions. The amount required is what is appropriate to justify selling assets for a note, taking into account all relevant facts and circumstances.

(2) Guarantee. If a guarantee is used to satisfy the "seeding" requirement, the guarantee needs to be enough to satisfy only the 10% seed amount. The guaranty fee must be paid annually. 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.

(3) 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 trusts 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 sale treatment in any event because it is not treated as a transfer for income tax purposes.) Various speakers confirm that they have routinely done this over the last several years. 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.

(4) Substitution Power Does Not Cause Aggregation. Jeff Pennell indicates that a grantor substitution power does not require that the trust stock be aggregated with the grantor's stock for valuation purposes.

(5) Reporting Sale Transaction. Carol Harrington generally advises clients to report sale transactions; otherwise no statute of limitations is running as to whether there is a gift element. Many clients do not want to report for fear of an increased risk of audits. The odds of being audited do increase if there is a big sale; however, very

few gift tax returns are audited so Carol really can't say whether reporting the sale increases the odds of an audit. In Petter, the taxpayer got "Brownie points" because she fully disclosed everything in the return.

m. Installment Sales — "Underwater" Transactions. Potential solutions include the following.

(1) Renegotiate the rate to a lower interest rate or extend the term. (Mil Hatcher points out that reducing the interest rate is often like rearranging the deck chairs on the Titanic.)

(2) Reduce the principal amount of the note. One panelist indicated that he does not renegotiate the principal amount but cancels a portion of the note. He thinks that is not a gift, but would not do it more than once for any particular client. There is no cancellation of indebtedness income because the note is with a grantor trust. The planner advises the client to report the cancellation on a gift tax return, but clients usually ignore that sage advice. (Some planners are not comfortable reducing the principal amount of the note unless other concessions are made as consideration.)

(3) Contribute the underwater note to a GRAT (using the reduced value of the note as the value of the contribution to the new GRAT). Future appreciation would inure to the benefit of the GRAT remainder beneficiaries but there would be no new "seeding" requirement (which could be lost as well if there were more depreciation in the value of the underlying assets).

(4) 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.

(5) Any guarantees must be taken into consideration in determining the value of the note.

n. Income Tax Effect at Cessation of Grantor Trust Status or at Death. 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 (84 T.C. 667 (1985)) and Reg. §1.101-2(c)Ex.5 is the best authority. In Madorin, when grantor trust status ended during the grantor's life, the grantor was deemed to be released from his share of underlying partnership liabilities and recognized gain to the extent those liabilities exceeded the basis of the partnership interest. See also Rev. Rul. 77-402, 1977-2 C.B. 222 (cessation of grantor trust status causes recognition of income from partnership measured by difference between trust's adjusted basis of the partnership interest and its share of the partnership liabilities). Tech. Adv. Memo. 200011005 (debts incurred by GRAT/grantor trust for making annuity payments and secured by trust assets should be treated as amounts realized by the grantor when the trust ceased to be a grantor trust). These authorities suggest that the trust has to report future income, from the moment that grantor trust status of the trust ended.

At death, the possibilities include: (1) gain recognition by the grantor's estate at death; (2) deferral of gain recognition until the obligation is satisfied after death with the recipient treating payments as income in respect of a decedent; or (3) non-recognition event either by grantor's estate or by recipient of the payment as IRD. The view of most commentators is that there is no gain recognition at death, but that recipients of the note payments after the grantor's death will report the payments as taxable events. The authorities listed in the previous paragraph all deal with cessation of grantor trust status before death. Mil Hatcher is greatly comforted by several Chief Counsel Advisory Opinions. CCA 200923024 concluded that conversion of a trust from nongrantor to grantor trust status will not cause immediate recognition of income by the grantor. In dicta, the Advisory Opinion distinguished Madorin and Rev. Rul. 77-402 by noting that they

> are silent regarding the income tax consequences to the party who receives trust assets (the "transferee"), which in these examples was the nongrantor trust. We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the *death of the owner which is generally not treated as an income tax event*. (Emphasis added.)

CCA 200937028 concludes that property transferred to a grantor trust is not entitled to a step up in basis under §1014 at the grantor's death if the trust is not included in the grantor's gross estate for federal estate tax purposes. Mil is confident that death is not a taxable event for income tax purposes.

o. Discounting Note for Estate Tax Purposes. Section 7872 allows using the applicable federal rate (AFR) for gift tax purposes. There is a provision in §7872 saying that the IRS can issue regulations coordinating the estate and gift tax provisions. We know that §7872 provides an artificially low interest rate — the rate at which the United States government can borrow. Does that mean that we can discount the value of the note for estate tax purposes because there are no regulations on point for estate tax purposes? Because there is no coordinating regulation Mil Hatcher says that general valuation principle should be applicable, and it may be possible to discount the note for estate tax purposes if the note uses the AFR as the interest rate. HOWEVER, the IRS agent may feel you have not played "by the straight and narrow," and you will draw scrutiny on every aspect of the installment sale by taking a discount on an AFR note for estate tax purposes.

p. 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. See Gibbs v. Comm'r, T.C. Memo 1997-196.

q. 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, 90% of the gift element would pass to an incomplete gift trust, and there would be no immediate gift taxation on that portion.

r. 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."

s. Reverse Freeze. Transfer preferred interests to the children and have the parents retain the common interests. Appraisers say that preferred interests in a family limited partnership would need a preferred return of 10-12% to be worth face value. One speaker indicated that the last preferred partnership freeze transaction he did had a preferred return rate of 9%. (Shannon Pratt has told Jonathan Blattmachr 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 9-12%, 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.

12. Estate Planning With QTIP Assets

Read Moore (joined by Joy Miyasaki in a workshop) presented a number of creative estate planning ideas for surviving spouses who are beneficiaries of QTIP trusts.

a. Different Strategies Required. Different rules apply than traditional estate planning for individuals. Different tax rules apply because the trust is not a grantor trust and §2519 applies. Furthermore, there are fiduciary considerations because the trust owns the assets.

b. Distributions to Get Assets Out of QTIP Trust So Surviving Spouse Can Do Transfer Planning.

(1) Marital Deduction Rules. Nothing in the marital deduction rules prevents the trustee from making distributions to a spouse. If the trustee knows the spouse will turn around and make a gift of the assets, does that disqualify the distribution? If the instrument states that the trustee is to distribute the assets to someone else as directed by the spouse, that disqualifies the trust for marital deduction purposes. However, the trust can say that the trustee is authorized to make distributions to the spouse so the spouse can subsequently make gifts if he or she wishes to do so. However, the distribution cannot be contingent on the spouse making gifts.

(2) Giving Spouse Power to Withdraw. If the spouse has the ability to withdraw the assets from the trust, that would make gift planning much easier. Giving the spouse a withdrawal power does not turn the trust into a general power of appointment marital trust (which would eliminate some possible planning, such as reverse QTIP elections or qualifying for the previously taxed property credit) as long as the creation of the power is delayed for at least a day; Read typically uses a delay of nine or 15 months. The existence of a spousal withdrawal power may reduce (or even eliminate) the undivided interest discount valuation advantage under the Bonner case, discussed below.

Example Clause: "If my wife is living 15 months after my death, my wife may withdraw from time to time so much or all of the principal of the trust as my wife directs by a signed instrument delivered to the trustee during my wife's life."

(3) Distributions Allowed Under Standard. Is the trustee authorized to make distributions to the spouse so that he or she can make gifts when there is a standard for distributions, particularly for restrictive standards such as amounts needed for health, education, support and maintenance? There have only been a handful of reported cases around the country regarding distributions for the purpose of permitting beneficiaries to make gifts, and not all of them involve marital trusts. Most refuse to allow a distribution to permit a beneficiary to make gifts where that was not within the standard stated in the instrument. If the distribution standard includes "welfare" of the beneficiary, some cases have allowed distributions of the beneficiaries so they could make charitable gifts.

Several professional fiduciaries in the workshop indicated they would not make a distribution under a "health, education, support and maintenance" standard for the purpose of allowing a beneficiary to make gifts. Some planners indicated they would do so if there were an indemnity to the trustee from the surviving spouse.

If the trust instrument has a broad standard (such as the "sole and absolute discretion of the trustee"), trustees would have the authority to make a distribution to facilitate gifts by the beneficiary. The trustee would consider the size of the invasion relative to the size of the trust as well as other factors, such as whether there was any previous strong pattern of giving.

(4) Modification. If all beneficiaries agree, it may be possible to have the trust agreement modified in a court action to allow a broader standard for distributions. However, consider potential gift tax issues for the remainder beneficiaries (as discussed in the following paragraph).

(5) Tax Issues With Distributions. Three Tax Court cases have addressed whether assets distributed from a Marital Trust should nevertheless be included in the spouse's estate because the trustee was not authorized to make the distribution. The cases emphasize the primacy of state law for purposes of determining whether trust assets are properly distributed. The Tax Court did not insert itself into the role of trustee to determine whether its decisions were correct. Council, 65 T.C. 594 (1975); Hartzell, T.C. Memo. 1994-576; Halpern, T.C. Memo. 1995-352.

Another potential issue is whether remainder beneficiaries make a gift if they do not object to the distributions (or agree/do not object to a court modification to allow a broader distribution standard). There have been rulings that suggest the possibility of gift treatment where the income beneficiary does not require the payment of dividends or the reinvestment of assets or if the beneficiary accepts the underfunding of a bequest (Rev. Rul. 84-105). The Dickman Supreme Court case verifies that forgoing a valuable right or property interest constitutes a gift. However, if the surviving spouse has a testamentary limited power of appointment over the trust, the value of the remaindermen's rights may be very speculative.

Planning Tip: This is one reason it is very helpful to give the surviving spouse a testamentary power of appointment over QTIP assets (if that is not inconsistent with the testator's goals). It increases planning opportunities.

c. Assigning Income Interest. If distributions cannot be made from the trust for transfer planning purposes, there are two ways that lifetime transactions can reduce the value of assets in the trust subject to estate taxation: (1) an assignment of the spouse's income interest, and (2) a freezing transaction.

Section 2519 provides that if the spouse disposes of the income interest in a QTIP trust, that is deemed to be a disposition of the remainder. There are two gifts: (1) the disposition of the income interest which is taxable under §2511, and (2) a deemed gift of the balance of the trust property under §2519. The advantages of entering into this gift transaction include the classic advantages of gifts — to take advantage of the lower gift tax effective rate, low values, estate freezing, etc.

(1) Net Gift; Subject to Three-Year Gross Up Rule. The §2519 gift is a net gift, because the donor has a right of recovery from the donee for gift taxes on the §2519 gift unless the reimbursement right is relinquished. Estate of Morgens, T.C. 133 T.C. 17 (2009) confirms that the gift is a net gift, and that the gift tax paid by the donee is subject to the gross up rule under §2035(b) if the surviving spouse dies within three years of the gift.

