HECKERLING MUSINGS 2007

Highlights of Estate Planning Hot Topics and Current Developments Discussed at 2007 Heckerling Institute on Estate Planning

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Introduction

The 41st Annual Philip E. Heckerling Institute on Estate Planning the week of January 8, 2007 was again outstanding. I have summarized some of my observations from the week that I want to take away from the Institute. I attribute all the good ideas to other speakers at the conference and other ideas that I have recently heard. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. The summary includes some substantive items that I personally found interesting and includes a wide variety of interesting and creative planning strategies. (I obviously could not attend all of the meetings, and doubtless there are many other highlights from the week that I have not included.) I generally have not included a number of current developments that were discussed at the Heckerling Institute but that I have previously addressed in my "Fall Musings 2006."

1. Estate Tax Legislation Update.

Because of the difficulty of reaching 60 votes in the Senate in light of the entrenched positions of Senators on the estate tax issue, it is certainly possible (perhaps even more likely than not) that a compromise will not be reached until 2009 when the "gun is at the heads" of Congressmen to avoid the drastic changes that will occur in 2010 and 2011 under current law. Both sides have taken very entrenched positions, as evidenced by the Trifecta bill this summer when the Republicans could not pick up any additional votes even by adding an increase in the minimum wage that has been long awaited by the Democrats. An effect of the delay is that the ever important ten-year revenue cost of legislation gets considerably larger closer to 2010, because the reform legislation would replace a system for most of the ten-year window that is based on pre-2001 law. We are likely to see extremely long phase-ins to reduce the ten-year revenue cost. Reform measures would likely include estate and GST exemptions in the $3.5-5.0 million range and reduced rates (how low is a major point of disagreement). As a measure of providing some revenue offset, it is likely that there may be a provision disallowing some types of intra-family discounts.

Here's an interesting viewpoint that I had not heard previously. Even in 2009, it may be difficult to reach agreement. While the Democrats will not want the estate tax to be repealed for a year in 2010, the Republicans would likely feel even stronger that they would not want to return to pre-2001 law in 2011. The Democrats may feel that they have the leverage to be very hard-nosed in the negotiations, leading to stalemate (i.e., the failure to get 60 votes in the Senate). The Democrats, remembering the maneuvers of the Republicans to achieve complete repeal or a 15% tax rate, may be reluctant to agree to a tax rate below the 35% rate in the bill introduced by Louisiana Senator Landrieu last summer, and may determine that they can wait until the rate automatically returns to 55% (or 60% in the bubble) in 2011 to bargain with the Republicans.

2. **FLP Planning Issues**.

a. Senda Integrated Transaction Dictum. The Eighth Circuit recently approved this indirect gifts case. 433 F.3d 1044, *aff'g*, T.C. Memo. 2004-160. There is dictum in the Tax Court case suggesting that a step transaction doctrine might apply even if the contribution is made to the partnership prior to gifts of partnership interests. The Eighth Circuit also had dicta that might be interpreted to support that approach: "The tax court recognizes that even if the Sendas' contribution would have first been credited to their accounts, this formal extra step does not matter." The case specifically said that the step transaction doctrine applies broadly to estate and gift transactions.

Several speakers said that the step transaction doctrine should not apply here. The step transaction doctrine ignores unnecessary steps to determine tax consequences, and the donees never ended up owning the underlying assets.

Nevertheless, the client should wait some period of time after funding the partnership before making transfers. Several respected speakers said that planners should merely wait a day, to clearly document that the contribution to the partnership was made prior to gifts of the limited partnership interests. Other planners suggest waiting 6 months. Those who suggest just waiting one day say that waiting 6 months should not really make a difference if there was the intent at the outset to make the subsequent gift and if that intent is enough to apply a step transaction theory.

There is a pending case in audit where the IRS agent argued this indirect gift theory even though the gift of the partnership interest was not made until made 8 months after the partnership was formed. (Part of the reason for the delay was that the client could not decide how much gifts to make.) The agent has issued a notice of deficiency and that case is now going to the Tax Court. (Perhaps it will be settled at Appeals.)

John Porter tried the Holman case in December 2005 to the Tax Court and is still awaiting decision. In that case, the IRS made the indirect gift argument even though the partnership interest was not given until 8 days after the partnership was created.

