Estate of Jensen v. Commissioner, T.C. Memo. 2010-182 (August 10, 2010)

"Built-In Gains Discount" Allowed in Valuing C Corporation Based on Present Value Analysis of Corporate Income Tax Liability on Eventual Sale of Assets, Taking Into Consideration Anticipated Future Appreciation in Corporate Assets

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Synopsis

The built-in gains tax discount was determined under a present value discounting approach. The case is appealable to the Second Circuit, and the court refused to speculate on whether the Second Circuit will use a "dollar for dollar" approach for determining the built-in gains tax discount that has been adopted by the Fifth and Eleventh Circuits. The court rejected the IRS appraiser's approach of analogizing to closed-end funds, which would have disallowed any built-in gains discount to the extent that the built-in gains tax was less than 41.5% of the corporation's net asset value. The court made its own present value analysis, assuming equal growth rates and discounts under two scenarios (5% in one and 7.5% in the other). Not surprisingly, the court's calculation was very similar to the dollar-for-dollar discount based on the amount of built-in gains tax at the date of death (because the assumed appreciation in the assets and the capital gains tax was offset by the assumed discount to present value when the factors were the same).

Basic Facts

1. Decedent died with a revocable trust that owned 82% of a C corporation, the primary asset of which consists of appreciated real estate and improvements used as a summer camp. If the assets had been sold on the date of death, there would have been a built-in long term capital gains tax to the corporation of approximately $1.1 million. (The liability was initially estimated at $965,000 but the estate on brief claimed a built-in gains tax of $1,133,283.) At the date of death, a sale or liquidation of the corporation or its assets was not imminent or planned.
2. The IRS on audit allowed a 5% lack of marketability discount and a discount of $250,042 for built-in capital gains tax. Eventually, the parties agreed to a 5% lack of marketability discount (there is no discussion in the case as to why the agreed lack of marketability discount was so low), and the only issue for the court was the amount of built-in gains tax discount.

Holding

The built-in gains tax discount is determined (by Judge Vasquez) based on a present value analysis, taking into consideration anticipated future appreciation in the corporate assets over an estimated 17-year holding period after the date of death. The court rejected the IRS appraiser's approach of analogizing to closed-end funds, which would have disallowed any built-in gains tax discount to the extent that the built-in gains tax was less than 41.5% of the corporation's net asset value. Instead, the court calculated a present value built-in gains tax discount of about $1.2 million under several different scenarios, and therefore allowed the full $1,133,283 built-in gains tax "dollar-for-dollar" discount requested by the estate.

Analysis

1. <u>Taxpayer's Expert</u>. The estate's expert calculated the built-in gains tax based on the difference between the fair market value of the real estate at the date of death less the estimated tax basis times a 34% tax rate plus a small tax increase for income over $100,000. The calculation was:

   [$3,300,000 (FMV) - $500,000 (basis)] x 34% + $13,000 (tax increase for income over $100,000) = $965,000.

The estate's brief subsequently requested a discount of $1,133,285 for state and federal tax. [Observe: the additional $168,000 equals the amount of the $2.8 million gain times 6%, which is approximately the amount of the state income tax. The parties agreed that the combined state and federal income tax rate was 40%.]

The estate's appraiser calculated that a dollar-for-dollar discount was appropriate because "[t]he adjusted book value method is based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets." The appraiser also noted that the Estate of Dunn Fifth Circuit case allowed a dollar-for-dollar discount.

2. IRS Expert. The IRS expert used a novel approach of examining the amount by which built-in gains tax exposure to each of six closed-end funds depressed their values in relation to their net asset values. The built-in gains tax exposure did not exceed 41.5% of the net asset value for any of the six funds. The expert found no direct correlation between higher exposure to built-in gains tax to the discounts for net asset value for the funds. Therefore, the expert concluded that no built-in gains tax discount should be allowed to the extent that the built-in gains tax did not exceed 41.5% of the net asset value.

   The expert "opined that full consideration (i.e., a dollar-for-dollar discount) should be given" for the built-in gains tax that exceeded 41.5% of the net asset value.

   To support its conclusion of allowing a discount of about 50% of the built-in gains tax, the expert opined that there are methods to avoid paying the built-in gains tax by engaging in a § 1031 like kind exchange or converting to an S corporation (while acknowledging that there are limits and restrictions on those methods).

3. Burden of Proof. The court's conclusions were based on a preponderance of the evidence so the court did not address whether the burden of proof shifted to the IRS.

4. Dollar-for-Dollar Discount. The Fifth (Estate of Dunn) and Eleventh (Estate of Jelke) Circuits have allowed dollar-for-dollar discounts of the built-in gains tax (i.e., 100% of the built-in gains tax based on the amount of gain in the corporation's assets at the date of death.)

   This case is appealable to the Second Circuit, and a Second Circuit case, Estate of Eisenberg (1998), was one of the first cases to allow any built-in gains tax discount after the repeal of the General Utilities doctrine. Indeed, that was the case in which the IRS, by its acquiescence (1999-1 C.B. xix), acknowledged that a discount for built-in gains tax may be applied in appropriate circumstances. Eisenberg did not address whether the discount should be dollar-for-dollar, but the estate argued that the Second Circuit will do so when it next addresses the issue, in light of the Fifth and Eleventh Circuit opinions that were decided after Eisenberg. The court refused to speculate on what the Second Circuit will do, and did not address whether a dollar-for-dollar discount should be allowed based on date of death values. (Instead, as discussed below, the court applied a present value analysis based on its estimate of future circumstances, the result of which was basically a dollar-for-dollar discount.)

5. Rejection of Closed-End Funds Approach and Minimizing Discount Because of Alternate Methods to Avoid Payment of the Built-In Gains Tax. The closed-end funds reviewed by the IRS expert were not comparable to the real estate owned by the corporation. Closed-end funds invest only indirectly in real estate (such as with real

estate investment trusts) and hold various types of real estate. Also, discounts for closed-end funds are attributable to various factors (including manager or fund performance) and the built-in gains tax effect cannot be estimated.

After reviewing the limitations and restrictions on the possible avoidance (really deferral) methods, the court was "not convinced that a viable method for avoidance of the built-in LTCG exists for a hypothetical buyer" of the corporation's stock. The court concluded that the possible avoidance methods would not significantly reduce the discount for built-in gains tax.

In sum, "we do not give much weight to respondent's expert's valuations."

6. Present Value Approach to Determine Built-In Gains Discount. Footnote 13 observes that the Tax Court "has frequently applied a present-value approach based on all the facts and circumstances . . . to determine the taxpayer's discount for the built-in tax liability" (citing Estate of Litchfield, Estate of Jelke, Estate of Borgatello, Estate of Dunn, and Estate of Jameson.)

   The court calculated estimated future values of the land and related improvements under two assumed scenarios: using a 5% appreciation rate (the rate of appreciation assumed in the taxpayer's separate real estate appraisal) and using a 7.5% appreciation rate (based on pre-tax return of income data in the taxpayer's expert's report). It assumed assets would be sold in 17 years. (There was no evidence of what turnover rate was anticipated. The court looked to the "average useful or depreciable life" based on the depreciation figures used in the taxpayer's real estate report.)

   The amount of built-in gains tax based on those appreciated values in 17 years was determined by multiplying the assumed appreciated values by a 40% tax rate. The resulting tax amounts were discounted to present value using a discount rate equal to the assumed appreciation rate. There was no discussion by the court as to how the discount rate was chosen and why the discount rate should equal the assumed rate of appreciation.

   The court's calculation resulted in a built-in gains tax having a present value of $1.23 million and $1.26 million under its two scenarios. Each of these exceeded the estate's request for a 1.13 million discount, so the estate's requested discount was allowed. The end result was that the court allowed a dollar-for-dollar built-in gains tax discount in light of the way it calculated the present value of the built-in gains tax.

Observations

1. Present Value Approach. There are two general approaches for calculating the built-in gains discount. First, a dollar-for-dollar approach is allowed in the Fifth and Eleventh Circuits. (Estate of Dunn, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke III, 507 F.3d 1317 (11th Cir. 2007), cert. denied (2008). (In Estate of Jelke, the court observed (in footnote 38) that in Simplot, 112 T.C. 130, 166 n.22 (1999) rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001), the IRS presented an expert witness who concluded that, when valuing a closely held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate.) Second, other courts have applied a present value analysis, considering when the corporation might sell appreciated assets and determining the present value of the additional corporate level capital gains costs. This case follows the trend of prior Tax Court cases of estimating the present value of the

eventual built-in gains tax. The cases have made that present value determination in different ways, but the clear trend in the Tax Court, so far, is to use a present value approach rather than just allowing a dollar-for-dollar discount. (In Estate of Litchfield, 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 be appropriate in another case where that argument is made.")

2. Consideration of Future Appreciation. There is no consistency in the cases as to whether future appreciation should be considered in the present value analysis. On one hand, the corporation is being valued as of a particular valuation date, and arguably neither increased liabilities nor increased asset values should be taken into account. On the other hand, a purchaser buying a corporation with appreciating assets will have to incur a second level capital gains tax on future appreciation that a purchaser of directly owned assets will not have to bear. As a result, prospective purchasers presumably will pay less for the corporate interest that would be subject to the additional tax on future appreciation, and an adjustment should be made in some manner with respect to the built-in gains tax attributable to future appreciation.

   a. Cases Rejecting Consideration of Subsequent Appreciation.

      In Estate of Bailey (T.C. Memo. 2002-152), the IRS expert made various assumptions in its present value analysis of the built-in gains tax, including an assumed growth rate of 2%, a discount-to-present value rate of 8%, and an assumed 5-year holding period. The court did not specifically comment about considering future appreciation, but just concluded that the expert "offered no explanation or support for any of the many assumptions that he utilized" and found the report unpersuasive.

      The Tax Court in Estate of Jelke (T.C. Memo. 2005-131, Judge Gerber) specifically rejected the taxpayer's expert's argument that if a present value approach is used, there should a consideration of "a long term projection... that the stock will appreciate" and that "[i]f the stock appreciates, the capital gains tax liability will appreciate commensurate [sic]." The court responded:

      > "If we were to adopt the estate's reasoning and consider future appreciation to arrive a subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciation value and the tax liability and then reduce its current fair market value by the present value of a future tax liability."

      The taxpayer in Jelke pointed out that the IRS experts, in several other cases, have considered future appreciation in determining the present value of the built-in gains tax. In Estate of Borgatello, the IRS expert used assumed future appreciation in its determination of the built-in gains discount, and the court used a compromise between the positions of the IRS's and taxpayer's experts. In Estate of Bailey, the IRS expert similarly assumed future appreciation in its analysis, but the court rejected that expert's approach as being unpersuasive. The Tax Court in Jelke responded that it was not bound to follow the same approach used by experts in other cases, and that even in Borgatello, "the expert's approach does not represent the ratio decidendi of the case." [*Ratio decidendi? I'm impressed. Remember that term for cocktail party discussions.*] Of course, keep in mind that the Eleventh Circuit eventually reversed the Tax Court, holding that a dollar-for-dollar discount is appropriate. 507 F.3d 1317. The Eleventh Circuit took note of the taxpayer's concern about not taking into consideration future appreciation: "The estate attacks this approach on the basis that it is incomplete and inconsistent, as over this 16-year period, CCC's securities could appreciate in value, increasing tax payments and obviating the need to reduce built-in capital gains by present value principles. The same could be true if the assets were to depreciate in value over the projected period." Id. n.9.

b. Cases Supportive of Considering Subsequent Appreciation.

In Estate of Borgatello (T.C. Memo 2000-264, Judge Wells), the IRS expert's approach of determining the built-in gains tax discount was to use a present value approach, assuming that the corporation's assets would have a 2% growth rate, that the assets would be held for 10 years before being sold, and that the resulting built-in gains tax at the end of 10 years would be discounted to present value at 8.3% (the long term applicable federal rate + 2% for added risk). This approach resulted in a 20.5% built-in gains tax discount (discount to net asset value). The taxpayer's expert used a dollar-for-dollar discount, resulting in a 32.3% discount to net asset value. The court concluded that there was not much support for the government's contention that a buyer would wait 10 years before liquidating the assets and reached a middle ground of using a 24% discount to net asset value. (This represented about 74.3% of the dollar-for-dollar built-in gains tax based on the amount of gain at the date of death.) The court did not have any discussion whatsoever of whether it was appropriate to assume a future growth of the assets in applying the present value analysis, but took into account the IRS's expert's conclusion (based on considering future growth of the assets) in reaching an eventual compromise amount of the appropriate discount.

In Estate of Dailey (T.C. Memo. 2001-263, Judge Foley), one of the IRS's experts acknowledged that he would take into account holding-period asset appreciation in calculating appropriate valuation discounts to net asset value (as cited in footnote 12 of Estate of Litchfield).

Estate of Litchfield (T.C. Memo. 2009-21, Judge Swift) is the first case in which the court has specifically criticized the IRS's expert for not assuming a growth rate during the holding period in making the present value computation. That case involved the valuation of a decedent's stock in two corporations that had elected S corporation status about one year before the decedent died (so still had nine years to run on the 10-year period of built-in gains after conversion from C corporation to S corporation status). The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates after discussions with the officers and boards of directors of the corporations (5 and 8 years for the two separate corporations, vs. 54 and 29 years used by the IRS's expert), 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 opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.)

In Estate of Litchfield, the court was more persuaded by the taxpayer's expert as to the turnover estimates, including conversations with management and discovery that there were many elderly shareholders concerned with paying estate taxes, and that management had addressed selling assets to be able to provide liquidity to the shareholders' estates. A key distinction between the approaches of the parties is that the taxpayer's expert considered an amount of assumed appreciation in the assets during the holding period and took into consideration the additional capital gains taxes attributable to that appreciation in some manner.

The court agreed that an adjustment should be considered with respect to the additional level of capital gains taxes on future appreciation.

> "[R]espondent's expert does not take into account appreciation during the holding period 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. See Johnson & Barber, 'Tax-Inefficient Entity Discount,' 6 Valuation Strategies 20, 46 (Mar./Apr. 2003). On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller."

The built-in gains tax discounts allowed in Litchfield were not "dollar-for-dollar," (the estate did not request a "dollar-for-dollar" discount so the court did not have to address whether that is a proper approach to determine the discount), but the discounts were very substantial.

The Estate of Jensen opinion specifically criticized the IRS expert because the expert's report "did not account for the likelihood that the [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase) nor take into account time value of money concepts." The court cited Estate of Litchfield and Estate of Borgatello.

c. Summary Regarding Consideration of Future Appreciation. 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 tax discount. However, the two most recent Tax Court cases to address the issue have criticized IRS experts for not taking into consideration anticipated future appreciation in making the present value analysis of the built-in gains tax. In Estate of Litchfield, the court 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." Similarly, Estate of Jensen criticized the IRS expert for not taking into account "the likelihood that [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase)." The rationale for this approach is that 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, at the 2010 Heckerling Institute, said this issue is unsettled and that commentators disagree on the proper approach as to whether future anticipated appreciation should be considered. Estate of Jensen, coming on the heels of Estate of Litchfield last year, suggests a trend toward considering future anticipated appreciation.