(2) Assignment of Any Portion of the Income Interest Is Treated as Disposition of Full Remainder Value Under §2519. The final regulations issued in 1984 made a huge change, treating any disposition of any portion of the income interest as a deemed gift of the entire remainder interest in the trust. Treas. Reg. §25.2519-1(a). If a surviving spouse wants to assign only a portion of the income interest and make a gift of only a portion of the remainder value, the IRS has issued about 20 private letter rulings permitting the spouse to first split the trust into multiple trusts. The spouse could then dispose of the income interest in one trust, resulting in a deemed gift of the remainder of that trust, without resulting in a deemed gift of the remainder of the other trust. "If the client wants to do this, get a ruling from the IRS. This rule is for suckers; you must go to the IRS to get a ruling to bless the transaction." Because there are 20 of these rulings on the books, some clients might be comfortable not getting a ruling, but the concern is that there is an arguably inconsistent regulation.

This rule can also be used to the taxpayer's advantage. The spouse may be able to make a taxable assignment of only a 1% interest in the income, to minimize the gift tax on the income assignment, but result in a deemed gift of the entire remainder interest.

(3) Practical Implementation Problem — Spendthrift Clause. The strategy is easy in theory, but in practice very difficult. The main reason for the difficulty is that most trusts have spendthrift clauses, and state law cases almost unanimously provide that the income beneficiary cannot release the income interest if there is a spendthrift clause. The Restatement (Third) of Trusts takes the position that the beneficiary of a spendthrift trust can release his or her income interest, but no state has adopted that approach.

(4) Practical Implementation — Nonqualified Disclaimer. One method of making the assignment, even if there is a spendthrift clause, is a non-qualified disclaimer. State law generally provides that there can be a disclaimer even if there is a spendthrift clause. Many private letter rulings bless this technique. The practical difficulty is that many (but not all) states have a nine-month time limit on disclaimers. The

Uniform Disclaimer of Property Interest Act does not put a time limit on disclaimers for state law purposes. Even aside from the time limit problem, the surviving spouse has often accepted income for many years, and acceptance prevents a disclaimer.

(5) Practical Implementation — Agreement Among Beneficiaries. If there is an agreement among family members to commute the income interest or to permit an assignment despite the spendthrift clause, many rulings have recognized that a disposition can be made of the income interest to trigger §2519.

d. Freeze Transactions. Some classic freeze transactions are not available to QTIP trusts, such as GRATs, sales to grantor trusts, charitable lead trusts, etc. However, other strategies are available, but they involve both fiduciary issues and special tax issues.

(1) Possible Freeze Strategies. Possible freeze strategies include a loan to a family member, a sale of assets, or a preferred freeze partnership.

Possible advantages of a preferred partnership freeze include: (1) no gain recognition like there would be on a sale, (2) profits allocated to the QTIP trust are based on the character of income earned by the preferred partnership whereas interest on the sale note would be ordinary income, and (3) a distribution in kind is not likely to generate gain recognition.

(2) Section 1058 Loan of Stock to Surviving Spouse and GRAT. Another possible freeze strategy mentioned at the 2009 Heckerling Institute is for the QTIP trust to make 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 alternative minimum tax.

(3) Fiduciary Issues. (a) For a loan, the trustee must address the appropriate interest rate and whether the loan must be secured, taking into account the financial condition of the borrower. The trustee must make sure the transaction meets the prudent investor rule. (b) For a sale, the trustee must consider the appropriate price, interest rate, security, covenants, and coverage issues if the sale is being made to another trust. (c) For a partnership preferred freeze, the trustee must consider whether the preferred coupon rate is appropriate.

(4) Income Tax Issues. There will be interest income, and the sale transaction will be a taxable event generating capital gain income. This might be a disadvantage if the trust had been receiving qualified dividends taxable at a 15% rate, whereas the interest payments would be ordinary income. (In that situation, Read would

consider creating a freeze partnership.) In addition, the sale results in a capital gains tax even though the family owns the same assets.

While a sale to the spouse would generate a tax on the sale, the capital gains rate is just 15% (this year, at least) and the tax is paid from the QTIP thereby reducing the amount subsequently subject to estate tax, resulting in an effective tax rate of about 8%. Furthermore, there may be no gains if there is a step-up in basis at death and/or the assets decline in value.

Another special income tax issue that arises because the QTIP trust is not a grantor trust is that if the QTIP trust sells an interest in an FLP, there could be a substantial reduction of the partnership's basis in its assets if the partnership has built-in losses of more than $250,000. §743(a) and (b) (as amended in 2004). See Item 7.r for further discussion of this issue.

(5) Gift Tax Issue — §2519 Deemed Gift by Spouse. A trust cannot make a gift. However, if the trust receives too little value in the transaction, the IRS has asserted in some audits that the spouse is treated as making a constructive disposition of the income interest, which triggers §2519 and a deemed disposition of the entire remainder interest. Regulation §25.2519-1(f) says that the conversion of one type of QTIP property to another is not a disposition. The IRS has suggested that if the trust does not receive the proper price it is a disposition, but there is no authority for that position. Field Service Advice 199920016 suggested that an investment transaction might trigger §2519 if the conversion of trust assets limited the spouse's right to income. It considered whether the QTIP trust's participation in the formation of the family partnership should be treated as a disposition of the spouse's income interest under §2519. The spouse continued to receive income distributions at approximately the same amounts she would have received had the partnership not been created. The spouse was also the trustee of the trust. The IRS National Office concluded this did not invoke §2519:

> Thus, in order to invoke 2519, the conversion of the trust assets must work such a limitation on her right to the income as to amount to a disposition of that income. Although the conversion to partnership interests could yield this result, it does not necessarily follow. An investment in a partnership, despite possible restrictions on distribution, could be, under the right circumstances, a very lucrative investment.

Several other private letter rulings have refused to apply §2519 to the purchase of shares of a closely held corporation (PLR 9523029) or loans at the applicable federal rate (PLR 9418013).

This issue has arisen in a variety of estate tax audits. However, the IRS National Office has never embraced or advocated a constructive disposition rule under §2519 in any public or private ruling.

Practical Planning Tip: To reduce the deemed gift risk under §2519, if the trustee is going to contribute some of the QTIP assets to a family limited partnership, first split the QTIP trust into two trusts. If there is exposure under §2519, there is only a risk as to the assets in that separate trust. There have been 19 different rulings where a split trust idea worked, but there have not been any of these rulings in several years.

Similarly, for sale transactions, first split the trust and sell from only one of the trusts in order to reduce the §2519 risk.

John Porter has handled cases involving the formation of an FLP by the trustee of two QTIP trusts (together with other partners). The cases arose after the surviving spouse's death. The IRS argued 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. 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.

(6) Gift Tax Issue — Gift by Remainder Beneficiaries. Another potential gift issue is whether remainder beneficiaries make a gift if they do not object to a transaction by the trustee for inadequate consideration. However, if the surviving spouse has a testamentary power of appointment, the value of the gift may be very speculative.

e. No Aggregation With Spouse's Assets For Valuation Purposes. Several cases make clear that QTIP assets are not aggregated with the surviving spouse's assets for valuation purposes. Estate of Bonner v. U.S., 84 F.3d 196 (5th Cir. 1996); Estate of Mellinger v. Comm'r, 112 T.C. 26 (1999), acq., 1999-2 C.B. 763. Those cases involve situations in which the decedent and the surviving spouse each owned one-half of the assets (sometimes as community property) and the decedent's one-half passed into the QTIP trust.

(1) Distribution to Spouse. What if the QTIP trust originally owns 100% of the asset and makes a distribution of a portion of the assets to the spouse to get undivided interest discounts by both the surviving spouse and the QTIP trust? Because the cases did not involve that specific situation, a possible planning alternative is to make a distribution from the trust and have the spouse make a gift of the asset in order to achieve clearly different undivided interests.

(2) Section 2519 Disposition as to Portion of QTIP Assets. Another possible way to trigger the Bonner valuation result is to split the QTIP trust into two trusts and implement a §2519 trigger for one of the trusts. There would be nothing from the trust for which the §2519 trigger had been made to be included in the surviving spouse's estate. Therefore, the remaining assets in the other QTIP trust should be entitled to an undivided interest discount.

f. Deathbed §2519 Disposition to Reduce State Estate Tax. A deathbed §2519 disposition that would trigger a gift tax on the assets in the QTIP trust may be able to save state estate taxes if inclusion of the QTIP trust for state purposes is based on inclusion for federal estate tax purposes. Most states do not have a state gift tax. The federal gift tax paid would be brought back into the estate (for both federal and state death tax purposes), so state estate taxes would have to be paid on the amount of the federal gift tax. The best approach to implement this strategy would be to make an assignment of only a 1% sliver of the income interest to reduce the amount of the federal gift tax (and resulting state estate tax paid on that amount).

13. Roth IRAs

Professor Chris Hoyt addressed planning opportunities with Roth IRAs. Contributions to a Roth IRA are not deductible. It is also possible to convert traditional IRAs to Roth IRAs, by paying income tax on the current amount in the plan. The basic advantage of Roth IRAs is that future withdrawals from the Roth IRA will be tax free (subject to special rules discussed below). These are important for all clients because (1) the income limits on Roth IRA conversions are lifted beginning in 2010, and (2) many employers allow "Roth Accounts" for 401(k) plans, which can be a terrific strategy for leaving a tax-free growth legacy to children.

Chris and his wife will be converting some of their retirement accounts this year to a Roth IRA, and we all should consider it as well, he says.

The September 2009 issue of Trusts and Estates is devoted entirely to Roth IRAs and has a number of excellent articles about Roth IRAs and Roth conversions.

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 70½). 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 59½, 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, and because an income ceiling applies for making contributions to Roth IRAs if the individual is an active participant in a retirement plan.

b. Advantages of Roth IRAs.

   (1) Conversion Allows Stacking Odds in Taxpayer's Favor. The conversion opportunity is unique, because the government "lets you win" — if conditions change by October of the following year, it is possible to "undo" the conversion.

   (2) Option to Pay Income Tax Over the Following Two Years for Conversions in 2010. The amount of a Roth IRA conversion is typically recognized as taxable income in the year of conversion. However, a special rule applies for conversions in 2010 — the individual generally reports one-half of the conversion income in each of 2011 and 2012, respectively, but may elect to report all of the income in 2010. (The election to be taxed all in 2010 might make sense if Congress significantly raises the income tax rates beginning in 2011, but that may not be known before the election must be made.)

   (3) Tax-Free Withdrawals. If withdrawals are made after age 59½, the withdrawals are tax-free (subject to several "5-Year Rules" discussed below).

   (4) Can Effectively Contribute More in Tax-Sheltered Account. There are limits on how much can be contributed to a 401(k) account each year. (Unlike regular Roth

IRAs, there is no income ceiling limiting contributions to a 401(k) or Roth 401(k) account.) An individual can contribute $16,500 of after-tax dollars to a 401(k) account in 2010 ($22,000 if an employee is over age 49). If a $22,000 contribution is made to a Roth 401(k) rather than a regular 401(k) account, this is the equivalent of putting over $30,000 in a traditional 401(k) account.