Practical planning pointers:

- Make clear that assets are held by the partnership and verify that before making gifts of limited partnership interests.
- Discuss with the client the possibility of making gifts, but do not discuss with the client how much the client wants to give when the FLP is created. Leave that as an open question so no one can argue step transaction or prearranged transaction.
- To help rebut an integrated transaction attack, the planner should be careful that documents do not describe overall transactions anticipating the transfer of particular amounts of limited partnership units.

b. Full Consideration Exception to Section 2036. There are two legs to the "bona fide sale for full consideration" exception to §2036. There must be a bona fide sale (addressed in the Rosen [T.C. Memo 2006-115] and Korby [T.C. Memo 2005-102 and 2005-103] cases in 2006), and the transfer must be for "adequate and full consideration." The Bongard [124 T.C. 95 (2005)] and Kimbell [371 F.3d 257 (5^{th} Cir. 2004)] cases said that the full consideration requirement is met by having proportionate transfers to a partnership that maintains capital accounts and allocates distributions among the partners pursuant to the capital accounts. However, the IRS is still arguing that the "full consideration" test requires more than that. The IRS's brief in the Korby case to the Eighth Circuit, argued:

- The partnership must respect formalities (proportionate transfers reflected in capital accounts, which is the test in Tax Court and Fifth Circuit).
- ALSO, the transaction must not deplete the estate (before and after the transfer to the FLP).
- The IRS recognizes that some immediate dissipation in value occurs whenever there is a transfer to any entity, but "the diminution in value from the partnership restrictions must be offset by some other advantage to holding assets in partnership form."

Conclusion: We cannot assume the "full consideration" issue is resolved. The Third Circuit in Thompson said there is "heightened scrutiny" if there is a dissipation in value, and a concurring opinion, joined by 2 of the 3 judges, explained that the depletion rule would not apply in "routine commercial transactions”—intimating that it would apply in other transactions.

c. Conclusions Regarding Section 2036 Application.

The IRS is attacking 2036 in bad facts cases. (The Rosen and Korby cases both involved terrible fact situations.)

As a practical matter, unless there is a transfer of almost all of the decedent’s assets to the FLP, the IRS is treating FLP cases as discount cases and negotiating the amount of the discount. If agreement cannot be reached, they may throw in a §2036 claim in a negotiating posture, but they generally approach the case as a valuation case.

2036(a)(2)—IRS field agents generally are not attacking partnerships under §2036(a)(2) or applying Judge Cohen’s broad “in conjunction with” analysis. The “Appeals Coordinated Issue Settlement Guidelines” IRS document published in the fall of 2006 is insightful, by omission, in merely providing a very abbreviated summary of Judge Cohen’s oft-criticized §2036(a)(2) analysis in Strangi. As a practical matter, §2036(a)(2) gets thrown in merely as an additional argument when there is a bad facts §2036(a)(1) case.

BUT the arguments are there, and Judge Cohen’s Strangi 2036(a)(2) discussion and Bongard’s finding that control over cash flow to the partnership triggered §2036(a)(1) points out that the §2036 risk is inherently always there.

Ron Aucutt Observations about §2036. We can easily avoid §2036(a)(1) by not being sloppy. We can avoid §2036(a)(2) because the broad §2036(a)(2) analysis is not supported by a single citable consensus authority. But many are concerned about §§2036(a)(1) and a)(2). Why?
(i) Out in the field, IRS agents sometimes apply some of these authorities in a much more sweeping and concerning manner than one would imagine by just reading the cases. For example, in the Peracchio case, the IRS raised a lot of arguments, which the client and counsel had to deal with, but the IRS before trial dropped all of the arguments other than the valuation issue. As another example, agents sometimes hold up any borrowing as showing an implied agreement of retained enjoyment under §2036(a)(1).
(ii) Section 2036 is an estate tax provision and brings lingering uncertainty—so it brings back not just what is transferred but all intervening appreciation. Also, there is no way to start the

estate tax statute of limitations. "The only way to start the estate tax statute of limitations is to die."
(iii) Clients want certainty. They want the planner to assure that there cannot possibly be a §2036 problem.

Ron typically concludes that whatever §2036 risk there is does not justify drastic measures to change an existing partnership, and he usually is content to let the partnership continue. But there are exceptions.