3. Choice of Discount-to-Present Value Factor (Which May Result in Dollar-For-Dollar Discount).

In Estate of Litchfield, the court relied on the taxpayer's expert's present value analysis to determine the built-in gains tax discount. However, the opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.) The present value of the built-in gains tax was less than the date of death value, so the assumed appreciation rate must have been less than the assumed discount rate.

Several other cases have described some of the growth rates and/or discount rates used by appraisers in making the built-in gains tax present value computations. E.g., Estate of Jameson, 267 F.3d 366, 370 (10% annual growth to harvest rate of timber, 4% annual inflation rate in the value of harvest, and a 20% discount rate); Estate of Jelke (IRS expert used 13.2% discount rate "based on the average annual rate of return for large-cap stocks in the period for 1926-1998"); Estate of Bailey (IRS expert used 2% growth rate and 8% discount rate); Estate of Borgatello (2% growth rate and discount rate of 8.3%, based on long term AFR + 2% for added risk).

The recent Ludwick case had a discussion of growth and discount rates in the court's estimate of the discount for valuing 50% undivided interests in a residence. The court assumed a growth rate of 3% and a discount rate for the present value calculation of 10%.

In Estate of Jensen the court used a factor to discount the anticipated future built-in gains tax to the present value that was exactly equal to the assumed appreciation rate (i.e., 5% and 7.5% in the two scenarios considered by the court). Using the same number for the assumed rate of appreciation and the rate to discount the future capital gains taxes to present value results in an offset. In effect, the built-in gains tax is compounded by an assumed appreciation rate and then discounted back to present value by the same rate. If the appreciation rate and the discount-to-present value rate are the same, it makes no difference how long the assumed turnover period will be. Indeed, the court's calculation of the present value of the built-in gains tax over 17 years ($1.23 million and $1.26 million) was about the same as the estate's determination of the current "dollar-for-dollar" built-in gains tax ($1.13 million).

The math analysis is not quite that straightforward, because the value of the real estate is being compounded, but the income tax basis that is subtracted to determine the amount of the gain is static and does not compound. (That is why there is a slight difference in the court's calculation of the present value built-in gains tax for the 5% versus 7.5% assumed appreciation/discount rate scenarios, and why the court's calculation is slightly different than the dollar-for-dollar discount amount.)

The assumed holding period, assumed growth rate, and "discount-to-present value" factor obviously greatly impact the calculation of the built-in gains discount. Courts should focus on specific discussion by experts of the reasons supporting the specific values for these factors used in their analyses.

4. Practical Planning Guidance. In the Fifth and Eleventh Circuits, claim a dollar-for-dollar built-in capital gains discount. Outside of those circuits, there is no certainty. If the experts use a present value approach, the trend of the current cases suggests that future anticipated appreciation should be taken into consideration in determining the present value of the built-in gains tax. In determining the estimated holding period before assets are sold, consider historical data, recent data, and actual conversations with management about anticipated plans (which is what the taxpayer's expert did in Estate of Litchfield).

Is it possible to admit testimony that buyers typically reduce the purchase price because of the built-in gains tax liability when purchasing interests in corporations without having a detailed analysis of the precise amount of the built-in gains tax discount? The difficulty is that the built-in gains tax factor is merely one factor considered in the negotiation process, and it is hard to say how much discount is allowed specifically for that factor. Furthermore, some judges have refused to allow that kind of general testimony.

A Preliminary Analysis: Tax Return Preparer/PTIN Regulations

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A few preliminary observations:

1. Over the past few months, Treasury has acted swiftly to issue multiple and successive sets of regulations affecting tax return preparers:

- Proposed amendments to 31 CFR, Subtitle A, Part 10 (Circular 230), RIN 1545-BH01 [REG-138637-07], governing practice before the IRS, published in the Federal Register on 8/23/10.

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- Final regulations regarding user fees, TD 9503, released 9/28/10. These final regulations adopt in full the proposed regulations (REG-139343-08) published in the Federal Register on 7/23/10.

- Final regulations regarding furnishing preparer tax identification number ("PTIN"), TD 9501, published in the Federal Register on 9/30/10. These final regulations adopt proposed regulations (REG-134235-08) amending Treasury Regulations Section 6109-2 and published in the Federal Register on 3/26/10.

2. As explained below, the new rules will not affect practitioners or banks who are fiduciaries of a trust or estate and who prepare returns in that fiduciary capacity. The new rules, however, will affect practitioners and banks in other situations, e.g. as tax return preparer for a corporate foundation; as tax return preparer for a third-party executor; as tax return preparer for third-party trustees.

3. The final regulations require that attorneys, CPAs and enrolled agents who are tax return preparers obtain and renew a PTIN. Tax return preparers who are not attorneys, CPAs or enrolled agents are also required to obtain and renew a PTIN—and, in addition, are subject to a new testing and continuing education regime.

4. As drafted, the proposed amendments to Circular 230 do not adequately deal with the question of when a tax return preparer has prepared "substantially all" of a return. This is a major flaw—because the proposed rules apply by their terms only to those who prepare, or assist in preparing, all or "substantially all" of certain documents.

5. Although the proposed amendments to the Circular 230 regulations (REG-138637-07) define "tax return preparer," they do not consistently use that term. To make matters worse, a separate (and different) definition of "tax return preparer" appears in Treasury Regulations Section 1.6109-2(g).

6. A set of "Frequently Asked Questions" posted at www.irs.gov/taxpros explains that although competence testing is expected to begin in mid-2011, "tax return preparers who have PTINs before testing becomes available will have until 12/31/13 to pass the competency test." [*Note: the FAQs also indicate that initial testing will be for Form 1040 series returns—but that the IRS "will issue additional guidance or instructions for other tax returns.*"]

EXECUTIVE SUMMARY

1. <u>Proposed tax return preparer regulations, RIN 1545-BH01 [REG-138637-07], published 8/23/10.</u> Proposed amendments to 31 CFR, Subtitle A, Part 10 (Circular 230), governing practice before the IRS. Proposed to be effective 60 days after publication of final regulations in the Federal Register. *[Note: it is expected that final regulations will be issued before year-end.]*

a. <u>Would expand application of Circular 230 to all compensated tax return preparers</u>, Under 31 CFR Section 10.8(b), as proposed,

> "Any individual who for compensation prepares, or assists in the preparation of, all or substantially all of a document pertaining to any taxpayer's tax liability for submission to the Internal Revenue Service is subject to the duties and restrictions relating to practice in subpart B [of Circular 230], as well as subject to the sanctions for violation of the regulations in subpart C [of Circular 230]." *[Note: for consistency, former 31 CFR Section 10.7(e), which allowed "any individual" to prepare a tax return, is also deleted.]*

(1) There is no definition of "substantially all" in Circular 230, either in its current form or as proposed to be amended.

(2) Treasury Regulations Section 6109-2(g) defines "tax return preparer" to mean "any individual who is compensated for preparing or assisting in the preparation of, all or substantially all of a tax return or claim for refund of tax." It also includes a list of factors relevant in determining whether a given individual is a "tax return preparer," as well as four examples, the last of which is somewhat relevant to the "substantially all" issue. It does not, however, directly address that issue. Moreover, there is no cross-reference in Treasury Regulations Section 6109-2(g) to the proposed Circular 230 regulations; to the contrary, its definition and

examples expressly apply "only for purposes of paragraphs (d), (e), and (f)" [of Treasury Regulations Section 6109-2].

[Note: The lack of guidance on this point in the proposed Circular 230 regulations is in contrast to the detailed explanation of "substantial portion" in Treasury Regulations Section 301.7701-15(b)(3).]

b. Would modify tax return preparation standards. 31 CFR Section 10.34(a), as proposed, would require "a reasonable basis" for all return positions. *[Note: this is a more relaxed standard than the "substantial authority" standard under the general civil penalty provisions of IRC Section 6694(a)(2).]*

c. Would create a new class of individual authorized to practice before the IRS, the "registered tax return preparer." 31 CFR Section 10.3(f), as amended, lists six categories of individuals who may practice before the IRS: attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents and "registered tax return preparers." *[Note: the scope of a registered tax return preparer's practice is limited under 31 CFR Section 10.3(f)(2), as proposed.]*

d. Would establish requirements for registered tax return preparers, including testing and continuing legal education. 31 CFR Sections 10.4, 10.5 and 10.6, as proposed, outline the application and renewal process, including:

(1) Completing an application and paying an initial registration fee.

(2) Filing required individual and business tax returns and payment of Federal tax debts (passing a "Federal tax compliance check").

(3) Passing a written competency exam administered by, or on behalf of, the Internal Revenue Service. The Preamble to REG-138637-07 clarifies that:

(a) Initially, there will be two competency examinations:

(i) one covering wage and non-business income Form 1040 series returns; and

(ii) one covering wage and small business income Form 1040 series returns.

(b) Individuals passing the wage and small business income Form 1040 series exam will be able to prepare any Form 1040 series return.

(c) Individuals passing the wage and non-business income Form 1040 series exam will only be authorized to prepare certain (as-yet-to-be-determined) returns and claims for refund.

(d) The IRS will provide transition rules covering the period beginning on the effective date of the regulations and ending on the date the "registered tax return preparer" examinations become available.

(4) Possessing a valid preparer tax identification number ("PTIN").

(5) Not engaging in conduct that would justify suspension or disbarment ("passing a suitability check").

(6) Renewing the registration as required.

(7) Completing, as a condition for renewal, 16 hours of continuing education each year.

[Note: Although there are no "grandfather" provisions, the IRS has announced, in IR-2010-99, issued 9/28/10, that it is considering exempting certain individuals from the testing and continuing education requirements, i.e. "a discrete category of people who engage in return preparation under the supervision of someone else—for example, some employees who prepare all or substantially all of the return and work in certain professional firms under. . . supervision. . ."

e. <u>Would expand the definition of "incompetence and disreputable conduct" (subject to sanction under Circular 230) to include</u>:

(1) Willfully failing to file by electronic media when so required, with a reasonable cause exception. 31 CFR Section 10.51(a)(16), as proposed.

(2) Willfully preparing all or substantially all of, or signing a tax return without a valid PTIN. 31 CFR Section 10.51(a)(17), as proposed.

(3) Willfully representing a taxpayer before the IRS unless authorized to do so. 31 CFR Section 10.51(a)(18), as proposed.

f. <u>Would require those responsible "for overseeing a firm's practice of preparing tax returns" to "take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates and employees for</u>

purposes of complying with Circular 230." 31 CFR Section 10.36(b), as proposed.

g. Would define "tax return preparer" to mean "any individual within the meaning of section 7701(a)(36) and 26 CFR 301.7701-15." 31 CFR Section 10.2(a)(8), as added by REG-138637-07.

[Note: (1) IRC Section 7701(a)(36)(B)(iv) provides that those preparing returns or claims for refund "as a fiduciary" are not "tax return preparers." Treasury Regulations Section 301.7701-15(d)(2) clarifies that this exception applies to "preparation of a return or claim for refund for a trust or estate of which the person either is a fiduciary or is an officer, general partner, or employee of the fiduciary." (2) REG-138637-07 generally does not use the term "tax return preparer."]

2. Final PTIN user fee regulations, REG-139343-08, TD 9503, released 9/28/10. *To be effective **9/30/10.*** Amends Treasury Regulations Section 300.9 to establish a $50 fee for individuals who apply for or renew a PTIN; annual renewal is required.

[Note: $50 represents only the government's costs for processing; on 8/19/10, the IRS announced the total fee is $64.25, with $50 allocated to the IRS and $14.25 allocated to the third-party vendor that operates the online PTIN registration system. IR-2010-91.]

3. Final PTIN regulations, TD 9501, published 9/30/10. *Generally applicable to tax return preparers after 12/31/10.*

a. Background. Existing IRC Section 6109(a) requires individuals making any "return, statement, or other document" required under the Internal Revenue Code to include "such identifying number as may be prescribed." Currently, preparers generally may use either their social security numbers or PTINs issued by the IRS. Under IRC Section 6695(c), a maximum penalty of $25,000 ($50 per failure) is currently imposed on those who fail to furnish a required PTIN.

b. Would require PTIN after 12/31/10. Would require that:

(1) after 12/31/10, every tax return preparer have a PTIN; and

(2) for tax returns and claims for refund filed after 12/31/10, the identifying number of a tax return preparer is the PTIN.

Treasury Regulations Section 1.6109-2(d) and 1.6109-2(a)(ii)).

[Note: The online PTIN application system became available on 9/28/10.]

c. Eligibility to obtain a PTIN. Treasury Regulations Section 1.6109(d) is amended to provide that, after 12/31/10, only attorneys, certified public accountants, enrolled agents or registered tax return preparers who are "authorized to practice before the IRS under Circular 230" are eligible to obtain a PTIN.

d. Expiration and renewal. Treasury Regulations Section 1.6109-2(e) authorizes the IRS to provide for the expiration and renewal of PTINs, including requiring that any PTIN issued on or before 9/30/10 will expire on 12/31/10.

e. Tax compliance check. Effective 9/30/10, Treasury Regulations Section 1.6109(f) authorizes the IRS to conduct a "tax compliance check" on those applying for, or renewing, a PTIN.

[Note: the preamble to the proposed amendments to Circular 230 (REG-138637-07) explains that the tax compliance check will cover both personal and business tax filings, including employment tax returns.]

f. Definition of "tax return preparer." "Only for purposes of [Treasury Regulations Section 6109-2] (d), (e) and (f), the term 'tax return preparer' is defined to include both:

> (1) individuals compensated for preparing substantially all of a tax return or claim for refund; and
>
> (2) individuals compensated for assisting in the preparation of all or substantially all of a tax return or claim for refund.
>
> Treasury Regulations Section 1.6109-2(g).
>
> *[Note: there is currently no exception for non-signing preparers who are supervised by attorneys, CPAs, or enrolled agents; there is also no exception for state-licensed tax return preparers, such as Licensed Tax Preparers in Oregon. There is also no definition of "substantially all."]*
>
> In an attempt to be helpful, TD 9501 (see 3. "Terminology") points out that [Treasury Regulations] Section 1.6109-2(g) includes a non-exclusive list of factors that can be used "to determine whether an individual prepared or assisted in preparing all or substantially all of a tax return or claim for refund." The three enumerated factors are: (i) the complexity of the work performed relative to the overall complexity of the return or refund claim; (ii) the dollar amount of the items attributable to the work performed relative to the total dollar amounts required to be reported; and (iii) the amount of tax or credit attributable to the work performed relative to the

total tax liability required to be reported. Under the regulations, an individual who prepares a single schedule may be a "tax return preparer." However, individuals are not tax return preparers if they are <u>not</u> described in Treasury Regulations Section 301.7701-15(b)(2) [relating to "non-signing tax return preparers"] or if they <u>are</u> described in Treasury Regulations Section 301.7701-15(f) [relating to persons who are not tax return preparers].

The examples provided in Treasury Regulations Section 1.6109-2(g) clarify that:

(1) An individual who does not exercise any discretion or independent judgment as to the clients' underlying tax positions is not a tax return preparer. Example 1.