(5) Contributions Over Age 70½ Permissible. Contributions cannot be made to a traditional IRA during or after the year in which the individual attains age 70½. However, contributions are permitted to a Roth IRA by an individual who has employment or self-employment income after age 70½.

(6) No Required Distributions From Roth IRA After Age 70½. Mandatory distributions are not required after age 70½ from a Roth IRA. (However, mandatory distributions are required after age 70½ from a Roth 401(k) account. Therefore, as discussed below, it is important to convert a Roth 401(k) account to a Roth IRA before reaching age 70½.)

(7) Can Reduce Taxable Estate. The Roth conversion can reduce the federal taxable estate, because the income tax paid on the conversion will be eliminated from the taxable estate. For example, assume an individual has a $3.6 million estate so that $100,000 will be subject to a 45% estate tax (assuming there is a $3.5 million exemption and a 45% rate). If the individual converts $300,000 of an IRA to a Roth IRA, the resulting $300,000 of taxable income will generate an income tax of about $100,000, which would be paid out of a traditional investment account. This will reduce the net taxable estate to $3.5 million so no estate tax would be due. In effect, by paying a net tax of $100,000 – 45,000, or $55,000, the family has been able to convert $300,000 from a traditional account into a tax-free account.

c. Disadvantages.

(1) Current Income Tax and Perhaps Higher Income Tax. Income tax on the conversion must be paid currently. Furthermore, if a person is in a lower income tax bracket in retirement years, the income taxed on conversion will likely be taxed at a higher rate than if there had been no conversion.

(2) Roth IRA May Have to Be Liquidated Faster Than Traditional Retirement Account. A traditional IRA and conventional retirement account can be liquidated over more than five years: between five years and 16 years for individuals who die between ages 71 and 91. However, if a Roth IRA fails to qualify for stretch treatment, the Roth IRA must be liquidated within just five years after the owner's death. (Stretch treatment is possible if all of the beneficiaries are either "designated beneficiaries" (i.e., human beings) or a trust that only benefits designated beneficiaries and meets certain other criteria — mainly that all beneficiaries must be human beings.)

(3) Possibility of Law Change. Will the Roth advantage continue in 10 years, 20 years, etc.? (Are you ever sure? This reminds Chris of the two hydrogen atoms who walked into a bar. One said "I think I lost an electron." The other said "Are you sure?" The first replied, "Yes, I'm positive.")

d. Conversion From Traditional IRA to Roth IRA. There is an income ceiling on *contributions* to Roth IRAs (although this can be avoided as discussed in the following paragraph), but beginning in 2010, the income limit is lifted on *conversions* of retirement accounts to Roth IRAs or Roth 401(k) accounts (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. Income tax has to be paid on the amount of the conversion, but for conversions in 2010, the income can be recognized either all in 2010 or over the following 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 59½ (because of complications with the special penalty rules for withdrawals before the five-year period is met).

e. <u>Does it Make Sense to Convert</u>? Converting to a Roth IRA 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. 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.

A Roth IRA is an excellent vehicle for passing on wealth to the next generation free of income tax.

f. <u>Best Candidates</u>.

(1) <u>Always in Top Income Tax Bracket</u>. An individual who will be in lower brackets in retirement years may pay more income tax by making a Roth conversion during high taxable income years.

(2) <u>Will Pay Estate Tax</u>. As discussed above, prepaying the income tax reduces estate taxes.

(3) <u>Will Be in Higher Income Tax Bracket in Retirement</u>. If the "Bush tax cuts" are repealed or adjusted, many individuals will be in a higher income tax bracket in retirement years than in 2010.

g. <u>Mechanics of Roth Conversion</u>.

(1) <u>Same Administrator</u>. The easiest way to convert is to have the account transferred to a Roth IRA with the same administrator.

(2) <u>Trustee-to-Trustee Transfer</u>. If the administrator is being changed, a trustee-to-trustee transfer can be made from a traditional retirement account to a Roth IRA.

(3) <u>60-Day Rollover — Least Desirable</u>. Least desirable is a "60-day rollover" because the individual may forget to complete the rollover, and more importantly, there is a 20% withholding requirement. For example, if a $10,000 account is converted, only $8000 would be transferred to the Roth IRA account. The individual would receive a refund with the next year's income tax return.

h. <u>Penalties For Distributions Within Five Years of a Roth IRA Conversion</u>. There are two different five-year rules.

(1) Investment Income 5-Year Rule. In order for distribution of the investment income of a Roth IRA to be excluded from gross income, the distribution must be made (i) after the individual reached age 59 ½, became disabled, acquired a first home, or died, AND (ii) more than five years after the taxpayer made a contribution or conversion to a Roth IRA. Otherwise, the investment income in the first five years is taxable, and there will also be a 10% penalty if the distribution is made before age 59½.

This presents a particular problem if the owner dies soon after the conversion. Distributions generally must be made within five years and must begin in the year after death. To partially offset this problem, a special "BIFO" (best in first out) rule applies. Distributions first come from tax-exempt non-deductible contributions, which would be tax free, and next from conversions, and finally from investment income accumulated during the Roth IRA years.

The Investment Income 5-Year Rule is a once-in-a-lifetime test for one's own Roth IRA (as long as the first contribution of conversion to any Roth IRA was made more than five years earlier). However, that does not apply for inherited IRAs — in that situation, the 5-year test is applied from when the decedent first made a contribution or conversion to a Roth IRA.

(2) "The Right Reason" 5-Year Rule. If distributions are not made for the right reason during the first five years following conversion, a 10% early distribution penalty can apply even though the converted amount is exempt from income tax. The most important permissible reason is a distribution after reaching age 59½, but other permissible reasons include distributions following death, disability, or for a qualified first-time home purchase (with a $10,000 lifetime cap). (The primary purpose of this test is to prevent an individual under age 59½ from making a Roth conversion in, for example, December 2010, and then liquidating the entire account in January 2011 in an attempt to avoid the 10% penalty for withdrawals before age 59½.)

(3) Technical Rules Differ. The determination of the five-year periods and other technical requirements for these two special rules are different for the two separate rules.

i. Planning Strategies For Conversions.

(1) Payment Election. The taxable income for a conversion in 2010 can be recognized in 2010, or over two years in 2011 and 2012. If the 2010 income tax return is extended, it is possible to wait until October 15, 2011 to make the election, taking into consideration Congressional changes in the income tax rates.

(2) Convert When Market is Low. Ideally, the conversion will occur when asset values in the account are low, so that the amount of taxable income on the conversion will be minimized.

(3) Use Other Assets to Pay Income Tax. Pay the income tax from taxable investment accounts. The effect is to move dollars from a taxable investment account to a Roth account. If an individual is under age 59½, other accounts must be used in order to avoid the 10% penalty for withdrawals from a retirement account before that age.

(4) Accelerate Deductions Into Years of Additional Taxable Income. Accelerate deductions into the years in which the conversion income is recognized. For example, if the client has a charitable deduction carry forward, it may substantially offset taxable income from the Roth conversion. An individual may make extraordinary contributions to a donor advised fund or private foundation to offset taxable income in the year the conversion income is recognized. Future year charitable donations could be made from that charitable account. Also, consider prepaying charitable pledges.

(5) Asset Protection. A person's IRA generally has $1 million of protection in bankruptcy court, whether a traditional IRA or Roth IRA. The Roth IRA provides greater protection since it holds after-tax dollars. Furthermore, IRAs that hold nothing but assets rolled over from a qualified retirement plan have additional protection. Therefore, avoid commingling a Roth IRA conversion with other Roth accounts. An inherited IRA has virtually no protection from creditors.

j. "Recharacterization" — 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).

k. 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 beginning on the first day of the tax year in which the person must make 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 70½, 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.)

l. 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 70½ (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 59½, 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 in existence for five years, withdrawals will be tax-free. However, if the rollover amounts 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.

m. Conclusion; Terrific Strategy For Tax-Free Growth Legacy to Children. Marcia Chadwick Holt has concluded: "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."

14. Charitable Rollover IRA

a. Generally. The Pension Protection Act of 2006 permitted a person over age 70½ to make up to $100,000 of charitable gifts directly from an IRA from 2006 through 2009 (extended to 2009 by the Wall Street "bailout" legislation). The donor benefits by not having to report the IRA distribution as taxable income, although the donor is not able to claim a charitable income tax deduction for the gift. Retirees have been particularly motivated to apply their charitable gifts to satisfy the mandatory minimum distributions that would be required in any event from the retirement account.

There are various basic requirements that must be satisfied to be able to make a charitable gift from the IRA without having to recognize income, including (1) the donor must be at least age 70½, (2) only IRAs qualify, not other qualified retirement plans, (3) the organization must be a public charity or private operating foundation, but not including a donor advised fund or supporting organization, and (4) the maximum amount permitted is $100,000 per year.

b. Extended for 2010? Planning Considerations For 2010. The charitable IRA rollover expired last year. It also expired in 2008, and in October of 2008 it was retroactively extended. Will it be extended again? Clients may safely go ahead and make the charitable gifts from their IRAs but only up to the amount of the minimum required distribution. If the charitable rollover law is not extended, the individual would have to withdraw the minimum required distribution amount in any event.

15. 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 (historical low of 2.0% for February 2009, 3.4% in February 2010). 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)"

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

16. Non-Tax Issues in Business Succession Planning

Skip Fox offered a number of practical suggestions for assisting clients with succession planning.

a. Major Issues. (1) Should the business be sold? (2) Should the business be continued after death? (3) Who will own the business? (4) Who will control the business? (5) Will children be treated equally? (6) MOST IMPORTANT: What provisions will be made for the present owner after the transfer of the business? (How can the owner be satisfied so he or she will not want to come back and try to take over the business?)

b. Interesting Statistics (From a Variety of Sources). 85% of the crises faced by family businesses focus around succession. Only 40% of business owners have even thought about succession planning. 30% had no plans to retire ever and plan to die while still in the business. 90% of all US businesses are family businesses. 78% of all new jobs created in the United States from 1977 to 1990 were created by family businesses. Over 150 of the Fortune 500 companies are family businesses.

Survival Statistics. Despite the advantages of family businesses, only 30% pass to the second generation, 12% to the third, and only 3% to the fourth generation (citing a study from 1997).