(2) If one individual (C) completes a tax return that is then reviewed by a second individual (D), both (C) and (D) are required to have PTINS. Example 2.

[Note: This example has raised a storm of protest. It would require both an estate tax attorney and his paralegal, for example, to obtain a PTIN; likewise for a CPA and her non-CPA associate. And although the IRS may be considering relief from the testing requirements for such subordinates, it is not considering relief from the PTIN requirement itself.]

g. <u>Potential exceptions</u>. In Treasury Regulations Section 6109-2(h), the Internal Revenue Service is authorized to "prescribe exceptions" to the general requirements of Treasury Regulations Section 6109-2.

COOPERATIVES 101- AN INTRODUCTION TO AGRICULTURAL COOPERATIVES AND THE FEDERAL REGULATIONS AND LEGAL CONCERNS THAT IMPACT THEM

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I. INTRODUCTION

For nearly a century, the Rural Business Cooperatives Program (the "Program") of the Rural Development Agency of the United States Department of Agriculture ("USDA") has provided technical assistance, education, legal, tax and policy advice to agricultural cooperatives (the terms "agricultural cooperatives" and "cooperatives" carry the same meaning for the purposes of this article). Its mission is to promote understanding and use of the cooperative form of business as a viable organizational option for marketing and distributing agricultural products.

The Program identifies the impacts of changes in federal legislation, law, regulations, and public policy on cooperatives and their members, and assists members in understanding and functioning in the changing environment. It also analyzes cooperative governance regarding member participation and organization, as affected by socio-economic change. The Program provides research that (i) focuses on unique cooperative economic, legal, financial, and organizational characteristics and contributions as they relate to public policy toward cooperatives; (ii) identifies factors that determine member participation patterns and techniques that enhance member involvement in their cooperatives; and (iii) serves to determine, analyze, and develop cooperative governance structures that facilitate member control, sound business operations, and realization of member needs and objectives.

We believe that agricultural cooperatives are leaders in providing the nation's food and agricultural supply system. Their activities and earnings are vital to the economies of the rural communities they serve which help promote wealth in rural America, a key priority at the USDA. Therefore, it is imperative that agricultural cooperatives understand the legal and regulatory dynamics on a state and federal level in order to maintain a measure of best practices in the agricultural industry.

This article will provide an overview of federal regulations and legal issues that currently affect cooperatives way of doing business. This is by no means exhaustive of the various legislation that govern cooperatives, but are the most pressing concerns according to the agricultural cooperatives we are in contact with on a regularly basis.

A. The Business of Cooperatives

In general, cooperatives are businesses like investor-owned businesses. They have similar physical facilities, perform similar functions and must follow sound business practices. They are usually incorporated under state law by filing articles of incorporation, which grants them the right to do business. The organizers draw up bylaws and other necessary legal papers. Members elect a board of directors, who sets policy and hires a manager to run the day-to-day operations.

But in some ways, cooperatives are distinctly different from other forms of businesses. These differences are found in the cooperative's purpose, its ownership and control, and how benefits are distributed. They are reflected in cooperative principles that explain the unique aspects of doing business on a cooperative basis, which is a business organization owned and operated by a group of individuals for their mutual benefit.[1]

In addition, cooperatives are based on a particular set of values and principles for consideration as a cooperative. These cooperative values are collectively self-help, self-responsibility, democracy and equality, equity and solidarity. The most widely-agreed upon basic cooperative principles are: 1) user-owned cooperative is owned by the people that use it; 2) user-control cooperative is controlled by the people who use it; and 3) user-benefit benefits generated by the cooperative accrue to its users on the basis of their use.[2]

B. The Definition of Agricultural Cooperatives[3]

An agricultural cooperative, also known as a farmers' cooperative, is a cooperative where farmers pool their resources in certain areas of activity. Agricultural cooperatives are distinguished between agricultural service cooperatives, which provide various services to their individual farming members, and agricultural production cooperatives, where production resources (land, machinery) are pooled and members farm jointly. Few agricultural production cooperatives are formed in the United States. For the purposes of this article, agricultural cooperatives will only refer to agricultural service cooperatives.

There are three primary types of agricultural service cooperatives in the United States: supply, marketing and service. Supply cooperatives supply their members with inputs for agricultural production, including seeds, fertilizers, fuel, and machinery services. Marketing cooperatives are established by farmers to undertake transformation, packaging, distribution, and marketing of farm products (both crop and livestock). Service cooperatives include various industries, such as, trucking, cotton ginning, drying and artificial insemination.

II. OVERVIEW OF FEDERAL REGULATION

There have been numerous federal and state laws which have impacted the way agricultural cooperatives are able to grow and market their goods. The most impacting of these laws have been environmental in nature. Several laws have contained provisions affecting agricultural land use and land use patterns. Many of these laws were originally passed over 20 years ago and have outlived its original intent. An increased ability to monitor and measure environmental problems and new information on the environmental impacts of agricultural practices has prompted amendments to and changes in the laws. In addition, as environmental awareness and concern have grown, new environmental laws have been passed.

Additionally, federal cooperative laws have provided for regulatory legislation on business dealings practiced by agricultural cooperatives. Pursuant to federal laws such as the Capper-Volstead Act of 1922 and the Cooperative Marketing Act of 1926, they convey privileges to cooperatives that meet certain tests. For example, Capper-Volstead provides agricultural producers with limited antitrust protection to market their production on a cooperative basis. Under Section 5 of the Cooperative Marketing Act of 1926, this protection extends to the sharing of market information. To qualify for the limited protection from antitrust liability provided by these two laws, membership must be limited to agricultural producers. So a cooperative with government entities as members would not qualify for the protection to set prices and share information accorded under these laws.

The Secretary of the USDA is conferred by Congress the primary responsibility for establishing and maintaining orderly marketing conditions for agricultural commodities and parity prices for farmers via Agricultural Marketing Agreement Acts in the form of marketing orders. These Acts delegate to the Secretary the task of completing the legislative regulatory scheme set with respect to the handling of a commodity within the confinement of the terms and conditions set out in the Acts.

A. Environmental Legislation

1. Water Quality Act of 1987

The Clean Water Act was reauthorized and extensively amended by the Water Quality Act of 1987 ("Water Quality Act").[4] The goal of the Water Quality Act is to restore and maintain the chemical, physical and biological integrity of the surface waters of the United States. The Act addresses pollution from municipal and industrial sources, nonpoint sources, and dredge and fill activities to include nonpoint sources of water pollution.

The Water Quality Act also regulates the discharge of dredged and fill material into waters of the United States, including marshes and wetlands, and established a state permit program to ensure that such discharges comply with environmental requirements.[5] Discharges of dredged and fill material are commonly associated with activities, such as port development; channel construction and maintenance; fills to create development sites; transportation improvements; and water resource projects, such as dams, jetties, and levies. Other kinds of activities, such as land-clearing, are regulated if soil is deposited in wet areas to change the hydrology of the area.

2. Federal Insecticide, Fungicide and Rodenticide Act as Amended ("FIFRA") of 1988

FIFRA provides regulatory authority for registration and use of pesticides and similar products intended to kill or control insects, rodents, weeds, and other living organisms.[6] Under FIFRA, a pesticide can[7]not be legally shipped or sold in the United States unless it is registered by U.S. Environmental Protection Agency ("EPA"). Pesticide labels approved by EPA delineate the legal uses of the pesticide. Selling a pesticide with a label that does not meet EPA standards or using a pesticide in any way other than provided for on its label is a violation of FIFRA. Thus, EPA can make it illegal to use a particular pesticide in specific locations or for particular pests by requiring the manufacturer to include those restrictions on the product's label. In addition, if a site or pest is not specifically included on a pesticide's label, then that pesticide is not legal for that site or pest.

3. Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") of 1980

CERCLA, commonly called the Superfund Law, requires cleanup of releases of hazardous materials in air, surface and groundwater, and on land.[8] Both new spills and leaking or abandoned dumpsites are covered. The legislation established a trust fund to pay for cleaning up hazardous substances in the environment. EPA is authorized to collect the cost of cleanup from the parties responsible for the contamination. Liability for cleanup costs falls to the individual responsible for the spill or contamination.

4. Resource Conservation and Recovery Act as Amended ("RCRA") of 1976

RCRA was passed to regulate the disposal of all types of solid wastes.[9] However, its major emphasis is the control of hazardous waste disposal. Under RCRA, EPA lists substances that are considered hazardous when disposed of on land. However, RCRA provides that states may assume responsibility for controlling hazardous wastes. Several pesticides are listed as hazardous waste materials; large agricultural producers and commercial pesticide applicators may be subject to RCRA or state hazardous waste regulations.

The regulation of underground storage tanks also falls under RCRA.[10] The law requires EPA to develop rules for detection and correction of leaks and establish performance standards for new tanks. States are required to make inventories of all underground storage tanks containing petroleum or other regulated substances.

B. Anti-Trust Legislation[11]

1. The Sherman Act of 1890

The Sherman Act of 1890 (the "Sherman Act") marks the first step in a long process of statutory, judicial and policy development of antitrust law in the United States. Congress derived its power to pass the Sherman Act through its constitutional authority to regulate commerce. Therefore, Federal courts only have jurisdiction to apply the Sherman Act to conduct that restrains or substantially affects either interstate commerce or trade within the District of Columbia. This requires the plaintiff must show that the conduct occurred during the flow of interstate commerce or had an appreciable effect on some activity that occurs during interstate commerce.

The Sherman Act is divided into three sections. Section 1 delineates and prohibits specific means of anticompetitive conduct, while Section 2 deals with end results that are anticompetitive in nature. Thus, these sections supplement each other in an effort to prevent businesses from violating the spirit of the Act, while technically remaining within the letter of the law. Section 3 simply extends the provisions of Section 1 to U.S. territories and the District of Columbia.

2. The Clayton Antitrust Act of 1914

The Clayton Antitrust Act of 1914 (the "Clayton Act") proscribes certain additional activities that had been discovered to fall outside the scope of the Sherman Act. For example, the Clayton Act added certain practices to the list of impermissible activities such as, (i) price discrimination between different purchasers, if such discrimination tends to create a monopoly; (ii) exclusive dealing agreements; (iii) tying arrangements; and (iv) mergers and acquisitions that substantially reduce market competition.

3. <u>The Robinson- Patman Act of 1936</u>

The Robinson-Patman Act of 1936 (the "R-P Act") amended the Clayton Act. The amendment proscribed certain anticompetitive practices in which manufacturers engaged in price discrimination against equally-situated distributors.

4. <u>Capper-Volstead Act of 1922</u>

The Capper-Volstead Act of 1922 ("Capper-Volstead") provides a limited exemption from the antitrust laws for agricultural producers to process, handle, otherwise prepare for market, and market their farm products on a cooperative basis. Capper-Volstead specifically authorizes separate and competing cooperatives to form a common marketing agency to set prices and market member products as if the cooperatives were a single entity. Several court decisions have held that farmers, through a single cooperative or a common marketing agency, may acquire substantial or even monopoly control over the sale of products they produce, so long as only farmers are involved in the scheme and the decision to work together is a voluntary one, and not the result of coercion or intimidation by the cooperative against nonmembers.

5. <u>Cooperative Marketing Act of 1926</u>

The Cooperative Marketing Act of 1926 (the "Marketing Act") expanded Capper-Volstead by allowing farmers and their local, regional and national cooperatives to exchange a host of information within their marketing system at a local cooperative meeting. It enabled federated cooperative systems and marketing agencies-in-common to effectively function as coordinated entities. The Marketing Act created the Division of Cooperative Marketing within the USDA to assist cooperatives in gathering and sharing data on output, prices, and demand. The Marketing Act also created the Cooperative Research and Service Division, now the Rural Development Cooperative Programs division, which conducts research studies and service activities relating to problems of management, organization policies, merchandising, sales, costs, competition and membership arising in connection with the cooperative marketing of agricultural products and the cooperative purchase of farm supplies and services.

C. Marketing Orders[12]

The Agricultural Marketing Agreement Act of 1937 and the Agricultural Adjustment Act of 1938 (the "Acts") authorize the Secretary of Agriculture to issue orders regulating the interstate marketing of agricultural products to establish a "parity price" for farmers.[13] The purpose of the Acts is to overcome the disruption of the orderly exchange of agricultural commodities in interstate commerce and conditions found to burden and obstruct the normal channels of interstate commerce. The goal is to protect the interest of the consumer and the purchasing power of the farmer. It is a measure intended primarily to benefit producers. [14] That is, to stabilize agricultural prices and to assure producers of a fair return through the effective control of the supply of basic agricultural commodities.[15]

D. The Tax Code- Subchapter T

The federal government and state governments recognize the way that cooperatives operate and tax them accordingly. Cooperatives generally do not pay income tax on surplus earnings that are refunded to members. Under Subchapter T of the federal tax code, these distributions are called "patronage dividends." The members, however, must include these refunds in their taxable income unless the refunds arise from personal expenses, such as electricity for the home, groceries and other consumer goods.

Under the requirements of Subchapter T, when a business is “operating on a cooperative basis”, according to federal rules, the cooperative may deduct “patronage dividends” from its taxable income. Patronage dividends are the refunds “paid to a patron 1) on the basis of quantity or value of business done with or for such patron, 2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and 3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.” The “preexisting legal obligation” rule requires that some formal obligation exist in writing to pay out patronage dividends. This obligation can be found in the cooperatives bylaws or the membership agreement.

Subchapter T allows cooperatives to retain patronage dividends and allocate them to the patrons’ equity accounts with the cooperative through “written notices of allocation.” If the equity is qualified as defined in the code, the cooperative can deduct the amount of allocations from its taxable income in that same year. Patrons include the amount allocated in their taxable income in the year they receive the qualified written notices of allocation. Subchapter T requires that at least 20% of the patrons’ patronage dividends be paid out in cash in order for the allocation to be qualified. Cooperatives can retain up to 80% as equity investments without owing tax on those investments.

Cooperatives can choose to delay the pass-through by retaining patronage dividends as nonqualified investments. The cooperative can retain any amount of the patronage dividends and take the amount into its taxable income for the year. When the patronage dividends are later redeemed in cash by the patrons, the cooperative can deduct the amount from its taxable income for the year of redemption.

III. OVERVIEW OF LEGAL CONCERNS

Many agricultural cooperatives have various legal concerns pertaining to cooperative governance, membership control and the legal documents that control them.

A. Board of Directors' Duties and Obligations

Some of the legal issues faced by both cooperatives and investor-owned businesses start at the corporate board level. Key decisions about organizational practices and procedures are made by boards of directors ("Directors"). Thus, it is essential for the cooperative to understand the standards of conduct required to be performed by all Directors, and the unique challenges faced by cooperative boards of directors ("Cooperative Directors") when performing their duties and responsibilities, but how they will implement the business plan. In general, Directors are elected or appointed persons who jointly oversee the activities of a company or organization, which are determined by the powers, duties, and responsibilities delegated to it or conferred on it by an authority outside itself specified in their bylaws. Once the bylaws have been adopted, Cooperative Directors should meet as soon as possible to avoid having to send out legal notices of it to the other Cooperative Directors. In addition, Cooperative Directors approve various resolutions designed to make the cooperative an operational business and ready to serve members.

In most cases, the Cooperative Directors act immediately on specific items, such as to: 1) conduct a membership drive; adopt a form of membership application or stock subscription; 2) adopt the forms for contractual agreement if used; 3) acquire capital; 4) select a bank in which to deposit funds; initiate steps to hire a manager; 5) authorize officers or employees to handle cooperative funds and issue checks; 6) design and install an accounting system; 7) provide for bookkeeping and auditing services; 8) print the articles of incorporation, bylaws, and other member documents for distribution to all members; 9) bond officers and employees in accordance with bylaws; and 10) pick a business location and seek bids for facilities and equipment.

Directors are held to three standards of conduct: 1) a duty of obedience; 2) a duty of care and 3) a duty of loyalty to the company or organization for which they serve, and act in “good faith” as a decision-maker for a company or organization. Directors have various responsibilities including (i) governing the organization by establishing broad policies and objectives; (ii) selecting, hiring, supporting and reviewing the performance of management; (iii) ensuring the availability of adequate financial resources; and (iv) accounting to the stakeholders for the organization's performance. In the case of a breach of these duties to uphold their responsibilities, Directors can be held personally liable to the organization for any injury it may have suffered due to the breach.

Cooperative Directors must conduct themselves at an even higher level due to the complexity and nuance of how cooperative businesses are structured. Unlike in a typical corporate environment, Cooperative Directors must be strong supporters and patrons of the cooperative as a general rule. They must understand its unique role in business. Thus, it is very important that the cooperative members select Cooperative

Directors who show a high level of competency and trust in their ability to lead. The standards of conduct by cooperative directors include: (a) Duty of Obedience; (b) Duty of Care; (c) Duty of Loyalty; and (d) The Good Faith Test.

1. <u>Standards of Conduct</u>

a. Duty of Obedience

Directors must exercise their powers for a proper purpose. While in many instances an improper purpose is readily evident, such as a director looking to feather his own nest or divert an investment opportunity to a relative, such breaches usually involve a breach of the director's duty to act in good faith. Greater difficulties arise where the director, while acting in good faith, is serving a purpose that is not regarded by the law as proper.

Cooperative Directors are held to the same standard as other Directors. Cooperative Directors must ensure that they do not or the cooperative does not engage in illegal or improper actions. They must make decisions for the cooperatives based not only on generally applicable laws, but laws that are especially applicable to cooperatives. Cooperative Directors bear the responsibility for cooperative’s adherence to laws and other legal obligations. Thus, it is critical that Cooperative Directors have a reputation for integrity, honesty and respect for the law to effectively communicate to the cooperative the legal obligations that it must meet. Thus, they must seek appropriate and adequate counsel to assist them in these endeavors to ensure that their actions are done in a proper and legal manner.

b. Duty of Care

Directors are held to a standard of care with respect to how they handle the company or organization's business affairs. They set policies such as credit, pricing, purchasing, marketing and services. They manage relations with members, professional management, employees and the public. The duties imposed upon Directors are fiduciary in nature, because Directors exercise their control and management over the company on behalf of the company or organization. Although the duties of Directors are several, they must exercise those duties jointly.

Cooperative Directors have the added pressure of maintaining the cooperative character of the organization. They must be familiar with and understand the importance of the cooperative principles, which are: 1) The User-Owner Principle where the people who own and finance the cooperative are those who use the cooperative; 2) The Use-Control Principle where the people who control the cooperative are those who use the cooperative; and 3) The User-Benefits Principle where the cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use. Cooperative Directors establish policies based on these principles, which must be well-communicated to the membership. Also, Cooperative Directors must make decisions not only based on corporate law, but on specific cooperative state statutory laws. These laws may include special tax laws that apply to cooperatives, cooperative antitrust laws that mandate or prohibit certain business structures and behavior, and state cooperative incorporation statutes that mandate certain special requirements for cooperatives.

Also, Cooperative Directors are required to have a clear understanding of financial documents, performance measures and the short- and long-term consequences of decisions made and actions taken. They must handle unusual financial issues, because cooperatives have special techniques to finance the organization since they operate for the mutual benefit of the members and not purely to maximize the value of the business. Thus, cooperatives have financial needs, opportunities and limitations not found in other businesses due to their unique business structure. The earning structure of cooperatives is different from other business structures. Cooperatives pay out to their member's patronage refund distributions. Cooperative Directors must determine and distribute these patronage refunds. They are involved in the balance between current monetary returns to members and additions to the cooperative's equity structure. There is also tension between the Cooperative Directors and the members as to whether the cooperative should choose debt or equity as a source of financing the business. Not only must Cooperative Directors act prudently when making these important decisions for the cooperative, they must also communicate these decisions to the members, such as, their decision to distribute year-end earnings to owner-patrons, and/or carefully explain to the members when some portion of earnings is retained as operating or equity investment.

c. Duty of Loyalty

As fiduciaries, Directors may not put themselves in a position where their interests and duties conflict with the duties that they owe to the company or organization. The single action most likely to impose personal liability on Directors is a conflict of interest. The law takes the view that it is not enough for Directors to attempt to be loyal to their company or organization. Their actions must be manifested so that they are transparent and accountable to the company or organization. Thus, a director will not be able to escape liability by asserting that his decision was in fact well founded, although his actions show otherwise.

Cooperative Directors are in a different position than other type of Directors. Cooperative Directors are required to balance deeply held issues by members both professional and emotional in nature. And like other members of the cooperative, Cooperative Directors deal personally with the cooperative. They have their own obligations toward the cooperative and their own expectations of benefits from it. Decisions that Cooperative Directors make about the cooperative will affect them as member-users just as they affect the cooperative and other members. Thus, the personal dealings that Cooperative Directors have with the cooperative place them in a precarious position. What appears to be innocent when done may in hindsight look very bad for Cooperative Directors. However, Cooperative Directors should not have problems if the conflict is clearly recognized, decisions are made solely with the interests of the cooperative foremost and all questions are addressed openly and honestly.

d. “The Good Faith Test”

Directors must act honestly and bona fide ("in good faith"). Courts have long held the view that the test to determine if a director acts in “good faith” is a subjective one, in which they consider the unique interests of the company or organization. However, Directors may still be held to have failed in this duty where they fail to direct their minds to the question of whether in fact a transaction was in the best interests of the company or the organization.

Cooperative Directors must balance any possible conflict of interest since as discussed above they are members of the cooperatives as well as directors. The single most action likely to impose personal liability for Cooperative Directors is the fact that they use the services of the cooperative and their duty of loyalty can easily be called into question. They are elected by members from within the membership and provide leadership by overseeing the cooperative's business affairs and establishing broad policies. Thus, it is imperative that Cooperative Directors are sensitive to their dual role and measure each step of their actions utilizing the "good faith test" measuring stick.

2. <u>Legal Recourse for Breach of the Standards of Conduct</u>

There are a variety of remedies available to members or organizations which seek legal recourse against Directors in case of breach of duties, to include, injunction, damages, rescission, account of profits and summary dismissal. Electing members to the board of directors is one of the most important functions of a cooperative member. Cooperative Directors can have a direct impact on the success of the cooperative and in turn on the profitability of the member's own business. They must be willing to communicate with members, legislators and regulators, and represent the cooperative at public functions. In addition, Cooperative Directors must be receptive to new ideas that may enhance the benefits or lessen the limitations of cooperative membership. It is worth noting that in most cases, serving on a board is not a career unto itself. Cooperative Directors are usually compensated very modestly for serving on a board, with the duties considered part of their responsibility as a member.

a. Directors- Investor-Owned Businesses

After the Enron scandal in 2002, Congress passed the Sarbanes-Oxley Act (the "Act") which introduced new standards of accountability on the board of directors for U.S. companies or companies listed on U.S. stock exchanges. Under this Act, Directors risk large fines and prison sentences in the case of accounting crimes. Internal controls of the company or organization are now the direct responsibility of Directors. This means that the vast majority of public companies now have hired internal auditors to ensure that the company adheres to the highest standards of internal controls. Internal auditors are required to report to an independent audit board accounting and financial business activities of the company for independent review.

b. Directors- Cooperatives

The same remedies are available to cooperatives except for remedies allowed for under the Act. The Act is only applicable to publicly-traded companies under jurisdiction of the Securities Exchange Commission, but some states are pushing for application to large non-profit organization. Although the provisions of the Act do not directly affect Cooperative Directors, they should be used as a guide for "*best practices*."

Additionally, Cooperative Directors may be held personally liable if they fail to act in accordance with statutory laws and regulations on behalf of the cooperative. They may in fact look to the cooperative to be indemnified in defense of a lawsuit. Legal fees and costs could nearly bankrupt a cooperative even if there is an eventual recoupment of its loss. Thus, Cooperative Directors are charged to think through business problems independently and to communicate to the members any events that may adversely impact the cooperative with the eye of avoiding possible litigation.

A director training schedule should be established to discuss topics such as legal liability, cooperative finance, management supervision, and member relations. Session topics for the entire membership should include member responsibilities, cooperative operating policies, and tax treatment of patronage refunds.

B. Membership Rights

One of the fundamental principles of cooperatives is the ability for each member to have an equal voice in the voting process. Cooperatives uniquely allow for every member of the cooperative to have one voting share since it is a user-controlled and not an investor-controlled organization. Unlike in investor-owned businesses, democratic control equals one member/one vote. However, the notion of "defining" democratic control has been a major topic of discussion as it relates to the voting treatment of outside investors which may contribute a larger percentage of equity capital than the cooperative members to the cooperative. These issues are usually discussed at a charter member's meeting.

1. Federal Legislation Response

Federal laws do not necessarily set forth requirements as to satisfying "democratic control." The federal laws related to cooperatives, such as, Capper Volstead; CoBank Borrowing eligibility statute; and the Ag Marketing Act of 1929, allow for alternative voting, but do not specify what those alternatives are. Internal Revenue Code Section 521 and Subchapter T, which govern a majority of agricultural producer cooperatives, are silent on this issue.

The Internal Revenue Service ("IRS") has not provided a statutory definition of "democratic control." It has, however, long been in favor of one member/one vote based on its reliance of case law as revealed in certain prior revenue rulings. In Rev. Rule 93-21, it held that the cooperative principles provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of Subchapter T.[16] In fact, the IRS has generally referred to “democratic control” as “the periodic assembly of the members at a democratically conducted meeting at which each member ordinarily has only one vote.”[17] However, the IRS training materials have referred to “member control” which means that members can control a cooperative either through one vote per member or through a voting system that relates to the size of the patronage each does with the cooperative.” In two private letter rulings, the IRS determined that a cooperative’s proxy voting arrangement satisfied the democratic control requirement and approved a weighted vote for the nomination of directors of a federated cooperative.[18]

2. State Legislation Response

As confusing as this may be, cooperatives can have some level of comfort in how to govern their organization based on the statutory requirement of their state laws. Some state laws do require one member/one vote. Those states that do not, cooperatives have several alternative forms of governance. The most widely used is “Weighted Voting” based on a member’s patronage, delivery rights and/or equity investment. Cooperatives would also issue preferred shares and common shares to differentiate the member and/or outside equity investor’s level of control. The “Membership Delegate System” would allow for members to choose a delegate to be represented at a meeting, or a “Board Nominating System” which would allow for multiple directors to be determined per geographical districts. The governing aspect of cooperatives is evolving in order for cooperatives to compete in a more competitive and diversified financial and economic environment. At the end of the day, however, cooperatives must still maintain the basic cooperative principles, such as having "democratic control" in the governance of their organization in order to keep their status as a cooperative.

3. Prevailing View

The risks that cooperatives face if your cooperative does not have democratic control are (i) loss of subchapter T eligibility[19], (ii) loss of eligibility as a 501(c)(12) organization[20], and (iii) possible lawsuits from members. As cooperatives start to "think outside the box" regarding the governing structure of their organization, make sure your cooperative is in compliance with not only the cooperative principles, but current and pending state laws that inevitably dictate how your cooperative should operate either as a one member/one vote organization or alternative systems.

C. Legal Documents[21]

Agricultural cooperatives, like other businesses, are tasked with the requirement to have documentation to prove their legal existence. Perhaps one of the most important aspects of legal representation is drafting articles of incorporation and bylaws. Other legal documents include the membership application, membership or stock certificate, revolving fund certificate, marketing/purchasing agreements, and meeting notices and waivers of notice.

1. Articles of Incorporation

In general, cooperatives organize as a corporation under a state statute. When a cooperative incorporates, it is given a distinct legal standing. Members generally are not personally liable for the debts of an incorporated organization beyond the amount of their investment. Each state has special enabling laws under which cooperatives may incorporate. It may be preferable to incorporate under the state's general corporation enabling act, but structure bylaws to operate as a cooperative.

Articles of Incorporation (the “articles”) indicate the nature of the cooperative business. Articles usually contain the name of the cooperative, principal place of business, purposes and its powers, proposed duration of the cooperative, names of the incorporators as may be required in most states, and information about the capital structure. In some states, the names of the first officers of the cooperative must be included. They should specify rather broad operating authority when incorporating even though services may be limited at the beginning.

The cooperative corporation is formed upon the filing of the articles, which is usually with the Secretary of State. After the organizing committee approves the articles, the attorney files for the corporation charter and include the recording fees. Once chartered by the state, the cooperative should promptly adopt bylaws.

2. Bylaws

The bylaws provide how the cooperative will conduct business. The language set forth within the bylaws must be consistent with both state statutes and the articles of incorporation.

Bylaws usually have membership requirements and lists rights and responsibilities of members; grounds and procedures for member expulsion; how to call and conduct membership meetings, methods of voting, how directors and officers are elected or removed, and their number, duties, terms of office, and compensation; time and place of director meetings; dates of the fiscal year; requirement to conduct business on a cooperative basis; how net margins will be distributed; process for redemption of members' equity; a consent provision that members will include the face value of written notices of allocation and per-unit retain certificates as income in the year they are received; distribution of non-patronage income; handling of losses; treating nonmember business; dissolution of the cooperative; indemnification of directors; and the process for amending the bylaws.

Also covered is how the board is structured to represent the membership, given geographical distribution and size of the membership and the scope of business and function of the cooperative. Directors may be selected to represent districts based on membership density, to reflect commodities or services to be handled, or some other basis that provides equitable representation. The organizing committee's recommended management structure should include the basis for director representation, voting methods, and board officers, and their terms.

For agricultural marketing cooperatives that lack a marketing agreement, the bylaws specify the extent of members' obligation to market through the cooperative. They outline the terms and conditions under which the products will be marketed and accounting procedures.

The committee prepares the articles and bylaws with the help of an attorney so provisions comply with laws of the state in which the cooperative is incorporated. The committee's role also is to assure the bylaw provisions will not conflict with operating procedures.

3. Membership Application

The membership application has five main parts: 1) applicant's statement asking to become a member of the cooperative; 2) signature of the applicant; 3) statement of cooperative acceptance of applicant; 4) signatures of the president and secretary; and 5) a statement of the duty and intent of the member.