Role of Women. Women own about one-third of all businesses in the United States; 24% have a woman as president or CEO and 57% have women in top management positions (citing a 2007 American Family Business Survey).

c. Difficulties of Succession Planning for Family Businesses. (1) Smaller pool of potential successors. (2) Nepotism; a PricewaterhouseCoopers 2007 study says that two-thirds of family businesses have a place for family members without measuring their performance. (3) Children's sense of entitlement if businesses pay all children the same even though some produce more than others. (4) Parents unwilling to tell children objectively how they are doing. (5) Sibling rivalry and picking one child over another can lead to tension. (6) Family problems can spill over into the business. (7) Large differentials; there is often a 25-30 year age differential as opposed to public companies where there are 5-7 year age differences for successor leaders. (8) Different outlooks; different generations may have much different views of the business. (9) Inability of the older generation to let go. (10) Aversion to succession planning; it involves difficult decisions, but the longer it is put off the more difficult it is.

d. Emotional and Psychological Conflicts. Skip provides a real-life example of how emotional conflicts can undermine a succession plan. "In one business, the father passed on the business to the eldest son; in so doing, the father minimized adverse tax consequences, and he was able to maximize the transfer of wealth to all his children. But the rest of the family did not see it that way. The other family members saw the father as a 'mean-spirited, old miser' who had secretly favored the eldest son in what they called "the Big Lie." Conflicts ensued between that son and the other members of the family, who happened to control other assets on which the business was dependent. The family's harmony was ruined, as was the smooth interplay of assets that were all owned by the same family."

e. Classic Entrepreneur Characteristics (From a 1988 Heckerling Presentation). (1) Often a veteran of World War II. (2) Enormous ambition and energy, egotistical; he can be stubborn, arrogant, and eccentric. (3) Poor delegator. (4) Tends to dominate everyone around him. The wife of the entrepreneur often worked in the business in the early days, and the husband may use her as a sounding board. There is a probability that the wife will outlive the husband and will control the business after the husband's death. The husband often has a communication gap with the rest of the family, and the wife is the "Chief Emotional Officer."

f. Basic Forms of Businesses. (1) Controlling owner — typically in the first generation. (2) Sibling partnership — often in the second generation where coordination can be more difficult. There are two basic forms: ones with an acknowledged leader and ones with shared leadership. (3) Cousin consortium — children of children control the business, and there are more likely to be family members not involved in the business. This is a very difficult model of business ownership.

The most successful form is to have a single leader. Others are more complex and more time is spent dealing with family relations rather than focusing on the business.

g. Alternate Ways of Transferring Ownership Among Children. (1) Equally to all children. (2) Leave the business to active children and other assets to non-active children. (This works unless the non-active children are given assets that are essential to the business, such as real estate, without clear guidelines for use of those assets by the business.) (3) Equal ownership by all with redemption provisions, but there must be resources to buy out minority owners).

h. A Process for Succession Planning. (1) Get a strong commitment from family members to work on succession planning. (2) Help family members set aside competitive ways and be more constructive. (3) Adopt business planning process that begins with a mission statement and strategic plan, with emphasis on the core value of the business. (An excellent example is provided below from the Smucker company.) (4) Create personal development plans for family members who work in the business. (5) Develop the appropriate governance structure. (6) Put in place legal and financial structures. (7) Create a culture in which key employees (whether they are family members or not) are expected to be owners.

i. Example Core Values. An excellent example of core values developed by the Smucker Company:

(1) The Basic Rule: treat everyone the way you wish to be treated.

(2) Five Beliefs: Quality, People, Ethics, Growth, Independence

(3) Actions, Not Words. (a) Tell people thank you for a job well done; (b) Listen with full attention; (c) Look for the good in others; (d) Have a sense of humor; "not at the expense of others, but as a brief relief from difficult tasks, can make our working atmosphere more pleasant and enjoyable"

17. ESOP Planning Issues

a. Significance. ESOPs offer an alternative for succession planning — but not in the traditional way that assets are typically transferred from parents to others. ESOPs are designed to transfer ownership of a business from the business owner to employees.

There are over 10,000 ESOP plans, and $800-900 billion of assets held in ESOPs. There are several associations that focus on lobbying Congress to preserve the ESOP provisions.

In the family business succession context, the ESOP may be considered in a situation in which the owners want to transition out of the business. They may or may not have children interested in continuing the business. They may have looked at a sale of the business to outsiders, but found that a sale is not realistic. There are employees in the company they would like to benefit. The ESOP offers a way to transition out of the business on a tax advantaged basis.

b. Basic Description of Structure and Operation. A shareholder owns the employer. The employer establishes an ESOP. Often, the company borrows some of the money from a bank or outside lender, often providing collateral. The company loans the money to the ESOP under a "mirror loan." The ESOP uses the money to buy the owner's stock. There may also be some "seller financing" from the owner. The ESOP owes the employer to repay the "mirror loan" to the ESOP from the employer and owes the seller if there is an element of seller financing. The employer makes annual contributions to the ESOP (for which it receives an income tax deduction). The ESOP uses the money to make required payments on the loan from the employer, which the employer then uses to make payments on the mirror loan to the outside lender. (The effect is that the employer can repay the principal on the loan with pre-tax dollars.)

The ESOP must be for the benefit of the employees (which can include the owner [if he or she continues as an employee, but not if the gain deferral election is made under §1042, discussed below] and the owner's family members who are employees). The ESOP will describe how stock is to be allocated among employees. If the ESOP has not repaid its loan, shares not yet paid for remain in a suspense account that is not available for distribution to employees. As the ESOP repays its loan, the shares are released and allocated to accounts of the participating employees. The ESOP must provide that the employees will have a put right (to the employer) over stock received from the ESOP. If the ESOP meets the various detailed requirements in the Internal Revenue Code, the ESOP is a tax exempt entity, and the employer receives deductions for contributions to the ESOP. In some situations (under §1042, discussed below), the owner can defer gain recognition on the stock sale if the cash is reinvested in publicly traded securities (and gain recognition is avoided altogether if the replacement securities are held until death, when there is a stepped-up basis).

The structure is simpler if the selling shareholder is willing to provide seller financing. The shareholder would sell stock to the ESOP for a promissory note from the ESOP. The selling shareholder gets paid over time instead of getting cashed out up front. The other payment arrangements are similar; the employer amortizes the entire loan (interest and principal) with tax deductible contributions to the plan.

c. <u>Qualification Requirements</u>. ESOPs are qualified retirement plans subject to the general rules of §401(a) and subject to ERISA (discussed below). There are also particular qualification rules for an ESOP. (1) It is designed to invest in company stock of the employer. (2) It can borrow money to acquire stock of the employer. (3) After the participant reaches age 55 and has 10 years of participation, the participant has the right to a diversification election to require the plan to diversify up to 25% of his or her account balance. (4) The trust has voting rights, and there are nine major corporate events for which the trust must solicit voting instructions from participants.

d. <u>Basic Income Tax Consequences</u>. There are unique tax advantages of using ESOPs to purchase the owner's stock.

<u>Interest</u>. The employer recognizes interest income when it receives interest payments from the ESOP, but the employer pays the same amount of interest to the outside lender (to the extent that there is third party financing), thereby receiving an interest deduction (which offsets the interest income).

<u>Principal</u>. The employer makes a deductible contribution to ESOP, which the ESOP uses to make the interest and principal payments on the loan to the employer. The effect is that the employer is able to buy the owner's stock and receive a tax deduction for the interest (which is offset by interest income) AND PRINCIPAL portion of the loan.

<u>Gain Deferral</u>. Section 1042 (added in 1984) allows the shareholder of a C corporation that is not publicly traded to sell shares to an ESOP and not recognize income currently if seller purchases "qualified replacement securities" (publicly traded securities, but not including mutual funds) during a "replacement period" (from three months prior to through 12 months after the sale). Shares allocated to a participant from the ESOP do not qualify for the gain deferral if those shares are later resold to the ESOP. There is no

requirement that the seller use the sale proceeds to purchase the replacement securities. The effect is that the business owner can diversify without current income taxation. The basis of the replacement shares is the basis in the shares that were sold, so that the gain is deferred until the replacement securities are sold. (Gain recognition is avoided altogether if the replacement securities are held until death when there is a step-up in basis.)

Requirements to qualify under §1042: (1) The owner must have held the shares at least three years, but the corporation can be converted to a C corporation within the three year period. (2) The ESOP must acquire at least 30% ownership of each class of outstanding stock or 30% of the value of all outstanding stock. (3) The seller did not acquire the stock under section 83 or an employee stock option plan. (4) The seller, seller's family, and 25% owners generally cannot participate in ESOP allocations as employees. (5) If the ESOP disposes of the stock within three years, the company owes a tax equal to 10% of the value of the stock.

e. S Corporations. About 10 years ago, Congress expanded the availability of ESOPs to S corporations as well. An ESOP trust can qualify as an S shareholder. ESOPS are tax exempt trusts, so the flow-through income from the S corporation's income that is attributable to the ESOP's stock is not subject to current income tax. Distributions that the company would ordinarily make to the shareholders for their payment of income taxes can instead be used by the ESOP to repay the interest and principal on the acquisition financing. In addition, it is possible to have an S corporation owned 100% by an ESOP, which has the effect of sheltering all of the S corporation income. After the ESOP has repaid the loans to acquire the stock, the company could retain all profits for growth and expansion without having to pay income tax on the earnings. (Originally, §1042 gain deferral also applied for sales to S corporation ESOPs, but that was determined to be too sweet a deal and was later taken away.)

f. Financing. Banks often are more reluctant than previously to finance leveraged transactions, so owners now look at using some bank financing and some seller financing. Seller financing may make sense, even though it may not for a sale to a third party, because the seller is still working in the company and is willing to bear the risk that the company is able to pay the debt. To the extent that banks are unwilling to finance the sale, that may be mezzanine lenders, who require high interest rates and perhaps the right to receive warrants to acquire stock in the future. The owners instead may decide to take advantage of the higher interest-rate premium and warrants and provide seller financing.

g. Qualified Retirement Plan Deduction and Allocation Limitations. An ESOP is a qualified retirement plan under §401(a), subject to the regular rules of defined-benefit contribution plans. Section 404(a)(9) generally limits the deductible amount of employer contributions to 25% of the compensation of all participants in the ESOP. (Amounts contributed to a qualified plan in excess of those limits are subject to a 10% excise tax, in addition to not qualifying for a deduction.) The ESOP is a qualified plan that is subject to the usual Code requirements with respect to participation, benefit accrual, vesting, distribution of benefits and non-discrimination. Furthermore, an ESOP may not integrate its benefit allocation with social security. There is no limitation on including the owner and family members as participants (as long as they meet the other requirements for participating in the qualified plan and as long as the §1042 gain deferral is not used.)

h. Control. The ESOP must receive voting shares and the trustees vote the shares. The trustees are originally determined when the ESOP is formed by the board of directors. The board often appoints the key shareholder or the shareholder's children. They run the ESOP and vote the shares; depending on how much stock the ESOP holds, they may control the board of directors and therefore control the company. However, the trustees are subject to strict fiduciary restrictions, as discussed below.

i. Qualified Retirement Plan and ERISA Requirements. An ESOP must satisfy the §401(a) requirements that generally apply to qualified plans plus additional provisions (including an obligation to maintain employer securities). An ESOP is also subject to ERISA, which means that there is a fiduciary that is responsible to make sure that plan assets are preserved for employees in addition to other requirements. For example, ERISA prohibits transactions between a qualified plan and a "party in interest" that involve an extension of credit. However, there is a specific exemption for ESOPs if the "exempt loan" meets a variety of detailed requirements.