The membership application signed by the member and approved by the board of directors is the legal proof that a patron is a member. A cooperative should have a completed membership application on file from every member. Membership and the amount of business done with members and nonmembers are important factors for certain antitrust and taxation provisions.

A membership certificate may be issued to each member as evidence of entitlement to all of the rights, benefits, and privileges of the association.

4. Marketing Agreements

In the marketing agreement, the cooperative agrees (i) to accept specified products of stated or better quality; (ii) to market them to the best of its ability; and (iii) to return to members all marketing proceeds less deductions for expenses and continuing capital needs. A similar contract with members can be structured for agricultural service and supply cooperatives.

The marketing agreement contains self-renewal provisions which should specify that after it has been in force for some initial period, it should continue indefinitely unless the member or the cooperative states in writing a desire to cancel or modify it. A cancellation request must be made during a specified annual period as noted in the contract.

A marketing agreement ensures sufficient control over products or services to be delivered so the cooperative can function. This is especially helpful in the first few years of operation when the cooperative is establishing its reputation as a responsible and successful business. Marketing agreements have helped some cooperatives get needed outside financial help. In some cases, cooperatives that use contractual agreements must file them with the state government.

5. <u>Revolving Fund Certificates</u>

When a cooperative retains funds from business with or for patrons as capital investments, it issues a written patronage refund certificate or a similar document to the member as a receipt for capital investments that will eventually be revolved or redeemed. Meanwhile, the “retain” is used to finance the business. Member investments may be deductions based on per-unit of product handled or services used, reinvested patronage refunds, or original capital subscriptions, if it is a non-stock cooperative.

D. Charter Member Meeting

According to most statutes under which cooperatives are organized, articles and bylaws must be adopted by a majority vote of the members or stockholders. For convenience in organizing, only the persons named in the articles, called the charter members, must vote to adopt the bylaws. These persons are regarded as members or stockholders as soon as the articles are filed. A good practice, however, is to invite everyone who has signed a pre-membership agreement to the meeting to ratify the bylaws.

A temporary presiding officer conducts this first meeting and reports that the articles have been filed. A draft of the proposed bylaws is presented, discussed and adopted as read or amended.

Further action is usually needed to accept those members or stockholders who have subscribed for stock or agreed to become members but are not named in the articles. Under some statutes, however, the incorporators can adopt the bylaws as incorporators rather than as members or stockholders.

If members of the first board of directors have not been named in the articles, they should be elected at this meeting. Here are some suggestions for selecting the first board of directors: 1) use a nominating committee to develop a panel of candidates for the board; 2) select only members as candidates; 3) nominate two candidates for each position; and 4) vote by secret ballot.

IV. CONCLUSION

Agricultural cooperatives have contributed greatly to the development of one of the world's most productive and scientific-based agricultural systems. On a macro-level, they have not only played a crucial role in creating wealth in rural America, but in shaping America's economy as a whole. On a micro-level, they encourage democratic decision-making processes, leadership development and education for their members.

Thus, it is imperative that their legal professionals understand the operational nature of agricultural cooperatives and agribusiness, in general. Due to the changing nature of federal regulations and laws, legal professionals must stay abreast on current topics that may impact cooperatives to ensure their compliance. The ultimate challenge is for legal professionals to effectively represent their agricultural cooperative-clients in order for them to thrive as successful businesses.

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[18] PLR 200629018 and PLR 9725011.
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A “One of a Kind” Opportunity is Closing:
Leveraging Large Taxable Gifts in 2010 with Life Insurance

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Advisors are well aware that the clock is ticking down on the historic lifetime wealth transfer opportunities available for their most affluent clients in the remaining days of 2010. Only a few months remain for advisors to go on the offensive so their wealthiest clients maximize this “one of a kind” wealth transfer planning opportunity available in 2010. By leveraging life insurance into the planning, advisors can create momentum and allow their clients to minimize their major short-term risk from a large taxable gift while also providing long-term investment certainty for the client’s family.

Consider the following:

- Taxable gifts are almost always more efficient than bequests at death (because they are tax “exclusive”), but for 2010 there is added incentive to give away assets.
- The current 35% top federal gift tax rate for 2010 is the lowest since 1934.

- The one year repeal of the generation-skipping transfer (GST) tax for 2010 presumably will remain in place through the end of the year.
- The likelihood of Congress enacting transfer tax legislation that is “retroactive” to January 1, 2010 now appears remote.

Come January 1, 2011, this highly favorable tax environment will be gone, replaced by a set of onerous transfer tax rates that are even higher than those that applied for 2009; under current law, in 2011 there will be a 55% top gift tax rate and a 55% top GST tax rate with perhaps only a $1,340,000 exemption amount.

Now that “retroactive” legislative action seems highly doubtful, a simple gift may be appropriate. For those advisors still concerned about “retroactive” legislation, it may be appropriate for their clients to use a formula (defined value gift) clause that has the effect of adjusting values based on “retroactive” law changes. Thinking ahead, sophisticated advisors also need to remember that in 2011, the broad “had never been enacted” sunset rule contained in Section 901(b) of the 2001 tax act may be interpreted to mean that Chapter 13 (concerning GST tax law) did apply to a direct skip made in 2010 – not to impose a GST tax in 2010 – but for all other GST tax purposes.

Some believe the current Congress will try to make one final attempt to tackle the question of estate and transfer taxes after the mid-term election in early November. Most believe that Congress will return the estate tax to its 2009 level – a $3,500,000 exemption and a top rate of 45% - at least for a couple of years. Heirs of those who die in 2010 may also get the choice of using either the current 2010 rules or the 2009 rules. Most commentators and even Senator Baucus (Chairman, Senate Finance Committee) have stated that the odds of retroactivity appear remote. To be safe, advisors should now begin a serious dialogue with their wealthy clients about making a large taxable gift in 2010, and then consider waiting on Congress before finally executing on this strategy in late December 2010.

For older unmarried patriarchs or matriarchs unable to implement marital deduction planning because of their current marital status, there may be even greater urgency to seriously consider making a large taxable gift in 2010. Perhaps a widow or widower is prepared to relinquish or dispose of ownership of a portion of a marital deduction (e.g., QTIP?) trust inherited from a predeceased spouse?

Advisors and their wealthy clients will miss a golden opportunity if they fail to strongly consider undertaking a large taxable gift program in 2010, even if it results in payment of significant gift tax come April 2011. Adding life insurance can safeguard the success of the transaction.

Taxable Gifts in 2010

Under current law, the maximum tax rate on taxable gifts made in 2010 is 35%. As the likelihood of retroactively diminishes, there is increasing likelihood that a 35% top gift tax rate will ultimately apply to gifts made in 2010 either outright to or in trust for descendents. The gift tax rate for 2010 is now hovering at a 75 year low point. The current 2010 federal gift tax rate of 35% is a 10% reduction from 2009 and is a 20% reduction from the anticipated 2011 rate (absent Congressional action). Clients who have already used their $1,000,000 lifetime gift tax exclusion amount and who intend to eventually transfer significant additional wealth to younger family members have a strong incentive to do so in 2010.

Generation Skipping Transfers in 2010

Under current law, the GST tax is suspended in 2010. This presents a unique opportunity for wealthy clients with the financial ability and desire to make significant lifetime transfers to grandchildren and younger generations that will never be subject to GST tax. In past years, the GST tax has been expensive and difficult to plan around. During the balance of 2010, a transfer to grandchildren and younger generations will be taxed the same way as gifts to children. However, since the GST tax system re-emerges in 2011 and thereafter, the best way to make a gift to grandchildren and younger generations in 2010 is probably outright and not in trust. An outright gift to grandchildren and younger generations raises some non-tax considerations on how to subsequently control or restrict their future access to assets received by them in 2010.

If 2010 gifts for grandchildren and younger generations are made in trust, distributions from that trust in 2011 and in subsequent years may be taxable distributions or taxable terminations subject at that time to GST tax. Moreover, these taxable distributions would be taxed more harshly. The GST tax on a taxable distribution from a trust is “tax inclusive” (the GST tax is applied to the total amount transferred, including the GST tax itself). Any GST tax paid on a direct skip transfer to a grandchild is “tax exclusive” (any GST tax is applied to the amount actually received by the grandchild).

Transfers to custodianships for grandchildren are subject to the same considerations because the GST regulations treat custodianships as trust equivalents.

Outright gifts of FLP or LLC interests directly to grandchildren can provide management control and restrictions on access to the underlying entity assets. If necessary, it should be relatively easy for a patriarch or matriarch to quickly form a new FLP or LLC (perhaps with their children), contribute assets to the entity and then make a gift of a very significant FLP or LLC interest to his or her grandchildren. Since no valuation discount would be sought on this large taxable gift, step transaction concerns recently raised by the Tax Court in *Pierre v. Commissioner*, T.C. Memo 2010-106 (known as Pierre “II”) and previously considered in *Holman v. Commissioner*, 130 T.C. 170 (2008), *aff’d* ___F.3d___(8th Cir., April 17, 2010), should not be present. A new FLP or LLC can be quickly organized and capitalized and then immediately thereafter a grandparent can make a large taxable gift of FLP or LLC interests outright to grandchildren. Waiting until December 31, 2010 does heighten the risk that an older donor might unexpectedly die before both making the gift and locking in its success by having the FLP or LLC purchase life insurance on his or her life.

The donor of a large gift made in 2010 to grandchildren and younger generations should also consider filing a Form 709 (gift tax return) for 2010 electing out of automatic allocation of GST tax. This will prevent the automatic allocation rule under pre-2001 law from applying to any direct skips made in 2010 once the GST tax returns for 2011 and beyond.

Net Gifts? Financed Net Gifts? How to Add Efficiency (and Minimal Complexity)

A “net gift” is a gift in which the donor and donee agree that the donee will pay the gift tax. For a large taxable gift, the amount of the taxable gift is equal to the amount of the property transferred *less* the amount of gift tax the donee will have to pay. Rev. Rul. 75-52, 1975-1 C.B. 310.

Use of a net gift can be compelling. In 2010, use of a net gift arrangement will decrease the effective top gift tax rate from 35% to about 26% on large taxable gifts on which gift tax must be paid.

Children and grandchildren may lack sufficient personal assets from which to pay the gift tax on behalf of their parent or grandparent. Likewise, a super affluent parent or grandparent prepared to shift significant wealth to children and grandchildren in 2010 may find it undesirable to have such large taxable gift reduced almost immediately by one quarter for the gift tax that must be paid.

In a financed “net” gift, when the gift tax on a large 2010 taxable gift comes due in April 2011, the patriarch or matriarch (donor) might lend the cash to the children and grandchildren to pay the net gift in exchange for a promissory note. By taking back a 9-year note pegged to the mid-term AFR rate, which was 1.94% per annum in September 2010, the patriarch or matriarch freezes asset growth in his or her gross estate. The advantage of a financed net gift is that the entire taxable gift proceeds can be fully deployed by the children and grandchildren, since it is not burdened by the need to deplete the gift amount in order to pay gift taxes due in April 2011.

If outright gifts rather than gifts in trust must be made in order to avoid future GST tax ramifications (such as taxable distributions), the donor may recognize capital gain on the amount by which the gift tax liability exceeds the donor's adjusted basis in the assets transferred. If the gift instead is made by the donor to his or her grantor trust that benefits only children, there should be no capital gain recognized on such a net gift transfer, but the unique 2010 opportunity to permanently eliminate GST tax will have been wasted.

A trust for children or an LLC for children and grandchildren can deploy the additional gift proceeds to buy life insurance on the life of the patriarch or matriarch. Some portion or all of the gift proceeds can be invested in life insurance policies on the life of the patriarch or matriarch that offer predictable after-tax equivalent returns approaching 10% through life expectancy. The current cost of such capital deployment to the trust or LLC is only 1.94% annually. A portion of the leveraged death benefit can be used to repay the estate of the patriarch of matriarch for the loan made in connection with the gift tax paid by the LLC.

Major Drawback to Large Taxable Gifts and Paying a Gift Tax: The Three-Year Lookback Rule Causes Inclusion of Gift Tax Paid in Donor's Gross Estate…But Life Insurance is a Short-Term Hedge.

Aside from the almost immediate payment of gift tax, the major risk for an older donor who pays gift tax on a large taxable gift in 2010 is if that donor dies within three years of making such gift. In such event, the gift tax paid on the gift must be included in the donor's gross estate. IRC Section 2035(b).

Clearly, use of life insurance as a short-term hedge can eliminate the primary risk of a large taxable gift that generates a payment of significant gift tax. Once the three-year lookback (estate inclusion) period has expired, a donor might want to reassess whether to continue with the life insurance program. In order to combine a three-year hedge with optionality if the donor survives the three years, the LLC might consider purchasing a UL policy with an "early cash value rider" that maximizes the amount of cash value available when the three-year period ends.

Leveraging a 2010 Large Taxable Gift with Life Insurance

On a long-term basis, dedicating some portion or all of the gift proceeds to the purchase of a diversified portfolio of life insurance on the life of the donor makes good investment sense. The life insurance policies could be owned by the LLC whose members are predominantly the donor's grandchildren and younger generations (with donor's children perhaps owning small management interests).

Once the gift proceeds are transferred to the LLC, the family's financial advisors need to design an investment program to safeguard and grow these assets. Most donors making large taxable gifts in 2010 want to ensure that the gift proceeds provide long-term financial security for their family.

Sophisticated investors recognize that the need for diversification of assets is vital. Wealthy patriarchs and matriarchs often have made their fortune by assuming outsized risks. Typically, they own a large, concentrated illiquid position in a private business, investment real estate or private equity investments which they would like to pass on to their heirs. The use of life insurance to offset the estate taxes imposed on these illiquid, hard to value but lucrative assets can be invaluable in preserving highly appreciating but illiquid core assets for subsequent generations of family members.

Here are some takeaways on why very affluent families often use the unique long-term features of life insurance as part of their wealth transfer planning:

- ***Predictable Value***. The asset's date of death value is known in advance with virtual certainty. Traditional investments lack such future certainty.
- ***Liquidity***. At the death of the donor, the asset is automatically paid in cash by the insurance company. Unlike traditional portfolio assets, conversion to cash is not reduced by commissions or management fees. Unlike illiquid assets, there are no transfer (legal) fees incurred and there is no time delay.
- ***Value Not Directly Linked to Market Performance***. In the case of a no lapse guarantee universal life (NLG UL) policy, the payment of the death benefit amount does not directly depend on financial market performance. This means that the asset value of life insurance at the death of the donor is quite stable, especially if a diversified portfolio of policies issued by many top-rated carriers is acquired and thereafter actively monitored. Active monitoring of the carriers' long-term financial

stability assures that their long-term promises to the policyholder will be met.

- ***Equity-like Returns/Bond-like Risk Due to Lack of Income Tax Friction***. The income-tax free return on invested premium dollars causes the after-tax equivalent internal rate of return (IRR) to be comparable or superior to most traditional equity investments at life expectancy. However, by implementing a diversified portfolio of NLG UL policies, there is a bond-like risk. The risk-reward tradeoff consideration for an investor in life insurance is more favorable than with traditional market-based investments. Unlike high yielding alternative investments whose performance can fluctuate widely year to year, life insurance provides a non-correlated asset whose performance is predictable, assuming it is actively monitored.
- ***Leverage***. Premiums paid for death benefit protection can provide significant leverage, as well as a competitive after-tax return on investment (IRR) through life expectancy when compared to traditional taxable investments over the same period.
- ***Avoids Estate Tax…Outcome Not Dependent on Future Investment Performance for Success of Transaction*****.** Ownership of the policy can be held by a trust (ILIT), FLP or LLC so that the death benefits will not be subject to federal estate taxes and perhaps GST tax. Unlike a sale to intentionally defective trust (IDGT) or GRAT transaction that are highly dependent on future investment

performance for their success in removing appreciation from the patriarch or matriarch's gross estate, a properly structured trust, FLP or LLC that owns a diversified and well-monitored portfolio of life insurance eliminates future investment performance as a consideration.

- ***Special State Government Oversight***. Unlike other investments which are either loosely regulated by the federal government or not regulated, all life insurance companies and their policies are regulated by state insurance commissioners. The carriers must satisfy specific capital reserve requirements set by their regulators, and invest a majority of their general account assets in a laddered portfolio of fixed income bonds and Treasury obligations. Should a problem occur, policyholders come before bondholders, stockholders and general creditors of the carrier (but the industry experience has been that the remaining carriers typically agree among themselves on how to assume the policies issued by a problematic carrier).
- ***Income Tax-Free Payment***. Policy death benefits (including the amount in excess of premiums paid) are generally received income tax free. IRC Section 101. Stock options, deferred compensation and large IRAs owned by decedent's present potential income in respect of a decedent issues for a family (income tax considerations in addition to estate tax considerations).

A Real World Example

Assume that in late 2010, a wealthy 75 year old widow (and non-smoker in relatively good health) decides to move forward with a very large taxable gift, to take advantage of the historic, soon to disappear, wealth transfer planning opportunity described to her by her estate planning advisor.

Assume the widow owns about $35M of assets in her own name and is the spousal beneficiary of a large $65M QTIP marital trust established at her husband's death. The independent trustee of the QTIP has absolute discretion to make distributions of principal of this trust to the widow during her life. The widow has fully utilized her $1,000,000 lifetime gift tax exemption in connection with prior wealth transfers primarily benefiting her children. The widow intends to eventually transfer the bulk of her wealth to her children and grandchildren but has long been concerned about the tax costs to do so. She has far more assets than she needs to maintain her current lifestyle.

In the coming days, the independent trustee of the QTIP will distribute $20M in assets outright to the widow. Before the end of 2010, the widow will give a) $10M to a fully discretionary trust for her children, and b) the other $10M will be transferred to a new LLC (to which relatively small contributions will also be made by the children in exchange for management interest in the LLC) and the widow will make a large gift of the (non-management) LLC interests to her grandchildren.

The widow agrees that it is preferable for the widow – not her children or grandchildren – to pay from her personal assets any gift tax due by undertaking a so-called financed “net gift” transaction. The gift tax due without a “net gift” would be $7M ($20M x 35% federal tax rate in 2010) if the widow is responsible for the payment of the gift tax. By entering into a “net gift” agreement with the donees, in which the donees are responsible to pay the gift tax, the widow would reduce the gift tax due to about $5,185,000. She would save about $1,815,000 in gift tax payments, and reduce the tax cost on these gifts to a roughly 26% effective gift tax rate. If loans to the donees are made now (to lock in the very low interest rates available today), the widow would take back two identical 9-year promissory notes of about $2,592,000 apiece, one from the trust and one from the group consisting of her grandchildren, each with interest payable annually at the prevailing mid-term AFR rate (1.94% per annum for September 2010).

The trustee of the trust for children will buy a $5M life insurance policy on the widow. The independent trustee decides to purchase a NLG UL policy, but has arranged to backload or to optimize premiums beyond the widow’s life expectancy. The trustee has experience administering trust-owned life insurance and has internal systems in place to assure timely payment of premiums on this type of product.

The following results occur:

Year	Insured’s Age	Net Annual Outlay	Net Death Benefit	Internal Rate of Return
2011	76	$116,127	$5M	4205%
2021	86	$116,127	$5M	21.71%
2026	91	$347,122	$5M	10.34%
2031	96	$347,122	$5M	3.07%

The family's advisors decide that due to the longer time horizon and for administrative peace of mind, the LLC should consider a one-time premium payment of $2,116,634 to purchase a $5M NLG UL policy on the widow's life.

The following results occur:

Year	Insured's Age	Net Annual Outlay	Net Death Benefit	Internal Rate of Return
2011	76	$2,116,634	$5M	136%
2021	86	0	$5M	8.13%
2031	96	0	$5M	4.18%

In considering available alternative policy design options, since a financed "net gift" agreement is contemplated the advisor and donor might consider adding an "ROP" (return of premium) rider if offered by the carrier. The extra premium paid by the policyholder (i.e., the LLC) can be viewed as an investment that will yield a known return at maturity of the policy. If offered, an ROP premium rider would work well in conjunction with a financed "net gift" because the donee(s) of a large taxable gift made in 2010 have a fixed obligation to repay the loan balance due the donor's estate when the donor dies. More wealth – in the form of additional net death benefit – would be available to the donor's grandchildren from the LLC when the donor dies and the loan must be repaid. Sometimes advisors and donors also consider utilizing the ROP rider merely to enhance the internal rate of return (IRR) performance on the policy.

In undertaking their due diligence, the family's advisors also explore the possibility of purchasing an "early cash value rider" to a UL policy – in lieu of a NLG UL policy for the LLC – in the event the family wishes to change course in three years once the widow has survived the three year lookback (estate inclusion) period.

Through this “early cash value rider,” the widow and her advisors can implement a “wait and see” approach. Under a “wait and see” approach, the widow would purchase a one pay UL policy with “early cash value rider.” The major advantage of such a policy is that once the three-year lookback (estate inclusion) period has expired, the widow might reassess whether or not to continue the life insurance program altogether.

In three years, the policy net cash surrender value would approximate the amount of the one time premium paid three years earlier. The policyholder (i.e., the LLC) would own an investment that produced no return over three years (and would suffer the loss of the time value of money).

The results that might occur are as follows:

Year	Insured’s Age	Net Annual Outlay	Net Surrender Value	Net Death Benefit
2011	76	$2,116,634	$2,116,634	$5M
2013	78	0	$2,116,634	$5M
2021	86	0	$2,215,464	$5M

If the policy were surrendered in three years, there should be little or no income tax due since the amount realized would essentially equal the premiums paid. See Rev. Rul. 2009-13, IRB 2009-21, Situation One (May 26, 2009). A surrender of the policy on the life of a 78 year old would avoid the MEC premature distribution rules (because the insured is older than 59 ½). Moreover, there is no annual accretion in the cash value in excess of premiums paid, which should avoid adverse MEC tax treatment during the first few years following the issuance of the policy.

In lieu of surrendering the policy after the end of the three year lookback (estate inclusion) period, the policyholder might consider other options. If the health of the donor insured has deteriorated, and the policyholder wishes to maximize the cash proceeds received in three years, the policyholder and donor-insured might consider a life settlement (sale) of the policy. Based on past experience, a policyholder who paid roughly $2.1M to acquire a $5M UL policy with an early cash value rider might receive an offer to purchase the policy in excess of $3M. Of course, in any life settlement the advisor and insured must weigh the possibility of a near-term death of the insured and foregoing the $5M death benefit.

If the health of the donor-insured remains strong, and the family wishes to continue the use of life insurance as one type of investment class, the policyholder might consider exploring an IRC Section 1035 like kind exchange of the UL policy with early cash surrender value for a new NLG UL policy or some other type of product that takes advantage of the prevailing mortality tables used by the carriers.

Conclusion

Integrating the use of life insurance to lock in the potential significant transfer tax savings available from a large taxable gift made in 2010 assures a successful wealth transfer planning transaction. The biggest risk – that the donor dies within three years of making a large taxable gift on which significant tax is paid and that must be included in the donor's gross estate – has been hedged by purchasing some life insurance.

Careful policy selection can provide either short-term optionality or predictable long-term investment returns. For those policyholders and insureds who want to reassess their options once the donor survives the three years lookback (estate inclusion) period, use of a UL policy with an "early cash value rider" preserves a variety of options: surrender the policy for the amount paid (and no tax consequences), settle (sell) the policy perhaps for an amount in excess of the cash value or exchange for a new policy that might provide access to favorable mortality tables.

The ILIT Liability Minefield: Trustees' and Counsels' Risks

By: Melvin A. Warshaw and David Neufeld

Toronto

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I. The Trend of Lawsuits Against ILIT Trustees

A. Irrevocable Life Insurance Trusts ("ILITs") provide an effective and efficient wealth preservation vehicle for settlers and a way to increase an insured's assets and liquidity. Life insurance, however, is a complex trust investment asset with unique characteristics that requires special attention.

B. There is an increasing trend toward lawsuits against trustees related to their fiduciary duties and supervision of trust assets.

1. However, there are only a few specific cases involving the ongoing review of trust-owned life insurance.

2. Typically, the ILIT trust beneficiaries bring the lawsuit.

   a. The donor-insured generally does not have standing to bring the lawsuit.

   b. The donor-insured generally has no interest in the trust after it is established.

   c. Often the donor-insured is deceased when the lawsuit is brought.

3. These cases are very fact specific.

4. Many cases turn on the specific language in the trust instrument.

5. An unscientific sense is that many of these lawsuits settle out of court.

C. Potential Bases of Exposure

1. <u>Negligence in Administering the ILIT.</u> If *Crummey* notices are not administered properly, the IRS could challenge the use of the annual exclusion; contributions to the ILIT and death benefit may be subject to gift tax or estate tax respectively. In *Hattleburg v. Norwest Bank Wisconsin*, 2005 WL 1574958 (2005), a trustee was held liable for estate tax incurred by a trust where the trustee knew that there were no *Crummey* provisions and still encouraged the donor to make gifts to the trust.

2. <u>Negligence in Maintaining the Life Insurance Policy.</u>

   a. In *Pearson v. Barr*, 2002 WL 1970144 (Cal. Superior Court 2002), the beneficiaries sued a CPA acting as ILIT trustee for failing to pay premiums. Despite the CPA's negligence in failing to pay premiums due to problems related to his practice, the case was settled. The trust instrument allowed for liability only for gross negligence, which the beneficiaries were unable to prove.

   b. In *Sanders v. Citizens National Bank*, 585 S.2d 1064 (FL Ct. Appeals 1991), the corporate trustee accepted gifts over a period of years but failed to pay the premiums. The original policy failed and the trustee could only obtain a new policy that the insured was unwilling to cover through additional gifts to the trust. The co-donors of the ILIT sued but their case was dismissed because the court determined they lacked the standing to sue. A consideration in this case is that the trust instrument specifically allowed the trustee to not pay life insurance premiums

3. <u>Inadequate Design or Premium Funding.</u> A few cases have focused on an ILIT that anticipated a specific premium paying pattern after which the policy cash value was expected to support the death benefit. In these cases, the ILIT trustee or advisor was sued when actual policy performance required additional premium payments (and additional gifts to the ILIT). There have been a pair of "vanishing premium" life insurance cases that did <u>not</u> involve an ILIT.

   a. In *Von Hoffmann v. Prudential Insurance Co*., 202 F. Supp.sp2d 252 (N.Y. Dist. Ct. 2002), the insureds were held to have a cause of action against the insurance company.

   b. In *Heslin v. Metropolitan Life Insurance Co*., 733 N.Y.S. 2d 753 (N.Y. Sup. Ct. 2001), the insureds were held not to have a cause of action against the insurance company.

   c. The question remains as to what exposure the trustee might have in this case. In *Kohler v. Merrill Lynch, et al*., 706 S.2d 1370 (Fl. Ct. Appeals 1998), the cash value in an existing trust was accessed to pay premiums on a new policy purchased by the ILIT. When the new policy premiums did not "vanish" as expected, the donor-insured was told additional gifts were needed to enable the trustee to pay additional premiums. There was no clear court decision as the case was remanded to a lower court.

4. Carrier Insolvency.

    a. If the insurance company issuing the policy either was chosen at a time when its financial standing was questionable or if that financial standing changed while the Trust owned the policy, the Trustee would be exposed for not anticipating any financial losses flowing therefrom.

    b. Measuring carrier financial solvency is difficult due to the constant change in the economy, state regulatory and tax environment in which all carriers operate.

    c. The recent sub-prime mortgage debacle is an example of unforeseen change that has had some impact on some carriers.

5. Conflict of Interest. If the trustee shares in the insurance broker's commission, this could be grounds for a legal proceeding.

6. Bad Investment Decisions and Inadequate Management of the Insurance Portfolio.

    a. These cases often try to balance the trustee's decision making process against the beneficiary's disappointment

    b. The case of *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009) is among the first reported cases addressing the duties and liabilities of an ILIT trustee under the UPIA with respect to investment management responsibilities and monitoring of life insurance policies.

        i. The case seemingly suggests that an institutional trustee will not be held to a high standard of management care of investment due diligence as it relates to life insurance policies. In several different aspects of the case, the court found that "the process was not perfect."

        ii. One of the most important takeaways from the case is that the court confirmed that UPIA prohibits the use of hindsight in determining the appropriateness of investments and unforeseeable market forces.

iii. The corporate trustee here, Key Bank, considered only continuing the existing VUL life insurance policies and one other alternative, switching to paid-up no lapse guarantee policy but with a significantly reduced death benefit. The court was silent on the trustee's duty to assess underlying costs and performance assumptions that are standard practice for life insurance management by an ILIT trustee.

iv. While admitting that "of course it could have done more," the court found Key Bank's due diligence adequate.

v. What apparently saved the ILIT trustee here was that Key Bank engaged an outside professional (consultant) to review the existing VUL policies to help determine if those policies remained appropriate investments for the ILIT.

vi. It is uncertain whether other courts in other states will be similarly satisfied that the UPIA permits such a relatively low review by professional ILIT trustees.

vii. The concern in relying on this case is that Key Bank was found by the court to have performed the *minimum* acceptable management duties *in this case.*

II. New World of Life Insurance

A. What are the decisions a trustee and counsel are—or should be—making at the various stages of an ILIT as it relates to the underlying life insurance investment?