There are four general 4 duties of fiduciaries of qualified plans: (1) duty of loyalty; (2) duty of prudence (which has evolved in a prudent expert standard); (3) duty to diversify (this is waived for ESOPs); and (4) duty to operate the plan and trust in accordance with its terms and the requirements of ERISA.

In addition, fiduciaries of a qualified plan are subject to three important prohibitions. The fiduciary: (1) cannot use plan assets solely for their own account or their own benefit; (2) cannot engage in transactions in which there is a conflict of interest; and (3) cannot receive any compensation from any third party (meaning the fiduciary cannot receive commissions or other compensation for engaging in a particular transaction.) Because of the first two prohibitions, whenever there is an ESOP sale transaction, the planner must look at the relationship of the parties to the ESOP. The fiduciary absolutely cannot sit on both sides of the transaction, so the selling shareholder cannot also be the trustee. There must be an independent trustee or at least independent counsel for advice to the trustee. Also, the fiduciary must make sure that the sale price is fair market value, using an independent appraisal obtained by the trust, not by the company, to determine fair market value. Also, an appraiser should provide an opinion that the transaction is fair and reasonable to the ESOP.

j. Long Term Commitment. Once the owner starts selling shares to the ESOP, it continues indefinitely. As employees receive stock from ESOP, they will probably eventually sell those shares back to the ESOP. (The ESOP must provide a put option for the participants to put the stock to the company at fair market value. The ESOP may, but cannot be required to, purchase the stock.) The effect is that the company gets an up front tax benefit, but on the back end, the company must have cash available to buy out the stock.

k. Family Training. Owners and family members must understand that the fiduciary duty requirement is taken very seriously by the Department of Labor. A vital part of structuring ESOPs is to educate the children on what they can and cannot do as trustees of the ESOP.

l. Use an Expert. ESOPs have many technical requirements. Use an ESOP expert.

m. A Common Use of ESOPs in Ownership Succession: Minority ESOPs. Owners often are not willing to sell 100% of the company, and may be unable to find a third party willing to purchase a minority interest. Even if they are willing to sell all of the company, there may not be sufficient financing for a 100% buyout. ESOPs often purchase 30% of the stock initially, because §1042 gain deferral is so attractive to the selling shareholders.

One challenge is that the buyer of the minority interest wants to pay a price that reflects minority discounts, and owners may be reluctant to sell at that price. (There is also a marketability discount, but the put option typically offsets that discount.) There is a narrowing range of the minority discounts for lack of control (often 10%) and owners should not get too caught up in the discount issue. One solution to avoid the minority discount issue is to structure the purchase as a multistage transaction. The ESOP would purchase a 30% block of stock, but enter into contractual arrangement to have an option to acquire enough stock ultimately to be a majority interest. Considering that option, there is an argument that the ESOP is buying an interest that justifies paying a control price. Those transactions are not being challenged anymore by the Department of Labor.

Another alternative is to use convertible preferred stock. An ESOP can buy common or convertible preferred stock. Preferred stock must have a reasonable conversion premium. For example, a typical transaction would be to have the ESOP pay $100 for preferred stock having a par value of $100 (with, say, a 5% cumulative dividend right). The preferred stock would be convertible to common stock worth $80 in today's value. Therefore, if the common stock doubles in value from $100 to $200, the ESOP could convert into common shares worth $80 at issuance but worth $160 at the time of conversion. Therefore, the ESOP would not share in all of the upside growth potential, and the owners may be willing to sell to the ESOP under that arrangement even with a minority discount.

The ESOP transaction may also result in wealth transfer opportunities. After the transaction closes, the equity value of the company is decreased because of the significant additional debt assumed by the company for the loan proceeds from the outside lender that the company in turn loans to the ESOP so that it can purchase the owner's stock. The company's value recovers as debt is repaid over time from the company's deductible contributions to the ESOP. There is an excellent opportunity for making gifts during the period of the depressed values.

n. Another Common Use For Succession Planning — Majority ESOP. The ESOP may purchase 100% of the stock from the owners who can elect §1042 gain deferral. One hundred percent bank financing is typically not available, and seller financing is often used similar to what mezzanine lenders would require — which often includes receiving warrants to acquire stock in the future. The warrants can be a good gifting opportunity for the family.

One of the huge tax advantages for ESOPs is the tax-free accumulation that applies for S corporations, but owners of S corporations cannot take advantage of the §1042 gain deferral. If the corporation is already an S corporation, the planners will need calculations to determine if the owners are better off "busting" the S election so the owners can have §1042 gain deferral. If that is done, it is possible to reelect S status after 5 years. Breaking the S election may not cause large C corporation income taxes during the 5-year period because the large tax deductible contributions to the ESOP for debt amortization may largely offset taxable income.

If the corporation is a C corporation, one planning alternative is to sell shares to the ESOP while the company is a C corporation, so the owners get §1042 gain deferral, but plan to elect S corporation status at the beginning of the company's next tax year. The 40% or more of cash flow saved from avoiding income tax allows for substantially faster amortization of large amounts of debt financing.

o. Challenges.

(1) Fiduciary Challenges. ESOP trustees are sometimes sued for not selling stock if the company drops in value. Cases have emerged of a presumption in favor of ESOP trustees' holding company stock. Different circuits have formulated different rules, but courts generally look for imminent peril of bankruptcy before the trustee should have to sell shares. However, very high standards of conduct are required.

(2) Indemnification. Johnson v. Courturier, (9th Cir. 2009) refused to permit the advancement of legal fees to an ESOP fiduciary as promised under an indemnification agreement. The case observes that only the company and not the participants can indemnify a trustee. The court reasoned that if the company pays the trustee to cover losses, that payment has a downward effect on the value of the shares of the trust, and the participants bear the expenses indirectly. Under the reasoning of this case, insurance seems to be the only answer for trustees rather than company indemnifications.

(3) Duty to Monitor Board. Department of Labor Interpretive Bulletin 94-2 states that if the ESOP has enough stock to influence the policy of the company, it has a fiduciary duty to do so. The ESOP should consider adding one or two outside directors to the board, and give them the ability to resolve conflict situations between the family and the corporation.

(4) Repurchase Liability. The company is obligated under §409(o) to buy back shares when participants leave the company. However, the distribution need not commence until the sixth plan year following the year of termination, and the payment can then be made over a five-year period. Furthermore, distributions of leveraged shares can generally be deferred until the ESOP has repaid in full the loan that it incurred to purchase the shares.

(5) Annual Appraisals. Annual appraisals of the company stock will generally be required. The appraisal theoretically would not be necessary in a year in which no transaction occurred, but as a practical matter ESOPs get annual appraisals.

18. Crummey Trusts

a. Notice of Crummey Right to Beneficiaries. Carol Harrington emphasizes that the Crummey case did not require giving notice to the beneficiary of the withdrawal right. One Revenue Ruling said that if there is no actual notice AND if the period of withdrawal is unreasonably short (three days in that ruling) the annual exclusion is not allowed. She thinks that Ruling supports that the failure to give notice alone does not disqualify the transfer for the annual exclusion. Carol has had lawyers call her and ask if they should concede the issue when the IRS objects on the basis of no notice being given. She is appalled. One PLR says that notice is required and it cites that Revenue Ruling. She reiterates that the IRS has NO authority for this position. Most planners provide that notice should be given to beneficiaries, but if notice is not given as to a particular gift, do not assume that means the donor necessarily loses the benefit of the annual exclusion for that gift.

Sometimes the trustee is also a beneficiary who has a withdrawal right. It makes Carol giggle to think of giving written notice to herself. If an IRS agent says that the beneficiary must give notice to herself, she would giggle in the agent's face.

b. Belt and Suspenders Approach. The normal approach is for the trustee to give notice to the withdrawal beneficiary of each gift. However, if various premium payments are going to be made throughout the year, trustees typically give one notice at the beginning of the year of each premium gift date and amount. Several private letter rulings (PLRs 8121069 and 8133070) have said that one notice at the beginning of the trust is sufficient. However, the PLRs involve trusts with premiums of about the same amount each year. Don Jansen indicates that he prefers a "belt and suspenders" approach. He gives a one-time notice when the trust is created, and also gives a notice each year. He can fall back on the global notice if the trustee forgets to give notice in one year. That only works if the gift is of the same amount and on about the same date in each year.

19. Domestic Asset Protection Trust Ruling

a. Self-Settled Trusts Generally. Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts:" Alaska, Colorado, Delaware, Missouri, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Nevada and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help 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 (as long as there is no prearrangement).

b. Private Letter Ruling 200944002.

(i) Completed Gift. This ruling recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot revest beneficial title or change the beneficiaries. (Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.)

(ii) Application of §2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036." While this is only a private letter uling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under §2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. See Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; Estate of German v. United States, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift apparently because the law of the grantor's domicile did not permit such trusts.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. Estate of Uhl v. Comm'r, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); Estate of Paxton v. Comm'r, 86 T.C. 785, 818 (1986)(self-settled trust assets included under §2036 because grantor's creditors could reach income and corpus); Outwin v. Comm'r, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§2036(a)(1) or 2038(a)(1)); Estate of German v. U.S., 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because grantor's creditors could not reach trust assets where trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

20. Fiduciary Liability Issues

a. Documentation is Key. Professor Randall Roth addressed fiduciary liability concerns, emphasizing that documentation is the key to protecting the fiduciary.

(1) Critical Importance in Litigation. "Litigators agree that in a court of law, it's not about truth but about evidence."

(2) The Curse of Knowledge. A recent study had one group of people who would "tap" out songs, and another group of listeners who tried to identify the song. The tappers were asked if they thought the listeners figured out the song, and half the time they thought they did. But the listeners got it only 3% of the time. When you know in your head what the song is, you assume too much about other people's ability to grasp that as well.

(3) The Curse of Honesty. Honest people tend to assume they will be believed when they tell the truth.

(4) Hindsight Bias. This is a technical term that psychologists have studied for decades. One example study is to have two groups of physicians. Half of them will be told a patient case study of symptoms and test results and ask if decisions about a particular patient were good or not. One group would be told that "Suzie died, but put that out of your mind. Just take yourself back to the beginning; erase completely that you know what happened." The other group were told about the same case study but were not told that the patient died. The physicians in the first group were far more critical of the decisions along the way, knowing the end result. The psychological studies say hindsight bias is incredibly robust and pervasive. It cannot be avoided. It doesn't even help to warn people about it. People look brilliant or foolish based on subsequent events.

Example of Case That Refused to Apply Hindsight Bias. In Stark v. U.S. Trust Company, 445 F. Supp. 670, 678-80 (S.D.N.Y. 1978), beneficiaries sued the bank trustee for not selling three specific stocks before they had lost more than 90 percent of their value. The court refused to hold the trustee liable merely because of the lost value:

> "It is not inherently negligent for a trustee to retain stock in a period of declining market values, nor is there any magic percentage of decline which, when reached, mandates sale. Indeed, the market's fluctuations have expressly been rejected as a trustworthy indicia of a holding's value — especially in times of general economic decline. Similarly, the fact that a stock may not be desirable for long term investment does not mean that a trustee is under a duty to sell it at the first possible opportunity. Stripped to its bare essentials, the plaintiffs' argument is that the Trustee was negligent and imprudent in retaining these securities because of their sharp drop in market price and allegedly insufficient analysis. Case law is clear, however, that the former charge is irrelevant if the latter charge is unfounded…The Trustee's retention decisions [in this case] were the result of careful and informed deliberation; the fact that in retrospect they may have been wrong or unwise is no ground for surcharge."