1. Creation of the trust

2. Acquisition of the policies

3. Ongoing maintenance of the trust and its investments

4. Termination decisions including whether to sell the policy to a third party.

B. The ILIT trustee must recognize and overcome outdated thinking concerning the life insurance portfolio.

1. Life insurance is far more than a custodial asset and is far more than a "buy and die" investment strategy.

2. In the past, ILIT trustees have made naïve assumptions which are no longer acceptable.

a. When it comes to acquiring the policy

   i. What is the trustee's role and responsibility vis-à-vis policy acquisition decisions made by the trust creator?

   ii. It may or may not be appropriate for a trustee to select "name brand" carriers with significant assets and investment grade financial strength ratings. For instance, selecting a "name brand," top-rated carrier is very desirable when selecting a Non-lapse Guaranteed ("NLG") universal life policy but is likely less relevant when selecting a variable policy where it is the platform of mutual funds that is important.

b. When it comes to maintaining the trust, to what extent will the ILIT trustee permit the donor to continue to dictate how the trust and its assets should be managed? Clearly, the trustee is dependent upon the donor to the ILIT to make future contributions to enable the ILIT to pay future premiums.

c. When it comes to deciding whether to continue the trust and/or its investments there are at least four options for the trustee to consider. If he or she fails to continually consider all of these possible courses of action and fails to document the decision-making process, then he or she is exposed to liability.

   i. Hold until death with out-of-pocket or cash value payments, which can involve:

      I. doing nothing

      II. policy conversion

      III. paid up reduced face

      IV. extended term

      V. 1035 exchange

   ii. Lapse or surrender

   iii. Borrow cash to pay premiums

      I. from family members

      II. from beneficiaries (such as split dollar)

      III. from a bank or other commercial lender with outside collateral

      IV. from a specialized lender collateralized with death benefit

iv. Sell to a third party in a life settlement

III. What Fiduciaries Should Know and Ask About Life Insurance.

A. There are spiral considerations involved depending upon the type of product selected.

B. Different product types carry different types of risks.

1. Permanent life insurance policies (e.g., whole life and no lapse guarantee universal life) are not interchangeable. Their performance varies substantially one from the other as does the financial strength of the numerous carriers offering these products.

   a. If a "non-guaranteed" product (e.g., whole life, universal life, variable life) is selected, the trustee has assumed investment risk of performance.

   b. Where the type of product is no lapse guarantee universal life (e.g., NLG UL), the trustee's primary responsibility as the policyholder is to ensure that premiums are paid on time and that the portfolio is diversified so that selected carriers have more than ample financial strength on a long-term basis.

   c. Accepting sales and in-force illustrations can never be accepted on their face as credible and predictive.

C. Interest-driven policies (universal life and current assumption whole life) are one type of current assumption policy type, under which the carrier assumes investment responsibility.

1. Current assumption policies have two components:

   a. Net amount at risk.

   b. Cash value account.

2. The death benefit in an interest-driven policy is the cash value account plus the net amount at risk.

3. Payments into the policy (premiums) are <u>not</u> fixed or guaranteed.

   a. Premiums accumulate at a currently declared interest rate set by the carrier, with a minimum rate specified in the policy.

   b. For example, pre-2004 policies may carry a 4% minimum (guaranteed) interest rate while newer policies may carry only a 2-3% minimum (guaranteed) interest rate.

c. The cash value typically is assessed a surrender charge (i.e., a penalty) imposed on the policy if surrendered in the first 10-20 years.

d. In these types of policies, the insurance company has shifted premium adequacy/sufficiency risk to the policyholder (ILIT) and insured. The policyholder must pay enough into the policy so that at the prevailing interest rate set by the carrier on the policy, all future insurance charges (COI) and other policy expenses can be withdrawn when called for by the carrier.

e. The policyholder (ILIT) and insured must estimate the annual funding cost of such interest-driven policies. Unfortunately, premiums are almost always projected using fixed or constant interest rate assumptions, even though the carrier has reserved significant rights to change the interest rate assumptions and cost of insurance (COI) charges in the future.

f. Life insurance agents in the 1980s recommended converting whole life policies to universal life coverage by offering flexible premium policies. Due to the hyper-inflation of the 1980s, clients were told their policies could participate in the high interest rates then offered in the bond market. Some policyholders were told that future premiums could "vanish." Unfortunately, interest rates fell precipitously, policies seriously underperformed and projections that future premiums would disappear failed to materialize.

D. Investment-driven policies (variable fixed and variable universal life) carry additional risk and reward.

1. Like interest-driven policies, these are current assumption policies.

2. Unlike interest-driven policies, investment-driven policies shift to the policyholder and insured the investment opportunity by obligating them – not the carrier – to allocate premiums and account values into sub-accounts offered by the carriers that mirror a menu of investment choices offered by mutual funds.

a. If premiums are heavily invested in equities (i.e., the stock market) the net amount at risk can be very volatile. Underlying policy account balances can quickly collapse in a down market if a sufficient amount of reserves are not maintained for market underperformance.

b. Premiums accumulate in the account with whatever earnings (or losses) are generated from the policy sub-accounts. Unlike with an interest-driven policy, there is no minimum return guaranteed by the carrier in the policy.

c. Similar to interest-driven policies, the insurance carrier has shifted the premium adequacy/sufficiency risk to the policyholder (ILIT) and insured. The policyholder must pay enough into the policy so that with interest all future insurance charges and other policy expenses of the carrier can be met *and* payments into the policy are also sufficient to offset sustained negative returns and increasing net amounts at risk.

d. It is impossible to estimate likely annual funding for these policies.

e. These VUL policies were popular in the 1990s, as agents and carriers believed that their customers could depend on equity markets to provide reliable 10%-12% annual returns, but with insurance customers (policyholders and insureds) accepting greater investment risk. Then the economic recession of 2008-2009 hit and customers did not receive the projected 10%-12% returns on their invested premiums. In the 1998-2008 period the S&P actually had a negative return.

E. In response, the industry accepted all the investment risk and offered up thinly funded no lapse guarantee universal life (NLG UL) products.

1. NLG UL products feature relatively inexpensive permanent death benefit guarantees.

2. The trade-off is that NLG UL policies typically offer anemic cash value.

a. Until recently, these attractive IRRs extended well beyond life expectancy (to say age 110).

b. Due to balance sheet portfolio yields, the cost of credit and pressure from state insurance regulators to more adequately reserve capital for these policies, some carriers have cut back the period of their death benefit guarantee to 90 years. (Other carriers have suspended writing new NLG UL polices or have raised the cost).

IV. Trustee's Duties in General

A. The Reality of the Situation

a. Trustee compensation is often minimal. For most corporate trustees, serving as ILIT trustee is often done as "loss leader" or client accommodation, in expectation of future profitability from the account once cash is available for investments.

b. Some insureds expect to continue to actively manage and participate in the decision-making process for their own trust-owned life insurance, notwithstanding the trustee's responsibility to manage the policies in the best interest of the trust beneficiaries.

   a. All too often the Settlor/insured acts as if it is "his" policy, ignoring the trust. When he or she wants changes, he or she tells the trustee what to do.

   b. Example: The Settlor wishes to sell the policy in the ILIT on the secondary market (a life settlement); in point of fact, he began the conversation with "I want to sell my policy." He believes this is the best move in terms of the overall family finances/investments. What if the beneficiaries believe they are better off retaining the policy but the Trustee follows the direction of the Settlor?

c. Very often the trustee is not involved in the structuring of the initial portfolio or selection of life insurance policies to be held in trust. Typically, the insured and his or her agent, and perhaps in consultation with the insured's estate planning lawyer, discuss the initial portfolio of life insurance. Rarely does the ILIT trustee participate in such initial decision-making.

   1. However, once the trustee accepts appointment and has control of the life insurance portfolio it is his or her duty to manage it. That might mean cashing in or selling the original policies along the way and replacing them with newer, better performing policies that diversify and minimize risk to the beneficiaries.

B. The Uniform Prudent Investor Act ("UPIA").

1. Section 4 of the UPIA, outlining duties at inception of a trusteeship, simply cross-references Section 2(a) of the UPIA: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the

trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."

a. The commentary to Section 4 of the UPIA states in part: "The criteria and circumstances identified in Section 2 of [UPIA] [Section 2 is the heart of the UPIA which contains the standard of prudent conduct] as bearing upon the prudence of decisions to invest and manage trust assets also pertains to the prudence of decisions to retain or dispose of inception assets under this Section."

b. Section 3(e)(5) of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) offers the following insight:

   i. Section 3(e)(5) of UMPIFA states: "Within a reasonable time after receiving property, an institution shall make and implement decisions concerning the retention or disposition of the property, or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, distribution requirements and other circumstances of the institution and the requirements of this [act]."

   ii. Much of the language of the Uniform Prudent Investor Act was copied into the text of UPMIFA.

   iii. The commentary to Section 3 of UPMIFA notes, in part: "This subsection requires the institution make a decision, but does not require a particular outcome. The institution may consider a variety of factors in making its decision, and a decision to retain the property either for a period of time or indefinitely may be a prudent decision."

2. Under the UPIA, the (ILIT) trustee must "act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries." UPIA, Section 6.

3. Under the UPIA, the (ILIT) trustee must "consider the purposes, terms, distribution requirements and other circumstances of the trust." UPIA, Section 2(a).

4. Under the UPIA, the (ILIT) trustee has "continuing responsibility for oversight of the suitability of investments already made, as well as…decisions respecting new

investments." UPIA, commentary concerning Section 2, Duty of Care.

5. Can the draftsperson of a new ILIT avoid the higher standards of the UPIA?

    a. The donor-insured of an ILIT may not want the trustee to be held to a high fiduciary standard (i.e., the donor-insured does not want the ILIT trustee to worry about the Prudent Investor Rule in the UPIA).

    b. A donor-insured can include specific language in a new ILIT that pre-empts and overrides the UPIA.

        i. The ILIT's trustee's duties would be defined by the trust instrument, not the UPIA law of the governing state law.

        ii. It is rare to find such pre-emption language in existing ILITs.

    c. The donor-trustee can reduce or eliminate the ILIT trustee's duty to monitor and track policy performance.

    d. The donor-trustee can reduce or eliminate the ILIT trustee's duty to diversify policy selection by authorizing the trustee to retain indefinitely the original policies purchased by the trust.

    e. The donor-insured can reduce or eliminate the ILIT trustee's duty to search the marketplace to see if better-performing policies have become available.

6. Some states have enacted statutes that reduce or even eliminate a trustee's various duties specifically with respect to life insurance policies held in trust. In order to avail oneself of a particular state's statutes reducing or eliminating an ILIT trustee's responsibilities with respect to life insurance policies held in trust, there are some basic practical considerations for a donor-insured and the draftsperson of the ILIT.

    a. The ILIT trust instrument must recite that the trust is governed by the law of such state.

    b. There must be sufficient nexus between the ILIT and such state.

        i. The trustee (or a co-trustee) presumably would need to be a resident of such state.

ii. The donor-insured and some of the beneficiaries might also be residents of such state.

7. Several states have enacted statutes that relieve an ILIT trustee of liability in managing life insurance as an investment.

a. Among the states with some type of protective statute for the ILIT trustee are Delaware, Florida, North Dakota, Pennsylvania, South Carolina, West Virginia, and Wyoming. Alabama also has a limited statute.

i. The Delaware statute (Title 12 of Delaware Code, Section 3302) is a good example. Section 3302(d) carves out an exception to the general fiduciary standard expected of a fiduciary under Delaware law, relieving the trustee of an ILIT for liability under Delaware law for a loss resulting from the trustee's failure to:

I. Determine whether the insurance contract is or remains a suitable investment;

II. Investigate the financial strength or changes in the financial strength of the life insurance company;

III. Make a determination of whether to exercise any policy option under the contract;

IV. Make a determination whether to diversify such contracts in relation to one another or to other trust assets;

V. Inquire about changes in the health or financial condition of the insured or insureds.

VI. The trust instrument must specifically recite each of these provisions of Delaware law.

ii. Florida has recently adopted a statute (736.0902) that not only reduces an ILIT trustee's liability under the Prudent Investor Rule but also deals with the topic of insurable interest.

I. Florida's law may be more protective than Delaware. Like Delaware, Florida relieves the ILIT trustee from any duty to manage the life insurance policies as an investment.

II. The protection afforded an ILIT trustee under the Florida statute may be broader in scope and easier to access because it relieves the trustee from liability for any loss sustained with life insurance without specific reference to the duties removed.

III. Unlike the Delaware statute, the Florida statute removes any duty to investigate whether there is a sufficient insurable interest in the policy, so long as the trustee did not have knowledge of a lack of insurable interest or a stranger owned life insurance (STOLI) type arrangement. (An ILIT trustee, therefore, is safe as long as it is ignorant).

IV. A trust instrument can opt out of the new Florida statute that eliminates the ILIT liability.

V. Unless the trust instrument specifically opts in, beneficiaries can eliminate the new statute from applying by objecting upon request of notice.

8. How does a beneficiary motivate a trustee in these states?

   a. In these states, a trustee is nothing more than a custodian.

   b. Does this mean a judge will leave beneficiaries without recourse in the event that their inheritance is reduced or eliminated due to no management of the investment in the policy?

9. In those states that have adopted "directed trustee" statutes, such an arrangement would appear to offer a somewhat more balanced approach, at least in theory.

   a. In a "directed trustee" arrangement, the trust advisor, protector or co-trustee would direct the trustee concerning the management of the life insurance and would be responsible for these activities.

b. As a practical matter, though, the “directed trustee” statute allows a bank or other professional possessing meaningful expertise or skills to avoid liability altogether, while a family member or friend of the insured named as trust advisor, with often limited knowledge about life insurance or estate planning, would bear full responsibility for the management of the investment in the policy. Somehow this does not seem equitable.

10. Increasingly, lawyers are drafting ILITs (and other types of trusts) that call for a “trust protector.” The trust agreement will typically set forth the dual roles of the trustee and the trust protector. While the trustee may be a trust company or other professional, the trust protector is often a person close to the family or a key financial advisor.

a. Depending on the powers granted in the trust agreement, the trust protector may be empowered to remove or replace an independent trustee, change the trust situs, veto distributions to beneficiaries and/or veto investment decisions (e.g., in an ILIT, the trust protector may have final say over product selection and restructuring of the life insurance portfolio). Along with these powers comes the potential for liability.

b. The liability of a trust protector has not been fully defined by state courts in the U.S. In a recent case for summary judgment, a state court of appeals indicated that resolution of this issue turns on whether the document (i.e., trust agreement) imposes fiduciary duties on the trust protector. The appeals court suggested that the document’s use of the term “fiduciary capacity” implied that the trust protector there owed “at least the basic duties of undivided loyalty and confidentiality…[and] the existence of at least some duty of care” to the beneficiaries. *McLean Revocable Trust v. Patrick Davis, P.C.*, 283 S.W.3d 786 (Mo. Ct. App. 2009).

V. Trustee’s Duties at Inception

A. The management of trust-owned life insurance is challenging for any trustee. Typically, a new ILIT initially holds few assets other than life insurance policies.

B. The initial assets of the typical ILIT generally represent a "concentrated" position in one investment class. Very often the life insurance investments are not diversified among a variety of different types of life insurance products.

C. The ILIT trustee must recognize that policy illustrations for non-guaranteed policies are *not* predictive. Except for NLG UL policy illustrations, illustrations on all non-guaranteed products are "projections" created by the agent with some involvement from the carrier to portray, generally, the "lowest possible" premium calculated with the most "hopeful" non-guaranteed results over many decades.

1. The most glaring defect in such simplistic projections is that the underlying earnings or interest rate is "fixed" over many years. This is unrealistic.