Example of Case That Did Give In to Hindsight Bias. In re Chamberlain's Estate, 156 A. 42, 43 (N.J. Prerog. 1931) held a trustee responsible following the 1929 stock market crash, based on an incredible degree of hindsight bias:

> "It was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition [in August 1929] was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur."

Professor Roth concludes that quote is laughable if it weren't so scary.

Another case applied hindsight bias against a trustee for selling an asset before values appreciated:

> "[The trustee] sold these stocks at or near their lowest price levels … at the time the country was just beginning to recover from the worst recession since the 1930's." First Alabama Bank v. Martin, 425 So.2d 415 (Ala. 1982) as modified on rehearing Jan. 14, 1983, *cert. denied*, 461 U.S. 938 (1983).

Professor Roth concludes: Who knows today — is the economy about to recover?

Diversification. The importance of hindsight bias is evidenced in various cases in which trustees have been attacked either for diversifying or not diversifying (depending on the outcome.)

(5) Conclusion Regarding Fiduciary Liability. It is not enough to have truth on your side. You must prove it in a way that is convincing to others (that requires documentation) AND hindsight is working against the defendant. Don't just do the job right — document that you did the job right.

(6) Lawyer's Duty to Raise Peripheral Issues — Such as Creating an FLP. Professor Roth has been involved in three cases where attorneys were sued for not having suggested that the client create an FLP. Twice, he testified that the attorney did not have that duty; once he testified as an expert that the attorney did have that duty — among other things, the family had a really good non-tax reason for setting up a family entity and the adult child was able to contribute assets to it.

In re Galloway, 2007 WL 5125298 (Minn. Dist. Ct) involved a case where estate beneficiaries argued that an attorney and bank trustee were liable for not doing enough to save taxes and specifically that they did not recommend use of an FLP. Despite the absence of non-tax reasons and evidence that saving taxes was not the decedent's primary objective, the lawsuit consumed vast resources. After 34 trial days and testimony from 12 expert witnesses, the court issued a 176-page opinion in favor of the bank, but the lawyer had already settled for an undisclosed amount.

Professor Roth's conclusion: Document what you talk about and what you don't talk about, if you think someone might argue that you should have talked to the client about the issue.

b. Fiduciary Liability of Trustee of ILIT. In In re Stuart Cochran Irrevocable Trust, 901 N.E.2d 1128 (Ind. Ct. App. 2009), the trustee of an ILIT hired an insurance consultant to review insurance policies held by the ILIT, and the consultant advised that the policies would likely lapse prior to the grantor's death. Accordingly, the trustee exchanged the policies for a policy with a lower death benefit that was guaranteed to age 100. Several years later, the grantor died unexpectedly. Beneficiaries sued the trustee for breach of fiduciary duties with respect to the management of the trust assets (and exchanging the policies for a policy with a lower death benefit). The trial court held in favor of the trustee, finding that it "acted in good faith to protect the interests of the Beneficiaries." The Court of Appeals agreed, emphasizing that courts should not apply hindsight in addressing fiduciary investment decisions. The court reasoned that "although it is tempting to analyze these cases with the benefit of hindsight, we are not permitted to do so, nor should we."

Planning Pointer: In this case, the corporate trustee was able to protect itself by engaging an outside consultant to review the policies to help determine if they remained appropriate investments.

c. Liability Denied For Failure to Sell Asset. In Sun Trust v. Farrar, 277 Va. 546 (2009) the court refused to hold the trust liable for failing to sell a coal mine. The plaintiff's economics expert testified that if the property had been sold for a particular price in 1987 how much the trust would have grown to and been able to distribute. The court held the trustee was not liable. A primary reason was that there was no evidence that the coal mine could have sold for that price; still the circuit court found the trustee had failed to properly market the property. The Virginia Supreme Court reversed because (1) the beneficiaries failed to meet their burden of proving damages, (2) the beneficiaries had the burden of proving damages with reasonable certainty, and (3) the court could not rely on speculation and conjecture.

21. Trust Protector Duties

McLean Revocable Trust v. Patrick Davis, P.C., 283 S.W. 3d (Mo. Ct. App. 2009) addresses the duties of a trust protector of a revocable inter vivos supplemental/special needs trust for a disabled beneficiary. The agreement authorized the trust protector to remove and replace the trustee. The trust held the settlement proceeds of a personal injury recovery. The trust protector was a lawyer who handled the suit and the successor trustees were the lawyers who referred the litigation to the trust protector. Conflict of interest concerns were raised.

The trust agreement merely provided that the trust protector's authority "is conferred in a fiduciary capacity and shall be so exercised, but the Trust Protector shall not be liable for any action taken in good faith." The defendant claimed that Missouri law imposes no duties on a trust protector. The court reasoned that lacking any duties imposed by state law, the issue was whether the document generated any duties and concluded this fact issue precluded summary judgment in favor of the defendant. The opinion suggests that the documents use of "fiduciary capacity" implied "at least the basic duties of undivided loyalty and confidentiality... [and] the existence of at least some duty of care." The opinion is troubling in suggesting that the trust protector's fiduciary duties are owed to the trust itself rather than to beneficiaries.

Practical Pointer: Drafters should define the role of a trust protector and better establish liabilities that may be imposed, especially if the trust protector is not meant to be held to fiduciary standards.

22. Built in Gain Discount, Litchfield

The latest Tax Court case to consider the built-in gains discount is Estate of Litchfield, T.C. Memo. 2009-21. The case involved the valuation of a decedent's stock in a C corporation and in an S corporation that had converted from a C corporation about 22 months before the valuation date, and the corporate-level capital gains tax would be imposed on the sale of assets within 10 years of the S election. The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates (after discussions with the officers and board of directors of the corporation), estimated appreciation of the assets up to the anticipated sale dates, calculated the estimated capital gains taxes on those sales dates (taking into account appreciation before the date of death as well as anticipated appreciation after the date of death up to the sale date for anticipated sale dates that were within ten years of the S conversion), and discounted the tax amounts to present values. The court agreed with the estate's appraiser as to the built-in gains discount.

- The court allowed the built-in gains discount.
- The taxpayer did not claim a "dollar for dollar" discount which the 11th Circuit allowed in Estate of Jelke, 507 F.3d 1317 (11th Cir. 2007). The court specifically observed in footnote 10 that the expert did not apply a dollar-for-dollar discount and that the court did not need to decide if that approach would have been appropriate in this case.
- Courts have not yet resolved whether anticipated future appreciation of corporate assets should be considered in determining the present value of the built in gains discount. The court did allow consideration of future appreciation and specifically criticized the IRS's expert for not taking into account appreciation after the valuation date to the anticipated sale dates "that also likely will occur and that will be subject to taxes at the corporate level—what one expert has described as the tax-inefficient entity drag." (If the asset were not in the corporation, future appreciation would not be subject to the double tax, so the analysis assumes that a hypothetical buyer would take this extra corporate level tax burden into account in negotiating a sales price.) Jeff Pennell says this issue is unsettled and that commentators disagree on the proper approach as to whether future anticipated appreciation should be considered.

23. QPRT Issues

a. Sale of Remainder Interest in QPRT. In Letter Ruling 200919002, the IRS approved (sort of) the sale of a remainder interest in a personal residence in a trust that meets the requirements of a QPRT. The ruling held that the value of the remainder interest at the value determined under §7520 would be for full consideration. Strangely, the IRS declined to express an opinion as to whether the trust qualified as a QPRT. The Ruling also declined to express an opinion as to whether the residence would be in either spouse's estate under §2036. However, there are sound arguments for excluding the value from the estate of the spouses following the sale of the remainder interest under the Wheeler. D'Ambrosio, Magnin line of cases. "This is not for the cautious, but it is a potential planning strategy."

b. "Reverse QPRT" After Initial QPRT. Various private letter rulings have approved reverse QPRTs — under which the owner transfers the use of a residence to someone for a term of years and retains the reversion. The donor is treated as making a gift of only the actuarial value of the term interest. E.g., PLRs 200904002, 200901019, 200848007, 200848003, & 200814011. **This is especially worth considering during low interest rate periods when the term value of the right to use the residence is relatively low and when current real estate values are depressed.**

Private Letter Rulings 200935004 and 200920033 deal with situations in which a reverse QPRT was created at the end of the term of a previous QPRT. For example, in Letter Ruling 200920033 Father originally contributed his residence to a QPRT, with the remainder passing to Son. At the end of the trust term, Son proposed transferring the residence to a QPRT in which Father could use the residence for a term of years. Son retained the reversionary interest. The ruling concluded that this would qualify as a QPRT if the new trust "is substantially similar to the sample in section 4 of Rev. Proc. 2003-42 and the trust operates in a manner consistent with the terms of the trust instrument and is a valid trust under applicable local law, and if Residence qualifies as a personal residence as defined in §25.2702-5(c)(2)." The ruling expressed no opinion concerning whether the transfer to the new QPRT would result in the residence being included in Father's estate under §2036 (apparently leaving open the possibility of arguing that at the time Father transferred the residence into the original QPRT there was an express or implied agreement that Son would allow Father to use the residence at the end of the original QPRT term). There are no objective rules for assuring that the "gift-back" to the original donor is a separate and independent act and that there is not an express or implied agreement that would trigger §2036 to include the residence in the original donor's estate.

Planning Pointer: After a reasonable period of holding the residence or renting it to the original donor, the original beneficiaries could meet with counsel to discuss a gift back to the original donor. They should use their own attorney rather than the original donor's attorney. For a discussion of these rulings, see Handler, Tax Update, TRUSTS & ESTATES, August 2009, at 9 and February 2009, at 10.

c. Explicit Right to Rent Residence at End of QPRT Term. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under §2036. E.g., Ltr. Ruls. 200825004, 200822011, 199931028. In the QPRT rulings, there is no §2036 inclusion as long as "there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid."

Observe that the IRS has not always conceded that selling or giving a residence and renting it back to the grantor for a fair rental value always avoids application of §2036. See Tech. Adv. Memo. 9146002 (distinguishing Barlow, 55 T.C. 666 (1971) [no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems]). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. E.g., Estate of Du Pont v. Comm'r, 63 T.C. 746 (1975). See also Estate of Maxwell v. Commissioner, 3 F.3d 591 (2nd Cir. 1993)(sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent, and rent payments effectively just cancelled the son's mortgage payments).

d. 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 from the grantor's estate; and 3) The grantor must pay fair market value 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 sells 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.)