2. Many policy expense factors, including cost of insurance (COI), are projected into the future by the carrier using current assumptions of favorable claims experience by the carrier. The policy authorizes the insurance company to impose increased COI in the future if, for example, similar types of policies do not actually lapse as originally projected by the carrier's actuaries.

3. The Society of Financial Service Professional's illustration questionnaire clarified that "…illustrations [projections] have little value in predicting actual performance or in comparing products in companies. So the risk associated with the possible inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policyholder." Illustration Questionnaire, Society of FSP, Newtown Square, PA.

4. The Society of Actuaries published an extensive examination of illustration practices associated with the purchase of life insurance and observed, "…(when) illustrations [projections] are used to show the client how the policy works, it is a valid purpose of policy illustrations. Illustrations [projections] which are typically used, however, to portray the numbers based on certain fixed assumptions - and/or are likely to be used to compare one policy to another – are an improper use of the policy illustration." Final Report of the Task Force for Research on Life Insurance Sales, Illustrations under the Auspices of the Committee for Research on Social Concerns, Society of Actuaries, 1992.

5. Policy projections are better characterized as "illustration beauty contests." This reflects the attractive impossibility versus the less attractive probability.

D. Rights and Expectations of Beneficiaries on Inception of Trust.

1. It is a well established principle of law that a beneficiary of a fully discretionary trust has only a speculative interest in trust property and personally has no enforceable rights against the trustee. He or she only has standing to sue for abuse of discretion if a trustee is dilatory or inefficiently administers the trust assets and such action or inaction proves detrimental to his or her beneficial interest.

2. But discretion does not imply the abandonment of prudence.

3. In many situations, a trustee defense based on the beneficiaries' investment directives (or donor investment directives or involvement), beneficiary acquiescence to poorly understood strategies, boilerplate trust language and self-serving exculpatory provisions may fail to avoid surcharge for a breach of fiduciary duty.

4. Unless the language in the trust instrument clearly shows the settlor's intent that the trustee can ignore principles of modern financial investing, a trustee should not retain property in the form received unless it is prudent to do so?

a. A power, such as discretion regarding investment decisions, tells a trustee that he or she has the ability to act or not act on any investment strategy.

b. A duty, however, imposes an obligation on the trustee.

c. In most jurisdictions, courts have ruled that discretionary powers, (including grants of "absolute discretion") must be exercised under the constraints imposed by the duty of prudence.

VI. Trustee's Ongoing Duties

A. What should the ILIT trustee do to monitor performance of the life insurance policies owned by the ILIT? The purpose for monitoring the policies is to determine if any policy is underperforming as well as to evaluate whether a new policy may provide greater benefit to the ILIT.

B. How might the ILIT trustee evaluate an ILIT's current policies and assess their performance?

1. Obtain and review (updated) in-force policy illustrations;

2. Compare the in-force illustration to the original illustration issued when the policy was purchased;

3. Compare the updated in-force illustration with prior years' in-force illustrations to determine performance trends;

4. Assess past policy performance and project likely future performance;

5. Review the current financial strength of the carriers whose policies are currently held in the ILIT and note any trends that may be a cause for concern;

6. Consider requesting an “informal” offer for one or more new policies (assuming the insured is cooperative and healthy);

    a. Before the insured is examined by a doctor, the insured’s medical records can be submitted to the carriers.

    b. Experience has shown that “informal offers” provided by carriers generally provide a 95% indication of their eventual final underwriting offers.

    c. The insured’s identity is disclosed but the HPAA prevents the carrier from disclosing the insured’s medical information to other carriers.

    d. Most importantly, an “informal offer” avoids a premature rating by the carrier that could result in becoming part of the insured’s permanent medical record, which can and will be shared with other carriers through the Medical Information Board (MIB). There is no reporting of “informal offers” to the MIB.

    e. Gathering various “informal offers” by surveying the entire marketplace often gives the insured and his or her advisors a good sense of the market and shows choice among carriers.

7. Compare the projected premiums, death benefit, cash value, death benefit guarantee and other relevant provisions of the current policies with any offers;

8. Assess the competitiveness of the current policy with potential new policies;

9. Decide whether to add, eliminate or exchange policies owned by the ILIT;

10. Keep a written record of all actions made in this review process;

11. Re-evaluate all trust-owned policies roughly every two to five years.

C. What are some of the external considerations that may impact the life insurance program?

1. Has the insured's health improved or declined since the policy was issued? Some carriers today have created super preferred categories (best underwriting) not available 10 or 20 years ago. All carriers monitor medical breakthroughs and advancements in medical treatment that generally result in greater life expectancy.

2. Diversification is vital to most insurance portfolios under the UPIA. An ILIT that owns only life insurance policies holds a concentrated asset that often carries higher risk.

   a. A trustee might diversify among a variety of different types of life insurance policies (i.e., whole life, variable, universal life, no lapse guarantee). This is a questionable strategy because certain types of policies may not be well-suited for the objectives of the particular ILIT.

   b. The trustee might diversify among a variety of different top-rated carriers, spreading risk in the event one carrier experiences financial difficulty in the future. Diversification and risk sharing is especially appropriate when purchasing no lapse guarantee policies providing a secondary guarantee of the death benefit (NLG UL policies), as well as in large coverage situations.

   c. A trustee who chooses not to diversify should address this issue in the IPS (discussed below at X.A). In many states that have adopted some form of the UPIA, a trustee need not diversify if there are special circumstances that might reduce the investment return. In these situations, the ILIT trustee should address the diversification issue in the IPS and state why he or she made the decision to spread (or not to spread) the coverage among a handful of carriers.

3. Does the split dollar plan or premium loan program comply with the final split dollar regulations?

   a. Has an "exit strategy" (e.g., estate freeze) such as a GRAT or sale to intentionally defective trust been implemented? If implemented, how is the underlying asset (investment) used to fund such "exit strategy" performing? What is the likelihood the "exit strategy" will ultimately succeed in transferring future appreciation to the ILIT to enable the trustee to pay future premiums and/or roll out of the split dollar plan or loan program?

b. When should a split dollar plan (which relies on the term value cost of life insurance protection, known as the reportable economic benefit amount) be converted to AFR loan regime reporting (relying on the aggregate annual interest due on prior premium advances structured as loans)?

c. If the split dollar loan program involves loans to an ILIT that only owns life insurance policies, are the loans to the ILIT "non-recourse" loans? If so, the contingent payment of interest rules in the final split dollar loan regulations apply to the loan, unless the parties to the loan (lender and borrower; insured and ILIT trustee in a private loan) each make a written representation to the IRS that a reasonable person would expect repayment in full of the entire loan, and the parties file the written representation with their tax returns for the relevant years. See Treas. Reg. Section 1.7872-15(d)(2)(ii).

4. The trustee should be aware of the life settlement value of the policies, as an alternative to surrendering the policies to the issuing carrier.

   a. An increasingly robust and transparent life settlement market has developed.

   b. If an older insured's health has deteriorated since a policy was issued, a life settlement funder may be prepared to pay far in excess of the cash surrender value to the policyholder to purchase such policy.

   c. Presumably, an ILIT trustee is now responsible for considering a life settlement (sale of the policy in the secondary market) as an alternative to surrender of the policy. Failure to do so may result in fiduciary liability for the trustee.

   d. There are some potential privacy and compliance issues, as well as life settlement laws in some states, that the ILIT trustee must consider.

5. Did the agent shop around for many different offers from virtually all of the top carriers? Some agents work for carriers supporting career agents who are precluded by contact from soliciting competitive offers outside their own company unless their own company fails to provide an offer. Will the agent disclose his or her commissions?

6. What impact will carrier demutualization have on the performance of the policy?

7. Has the policy inadvertently become a "modified endowment contract" (MEC) which will trigger potentially adverse income tax consequences to the policyholder under certain circumstances. An internal policy loan, premium finance, or converting the policy death benefit to paid-up status may each trigger MEC tax treatment.

8. If the ILIT is exempt from GST tax, how will premiums due in 2010 be paid by the ILIT in 2010? The donor-insured cannot allocate GST exemption to the ILIT with respect to any transfer made to the trust in 2010, absent reinstatement of the GST law by Congress.

9. If the ILIT is earmarked to be exempt from GST tax, how is the GST tax exemption allocated? Under the automatic allocation GST tax rules adopted by EGTRRA (in 2001), many ILITs are likely categorized as "GST trusts," even those for which no GST transfers to skip persons are contemplated. Treas. Reg. Section 26.2632-1(b)(2). GST exemption will be automatically allocated unless the "transferor" (insured) elects out on a timely filed gift tax return. (Note that the automatic allocation rules that applied to "indirect skip" transfers made under pre-2010 GST tax law would only return in 2011 if Congress overrules the "had never been enacted" rule of Section 901 of EGTRRA. Under Section 901 of EGTRRA, the various GST tax reforms enacted in 2001 do not apply to 2011 and beyond).

10. Have all *Crummey* notices been sent in a timely manner? The trustee should keep a control file that includes a copy of all *Crummey* notices as proof of notice for the beneficiaries.

VII. Professional Trustees: Held to a Higher Standard

A. Professional trustees are held to a higher standard of care than non-professionals (such as family, friends and business colleagues of the insured).

1. "A trustee who has special skills or expertise or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills." UPIA, Section 2(f).

2. "Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals." UPIA, Commentary to Section 2 regarding Professional Trustees.

VIII. National Bank Acting as ILIT Trustee

A. In addition to adhering to the UPIA, national banks serving as ILIT trustee are subject to fairly stringent due diligence requirements imposed by the Office of the Comptroller of the Currency (OCC) regarding the purchase and monitoring of life insurance.

1. In 1996, the OCC imposed a 10 point pre-purchase assessment analysis. See OCC Bulletin in 2000-23, replacing and updating OCC Bulletin 96-51, which initially detailed the 10 points of due diligence as part of a life insurance pre-purchase analysis.

2. While these OCC guidelines were apparently developed independently of the UPIA and do not necessarily relate to trust-owned life insurance, they both demonstrate increasing standards of care.

B. The trend for national banks is toward setting standards in connection with monitoring life insurance and assuring that there is both a pre-purchase and ongoing review of policies.

C. National banks must demonstrate compliance with the OCC Reg 9 risk standards.

1. A national bank knows that a trust-owned life insurance policy is a concentrated investment requiring "specific facilities for investment management, which must include procedures for trust-owned life insurance that demonstrates compliance with OCC Regs Sections 9.5 and 9.6a."

2. If a bank accepts a trust-owned non-guaranteed policy (whole life, term, variable, variable universal life or universal life, but not no lapse guarantee), it must demonstrate the expertise to evaluate the risk of premium adequacy under OCC Reg. Section 9.6(b), otherwise it must recommend restructuring to a guaranteed death benefit policy.

3. If the bank's facilities are not adequate for today's best management practices expected of national banks and the trustee can no longer administer a non-guaranteed policy, the trustee must recommend restructuring or obtain the beneficiaries' approval to do nothing.

IX. Lawyer Liability For ILIT Management and Operations

A. At the inception of the engagement is it clear who the client is?

1. The attorney is typically engaged to:

a. advise the trust settlor-to-be as to the value and efficacy of the ILIT;

b. structure an appropriate trust given tax and personal/familial considerations;

c. draft the trust and ancillary documents (such as *pro forma Crummey* letters); and

d. advise and possibly oversee ongoing trust maintenance issues, including the *Crummey* letters, possibly investment and insurance premium issues and potentially trust distributions.

B. However, once the trust is established does the trustee become the client as well?

1. An unskilled trustee typically relies on the donor-insured's legal or tax professional concerning the administration of an ILIT.

   a. Professionals serving as advisors to the donor-insured and friends or family who are unsophisticated ILIT trustees have the same basic fiduciary duties as a skilled trustee.

   b. There is a general trend toward greater liability of the attorney, based on the attorney's continuing duty to the insured's ILIT trustee after the ILIT is established.

   c. The enactment of the UPIA and the judicial relaxation of privity requirements, which allows third party lawsuits, support this trend. See e.g. *Estate of Schneider v. Finmann*, 2010 NY Slip Op 05281 (June 17, 2010).

   d. The *Schneider* case is especially relevant in the trust-owned life insurance context, because the underlying malpractice claim against the decedent's estate planning lawyer revolved around whether the lawyer negligently advised the decedent to transfer (or failed to advise the decedent not to transfer) the policy into the decedent's individual name. In siding with other jurisdictions that now have a relaxed privity rule, the appeals court noted that "the estate essentially stands in the shoes of the decedent," and, therefore, "has the capacity to maintain the malpractice claim on the estate's behalf." In its decision, the court noted that strict privity remains a bar against estate planning malpractice claims brought by beneficiaries or other third-party individuals (absent fraud or special circumstances).

2. This duty may extend to the choice of particular life insurance products and the ongoing need to review and revise as facts change.

   a. Counsel may have liability if the trustee acts on inaccurate legal advice about the life insurance, such as the choice of an under-capitalized carrier or poorly designed product in comparison to other options.

i. Rating agencies are unreliable and just using an agency rating may be prima facie negligence.

ii. Illustrations are not valid for due diligence.

b. The best option is to bring in consultants expert in the particular investment.

i. Document everything.

3. A conundrum: if the trustee is the client and the trustee's duty runs to the beneficiaries, and yet the settlor remains the client as well and in fact is paying all the legal fees, does the attorney owe a duty to the settlor, the trustee and, derivatively, the beneficiaries? What happens when what is best for the beneficiaries differs from what is best for the settlor?

X. How Trustees Can Protect Themselves.

A. Create an Investment Policy Statement (IPS). The Prudent Investor Rule of the UPIA imposes a duty on ILIT trustees to create a formal investment policy, known as an IPS.

1. The IPS is a written statement of the investment practices the trustee intends to use in managing the trust assets.

i. The IPS is not a legal agreement.

ii. The IPS is a statement by the trustee of how he or she expects to manage the trust assets in order to meet the trust's objectives.

iii. The IPS is a flexible statement that can be changed at any time by the trustee to improve the process and way in which the trust's assets will benefit the trust beneficiaries.

iv. There is no prescribed or specimen IPS that fits all situations.

a. If the ILIT is designed to invest exclusively in life insurance policies, the IPS should reflect this approach.

b. Creation of the IPS gives the trustee the opportunity to solicit insight from the trust's legal, accounting and other advisors.

v. Why is the IPS helpful?

a. The IPS guides the trustee in making investment decisions for the trust during administration of the trust.

b. If the procedures in the IPS are reasonable and have been followed, the ILIT is evidence of the trustee's compliance with the UIPIA, regardless of the trust's ultimate performance results. This may ultimately minimize the trustee's liability.

vi. What might be included in the IPS?

a. The type of policy to be purchased;

b. The ratings or other criteria required of the life insurance company issuing the policy to be included in the trust portfolio;

c. Risk tolerance level;

d. The premium schedule;

e. Current assets and investment choices;

f. Background information about the beneficiaries;

g. The purpose for the coverage and a statement of objectives;

h. Duties and responsibilities;

i. Contact information for all of the professional advisors;

j. Asset guideline.

vii. A copy of a couple of "sample" IPS statements are attached as Exhibit I to this outline.