24. Changed IRS Ruling Position on GST Ruling Regarding Modificiation of Exempt Trust

Carol Harrington was recently surprised by a changed IRS ruling position. The IRS will rule that certain modifications of exempt trusts will not cause the trusts to lose their exempt status if everyone agrees to the modification in a settlement agreement. If the parties cannot settle, the court will often issue an order contingent upon receiving a favorable private letter ruling. The IRS recently indicated that it will no longer issue those rulings unless all parties agree to the modification. That ruling policy allows any one beneficiary to "hold up the whole show." "Before incurring the expense for a ruling, give them a call and ask them how they're feeling today."

25. Life Insurance Surrenders and Sales

Revenue Ruling 2009-13 addresses the income tax effects of a surrender or sale of a life insurance policy. The surrender of the policy is not entitled to capital gain treatment. (Barr v. Commissioner, T.C. Memo 2009-250 confirms that result.) A sale of the policy by the insured requires that insured's basis in the policy be determined by reducing the cost of the insurance protection (but it did not say how to calculate that cost). The portion of the sale proceeds that would be treated as ordinary income if the contract were surrendered is treated as ordinary income under the "substitute for ordinary income doctrine." (Professor Jeff Pennell says he has taught income tax for decades and has never heard of that doctrine.) A sale of the policy to the insurance company itself is not covered in the ruling, but it would likely be treated as a surrender.

Revenue Ruling 2009-14 is a companion ruling addressing the income tax treatment of policies held by investors. Situation two addresses a sale of the policy by the investor, and it does not require reducing the basis by the cost of insurance. Jeff Pennell says "this is absolutely goofy. Go figure."

Jeff Pennell's conclusion: "This is a mess."

26. Pre-1942 General Powers of Appointment

There has been an increase in rulings and cases regarding pre-1942 powers of appointment for trusts created by old moneyed families as their children are dying. Pre-194242 general powers of appointment are subject to estate inclusion only to the extent they are exercised. §2041(a)(1). Make sure that the residuary clause does not exercise a power of appointment unless that is clearly intended.

a. Testamentary Power to Appoint to Individual's Does Not Include Estates of Those Individuals. In TAM 200907025, the issue was whether a power of appointment was a general power of appointment. The beneficiary had a testamentary power to appoint assets to the "children of Grantor and their descendants." The powerholder was a descendant of the Grantor of the trust, so did this power authorize the holder to appoint the assets to his own "estate?" The TAM concluded that it did not. There are several consistent state cases. Unless a power of appointment specifically refers to an estate, it only includes living persons. Otherwise, the limitation on the power would be meaningless. For example, if a child of the trust settlor could appoint to the settlor's descendants, the appointment could be made to anyone in the world if that were interpreted to allow appointment to the beneficiary's own estate.

b. Disclaimer of Pre-1942 General Powers of Appointment. Jeff Pennell says this is "the coolest thing around but they are getting scarcer and scarcer." Reg. § 25.2518-2(c)(3)(i) provides: "If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a *general* power desires to make a qualified disclaimer, the disclaimer must be made within a nine-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax." Therefore, even though no estate tax is imposed on the holder of a pre-1942 general power if it is not exercised, takers in default of exercise of the power can disclaim within nine months of when they receive the assets. Therefore, decades after the power is created, beneficiaries have another shot to disclaim to get the assets down to another generation. Numerous private letter rulings have approved that strategy.

27. Governing Law Provisions in Trusts

Professor Jeffrey Schoenblum discusses governing law provisions. Trust agreements often just apply the law of the state where the trust agreement is signed. However, there can be advantages of choosing the choice of law provisions as to different issues affecting the trust. In most circumstances, there most be some connection with the state whose law is chosen. Professor Schoenblum's thesis is it does not make sense to accept local law blindly on all issues if that is not the best answer and if other options are available. Some of the issues for which this could be significant are summarized.

a. Governing Law Clause Is Important. Governing law clauses cannot be ignored because the underlying conflicts of laws principles are so arcane and unpredictable. In addition, the settlor, trustees, successor trustees, beneficiaries, holders and objects of powers of appointment will not be in the same jurisdiction forever.

A good example of confusion that can be generated by choice of law issues is In re Chappell, a New York case from this year. It involved a New York testamentary trust that created a power of appointment, where the holder of the power died with a will that did not refer to the power but had a residuary clause. The issue was whether the residuary clause exercised the power. New York law was designated as the governing law in the original testamentary trust. The Surrogate Court held that adoption of New York law includes the New York conflicts of law principles, which requires applying the law of the state with the paramount interest. All of the beneficiaries were in Connecticut, so the New York court held that Connecticut law applied and under Connecticut law a residuary clause does not operate to exercise the power of appointment.

b. Categories of Issues That Should Be Considered.

(1) Statute of Limitations. In some cases, it is possible to use the law of a certain state that has a shorter (or longer) statute of limitations.

(2) Construction. Some trust agreements incorrectly refer to "interpretation." Interpretation is the process by which the settlor's or testator's intent is determined through fact finding. But the appropriate legal issue is "construction." Construction applies if, after inquiring into the facts, we cannot determine the intent. Choose the state whose construction law is most favorable.

(3) Validity of the Trust. There are three types of validity. A mere reference to "validity" does not necessarily suffice. It may be important to establish the governing law as to each of these types of validity (and different states could be

chosen for the different types of validity). The three types are: (i) Validity of transfers into the trust; (ii) Formal validity (such as notarization requirements, execution requirements; the adoption of a very liberal law of another state can come into play and help assure formal validity of a trust in any number of jurisdictions where a trust may operate); and (iii) Substantive validity (such as validity of rule against perpetuities clauses, spendthrift clauses, restrictions on beneficiaries before they can take under the instrument, etc.)

(4) Administration. Issues include duties and powers of trustees, exculpation, role and duties of affiliated persons, protectors, advisory committees, persons to whom a fiduciary duty is owed, principal and income allocation, permissible investments, compensation, and the power to terminate or modify the trust via judicial process or outside the judicial process. The draftsman could consider how to improve the situation in any of those subtopics.

(5) Related Instruments. Testamentary trusts do not necessarily have to be governed by the law that governs the estate generally. The law that controls whether a revocable trust can be revoked by will could be addressed (different states have differing rules). Powers of appointment are very tricky in the choice of law area, but the opportunities for governing the choice of law are limited because the law chosen by the settlor of the trust that created the power of appointment generally controls, not the law chosen by the holder or object of the power.

c. Can There Be Different Governing Law For Different Issues? Section 107 of the Uniform Trust Code limits the choice of law for a trust to a single state. Professor Schoenblum thinks that is a bad provision. The Uniform Trust Code adopted its provision from the Hague Convention on International Trusts. The European position is much more limited on the dispositive freedom of settlors, and he thinks the Commissioners did not focus on that difference. However, even the Uniform Trust Code only addresses choice of law as to construction, not other issues. Section 106 of the Uniform Trust Code says that to the extent the Code does not address any issue, common law remains in effect. So on all matters except construction, there can be different governing laws for differing issues even under the Uniform Trust Code.

d. Build in Flexibility. Build in the ability to change the governing law provisions, where appropriate. One approach is to give the trustee or trust protector the ability to change the governing law. When the situs of a trust is moved, the traditional rule is that the law of trust administration changes. The draftsman could address whether the law of administration would change automatically if the situs is changed, or whether a trustee or trust protector should make that decision.

e. Limitations.

(1) Substantial Relation. The law chosen must have a substantial relation to the trust. That can be nothing more than having some assets located in that jurisdiction, having at least one beneficiary residing in that jurisdiction, or having an office of the trust operating in that jurisdiction.

(2) Not Violate Strong Public Policy. The choice of law cannot be a violation of a strong public policy of the jurisdiction with the strongest relation to the trust. Nobody knows what "strong public policy" is. The Restatement (Second) of Conflict of Laws says, for example, that the rule against perpetuities does not

involve a strong public policy. If that does not involve strong public policy, what does?

28. Future Role of Estate Planners

Alan Rothschild discussed the role of estate planning professionals in this changing environment. As a result of increasing estate tax exemptions and demographic and societal trends, the importance of the focus of tax planning for many professionals will be greatly diminished. The professional will need to adjust his or her practice to respond to other areas where clients will need professional services. He urges professionals to choose areas where they want to develop areas of expertise and market those areas along with their estates planning abilities.

a. <u>Historical Background of the Origins of Our Profession</u>. One of the oldest known wills, the Will of Uah, dated 2548 B.C., illustrates how far back the basic language of our trade can be traced (in effect, this ancient will creates a limited power of appointment):

> I, Uah, am giving a title to property to my wife, Shefta, … all things to me by my brother … she shall give to any she desires of her children she bears me."

The "modern problems" we face regarding structuring plans in a way to provide incentives to children have challenged planners for over four centuries, as evidenced by this summary from 1556:

> "If your children and relations are notoriously vicious and debauched … do not abdicate or cast them off … but make provision for them in trust; in such manner and with such circumstance, as may relieve their necessities, but not their lusts."
>
> *A Theological Discourse of Last Wills and Testament*s William Assheton, Rector of Buckingham in Kent

[What a terrific phrase, even today — "as may relieve their necessities, but not their lusts."]

The 150-year old sheepskin documents hanging on our walls have language similar to the language of onion skin documents from the 1950s. Until the late 1960s, despite the existence of the estate tax, estate planning had evolved relatively little.

b. <u>Changing Nature of Estate Planning Practices</u>. Before the 1960s, most lawyers were not specialists. In 1960, there were only three firms in New York with over 100 attorneys. Beginning about 1970, the estate planning field grew rapidly, both in numbers and sophistication. In 1976 and 1981, there were dramatic changes in estate tax laws. The tax changes have been accompanied by a simplified probate process, streamlined estate planning forms and increasing exemptions.

Tom Eubank (Houston, Texas) made predictions 35 years ago that are still relevant today. He noted two challenges: (1) Increased work from non-lawyers for work traditionally done by the estate planning bar; and (2) increased estate tax exemptions. His conclusion: "The future for estate lawyers is uncertain and perhaps bleak, unless the practice of estate law is changed significantly."

Tom Eubank's predictions are particularly relevant today, with increased estate tax exemptions and lower market values. At a $3.5 million estate tax exemption, 99.5% of estates will not be subject to the estate tax. Compare that situation with 1976, when 139,000 estate tax returns were filed, representing 9% of all adult deaths.

c. Related Complimentary Areas. Areas suggested by Tom Eubank in his study (with several additions) are: (1) corporate and partnership law; (2) real estate law; (3) income taxation; (4) tax litigation; (5) family business counseling; (6) corporate litigation; (7) employment law; (8) charitable giving; (9) exempt organizations; (10) divorce law; (11)will contests and probate litigation; (12) elder law; (13) asset protection; and (14) international tax planning.

d. Demographic and Societal Trends.

(1) Aging Population. The elder law group is increasing dramatically. The number of persons over age 65 will be 40 million this year, increasing to 72 million in 2030. For individuals over age 85, 65% will have cognitive ability concerns.

(2) Increased Mobility and Globalization. "Mobile clients create significant multi-state, and unauthorized practice of law issues, including selection of domicile, community property and a myriad of state laws on spousal rights, homestead, and what constitutes the practice of law."

(3) Modern Families. Fifty percent of marriages end in divorce and most (men, at least) get remarried. There will be an increase of blended and modern families (including children of frozen sperm and embryos and posthumously conceived children). "Estate planning attorneys are already elder lawyers, we have just been afraid to admit it." --Doug Chalgian

(4) Growth of Non-Probate Assets. This results in the avoidance of probate, and increased importance for many families of retirement plan assets.

(5) Increased Litigious Society. Aging clients create more opportunities for will contests and guardianship proceedings. Blended families create a greater likelihood of estate disputes. An offshoot of the increasing litigious society has been the growth of the importance of asset protection planning.

e. Professional Judgment and Experience. Alan frequently gets questions from reporters about "do it yourself" estate planning. Legal Zoom advertises a $69 online will. Alan tells reporters that preparing our own will is like trying to wire you own house. You can go to Home Depot and buy instruction manuals and materials. If you do it right, great. But if you do it wrong, there are serious downside consequences, including burning the house down, or worse. What clients are buying is the attorney's judgment and expertise.

Paul Lippe, founder of LegalOnRamp, says "lawyers (and most professionals) do five things: read, create documents, find stuff, communicate, and think." Web technologies have streamlined the first four — allowing professionals more effective time for thinking and solving complex problems.

29. Interesting Quotations

a. Confidence in Washington. "You get great comfort in listening to our leaders in Washington when Senator Baucus says there's massive massive confusion." — Dennis Belcher

b. Reaction to Our Confidence in Washington. "Perhaps the Senate should form a circular firing squad." — Comment on ACTEC listserv

c. Retroactivity. "We just have to assume it is constitutional." — Dennis Belcher

d. Our Court System. "Everybody's entitled to their decade in court." — Conrad Teitell, in commenting that there will be lawsuits about the constitutionality of a retroactive reinstatement of the estate tax (if that occurs)

e. The Mood of the IRS. "Before incurring the expense for a ruling, give them a call and ask them how they're feeling today." — Carol Harrington, in commenting on the IRS's changed ruling position regarding the GST effects of modifying trusts

f. Carol's Short Form Reaction to Sunset Provision. After commenting on the nonsensical result from a literal application of the sunset provision in 2011, Carol Harrington observes that many say the courts won't interpret it that way because it's just too crazy. Carol agrees it is crazy, but the statute says that. She concludes, "Oh dear." (That may be the best *two* word summary I've heard of the sunset provision.)

g. Carol's Long Form Reaction to Sunset Provision. After going through various machinations of whether the move-down rule applies for GST purposes in 2011 as to 2010 transfers, Carol laments "I'm really dizzy." (And that may be the best *three* word summary of the sunset provision.)

h. Tax Laws. "Never watch our tax laws or sausages are made."— Carol Harrington

i. Where Were They Last Year?. "The Treasury did virtually nothing last year [on estate and gift tax projects]. I don't fault them for that." — Jeff Pennell

j. Tax Lawyers Don't Control. "Congress and tax lawyers don't decide what a will means. A will means what the testator intended it to mean when the will was signed. Courts will determine that." — Bruce Stone

k. The Uncaught. "There are the caught and the uncaught. But you cannot rely on being the uncaught." — Dennis Belcher, relaying situation where client refused his advice to get appraisal, got an accountant to sign the return with an appraisal, and the client got away with it.

l. Problem Solvers? "Attorneys identify problems you didn't know you had and solve them in a way you don't understand." — Dennis Belcher

m. Uniformity in Office Supplies. "When the company has board resolutions to document its reasons for decisions over several years, it just so happens that sometimes they are done with very similar ink and paper." — Carol Harrington

n. What Beneficiaries Care About. Estate beneficiaries have just two questions. What do I get and when do I get it?" — Dennis Belcher

o. Disclaimers. "The most common reason disclaimers fail is inadvertent acceptance. So counsel your client early and often not to accept benefits." — Professor Jeffrey Pennell

p. Jeff on FLPs. After being assigned all the taxpayer losses in the FLP area to discuss, Professor Jeffrey Pennell understands. "I get the stinky cases. 'Give it to Mikey. He doesn't like anything.'" — Professor Jeffrey Pennell

q. It's Never Too Late. "The fact she died before all the little details were completed did not keep them from getting a big whopping discount." — Carol Harrington's summary of Keller, where the estate received a 47.5% discount for interests in a FLP where the decedent had not transferred legal title assets into the partnership before the decedent's death.

r. Details, Details. Jeff Pennell's favorite statement from the Kelley case: "Although the exact amount of the expenses are not known by the court, the court finds them to be permissible."

s. Take What You Can Get. Jeff Pennell says that he once asked an IRS field agent why agents go after annual exclusions when truck loads of value pass out of estates through discounts. The response: "These are the cases we can win."

t. Sleaziness in the Estate Planning World. In observing one of the alternatives for GRATs mentioned by staffers to the Joint Committee on Taxation, to value the gift at the end of the initial term of the GRAT rather than at the creation of the GRAT: "That is something like an ETIP for GRATs, or a GTIP — but that sounds sleazy." — Carol Harrington

u. There's More To It Than Just Technical Tax Issues . Carol Harrington relays a client situation from years ago in which the client was in the process of purchasing flower bonds for his father but the purchase was not yet completed when the client called the lawyer and said his father had just died. The attorney replied, "You're not a doctor. Call an ambulance." They got the bonds purchased before the death certificate was signed.

v. No End To Treachery. "My dad always told me, 'You never know how long a snake is until it is dead.'" — Dennis Belcher

w. Some Things Are Inevitable. "Did you hear about the two Irishmen who left the bar? It could happen." — Professor Chris Hoyt

x. Are You Ever Sure? Two hydrogen atoms who walked into a bar. One said "I think I lost an electron." The other said "Are you sure?" The first replied, "Yes, I'm positive." — Professor Chris Hoyt

y. What We Can't Have. "Is the Roth IRA like a Cuban cigar? They're everywhere in Cuba. Once someone says you can't have something, everyone wants it." — Professor Chris Hoyt

z. Golf and The Laws of Physics. "Avid golfers are the only people who think curse words can alter the flight of a ball." — Professor Chris Hoyt

aa. As We Get Older. "As I got older, I started using glasses. When I was younger I drank directly from the bottle." — Professor Chris Hoyt

bb. Securities Lawyers and GRATs. "If three securities attorneys look at it, I assure you there will be at least two different answers… Securities lawyers will have all kinds of problems [with the discretionary distribution of stock from a GRAT in satisfaction of the annuity payment]. It's nice to know that someone is more paranoid than we are." — Mil Hatcher

cc. GRATs and Valuation. "One thing about GRATS. I've never found an easy to value asset." — Mil Hatcher

dd. Can't They Just Pay Attention? "There's nothing worse than sending out the notice, and having the client call 106 days later and ask –when is the due date?" — Mil Hatcher, referring to advising clients of the due date for making GRAT annuity payments

ee. Who's Really in Control? "There are three votes but only one counts." — Skip Fox, referring to the difficult recurring problem of the senior generation refusing to relinquish control in succession planning ff. <u>The Really Key Players in Succession Planning</u>. "The two most important people (other than the owner) to deal with regarding business succession planning are the spouse and the accountant. — Skip Fox

gg. <u>Cryogenics — You Want to Be Put on Ice</u>? Cryogenics is the ultimate "estate freeze." The cost of a head freeze is $75,000 and the cost of a full body freeze is $250,000. Some notable personalities have been frozen, including Walt Disney, Howard Hughes and Ted Williams." — Joshua Rubenstein

hh. <u>So That's What Men Are Good For</u>. "A woman without a man is like a fish without a bicycle." — Gloria Steinem, quoted by Joshua Rubinstein

ii. <u>Can't Have Children</u>? Someone asked the Spanish ambassador to the UN at a press conference why he did not have children. He did not have a Spanish-to-English dictionary handy and responded: "My wife is impregnable, inconceivable, and unbearable." — Joshua Rubenstein

jj. <u>Fish or Cut Bait</u>. There was a football game in the jungle — large animals playing small animals. At halftime, the large animals were ahead 55-0. The coach of the little animal team was dispirited, simply telling the team, "Come on, let's go finish the game." On the first play, the elephant was tacked for a one yard loss. On the second play, the gorilla was tackled for a loss. On the third play, the rhino was tackled for a huge loss. The coach was ecstatic. He yelled out, "Who got the elephant?" The centipede said "I did." "Who got the gorilla?" The centipede said "I did." "And who got the rhino?" The centipede said "I did." The coach was totally ticked off. "What were you doing the entire first half?" The centipede responded, "Coach, I was taping my ankles." — Professor Randall Roth

kk. <u>Documentation is King</u>. "Litigators agree that in a court of law, it's not about truth but about evidence … No documentation — Translation: I don't believe it." — Professor Randall Roth

ll. <u>Danger of Being Hindsighted</u>. "It was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition [in August 1929] was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur." (In re Chamberlain's Estate, 1931 New Jersey case, two years after the 1929 stock market crash) — Professor Randall Roth (who concludes that quote is laughable if it weren't so scary.)

mm. <u>The New Biology</u>. "The new biology provides a lot of "fertile" ground both for litigators and for planners." — Alan Rothschild

nn. <u>Few Pay Estate Tax</u>. At a $3.5 million estate tax exemption, 99.5% of estates will not be subject to the estate tax. Compare that situation with 1976, when 139,000 estate tax returns were filed, representing 9% of all adult deaths. — Alan Rothschild

oo. <u>Are We Changing</u>? "I wonder if I've been changed in the night? Let me think. Was I the same when I got up this morning? I almost think I can remember feeling a little different. But if I'm not the same, the next question is, "Who in the world am I? — Alice in Wonderland (quoted by Alan Rothschild) pp. Tax Policy. "I have on more than one occasion refused to teach a course on tax policy since I do not believe there is such a thing. Tax laws are driven by politics, budgets and government spending."— Jerry Kasner (quoted by Alan Rothschild)

qq. Get It In Writing. "The palest ink is better than the best memory.'" — Chinese proverb (quoted by Alan Rothschild)

rr. Show Me The Money. "How can I ever show my appreciation Mr. Darrow? Ever since the Phoenicians invented money, there has been only one way to answer that question." — Clarence Darrow (quoted by Alan Rothschild)

ss. What We Make of It. "This time, like all times, is a very good one, if we but know what to do with it." — Ralph Waldo Emerson (quoted by Alan Rothschild)

tt. Room at the Top. Daniel Webster was born in 1782 to a poor New Hampshire farming family. A friend advised Webster not to enter the legal profession because it was already overcrowded (in 1800!) and a difficult profession for a person of limited means or family connections. Webster responded to his friend, "There's always room at the top." — Alan Rothschild

uu. Sharpening the Axe. "If I had eight hours to chop down a tree, I'd spend six hours sharpening my axe." — Abraham Lincoln