Possible solutions to the valuation uncertainty for FLPs include a legislative answer or regulatory guidance. Estate tax reform legislation may address valuation discounts for intra family transactions, and further regulatory guidance under §2704(b) has been on the Treasury's regulatory guidance list for several years. While there is broad statutory authorization for further regulations, the IRS may not want to be in the political hot seat of basically outlawing discounts by regulations. Any regulatory response is (1) likely to be prospective only, and (2) not likely to be holistic (i.e., it won't say these tools are the exclusive tools for the IRS to use—and not §2036(1)(2).)

d. Section 2035 Conundrum. The three-year was abolished in 1981, and was revised with a substitute to deal with transfers like insurance or remainder interest transfers on death bed. The legislative history in 1981 committee reports dealt with a particular kind of interest that appreciated greatly in value at the moment of death, such as a life insurance policy or remainder interest. That is not true generally of a limited partnership interest that continues to carry the characteristics that contribute to the discount. So perhaps §2035 was not intended to apply to FLPs in that way. But, good luck with that argument. For example, Bongard (a full Tax Court opinion), jumps directly from 2036 to 2035 without any discussion of whether §2036 now applies to this type of transfer.

   There are various possible ways to restructure to avoid §2036 without triggering the three-year rule of §2035. If the agreement is revised to limit distributions to ascertainable transfers, that may not be a "transfer" under §2035. Ron Aucutt's favorite approach, if one spouse contributed assets to the FLP, is to revise the agreement to say that the contributing spouse has responsibility over investments, and the other spouse has responsibility over distributions.

e. Marital Deduction Mismatch Problem.

A marital deduction mismatch possibility exists at the first spouse's death for any underlying assets brought back into a decedent's estate under §2036 when the limited partnership interests (rather than underlying assets) pass to the surviving spouse by bequest under the decedent's will. The IRS has argued in some estate tax audits that only the (discounted) value of the limited partnership interests "pass to" the surviving spouse and qualify for the marital deduction, not the higher value of the partnership assets included under §2036. (The issue was mentioned in footnote 13 of the Bongard case, and the parties stipulated in the Korby cases that the marital deduction would not offset assets included in the estate under §2036 if only a portion of the assets were included in the first spouse's estate.)

A possible planning strategy to avoid this risk, suggested by Kevin Matz, would be to include provisions in the partnership agreement so that the surviving spouse (or QTIP trust) would not have restrictions on liquidating the partnership:

> "Perhaps the best way to accomplish this would be to provide in the FLP's governing documents (which may need to be amended to allow this) that the holder of the FLP interests that would pass to or for the benefit of the surviving spouse (e.g., the trustee of the QTIP trust) would be able to liquidate the FLP without the consent of any other person.
>
> "For example, suppose that the partnership agreement permits liquidation to occur upon the affirmative vote of the general partner and limited partners holding more than two-thirds of the outstanding limited partnership interests. In this situation, the trustee of the QTIP trust—who pursuant to the decedent's estate plan would receive the general partnership interest and more than two-thirds of the limited partnership interests—would be able to liquidate the FLP without the consent of any other person. Consequently, there would not appear to be any viable basis for the IRS to argue that the value of the FLP interests passing to the surviving spouse should be discounted." Matz, "Special Concerns in FLP Planning Where Both Spouses Are Living," 34 EST. PL. 16 (Jan. 2007)

3. **Defined Value Clauses**.

a. Basic Issue. McCord [461 F.3d 614 (5^{th} Cir. 2006), rev'g 120 T.C. 358 (2003)] involves a gift made by a formula giving a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless.

b. Two Fundamental Types of Defined Value Clauses.

(1) Defined Value Clauses That Limit the Amount Transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula)
(2) Defined Value Clauses That Allocate Amount Among Transferees (i.e., transfer all of a particular asset, and allocating that asset among taxable and non-taxable transferees by a formula) (The McCord case used the second type of clause.)

c. Observations Regarding Factual Background of McCord.

Apparently, the family was very charitably inclined. If the clause operated to leave more assets than originally contemplated to the donor advised fund at the Communities Foundation of Texas, the family would have simply substituted distributions from the donor advised fund for charitable contributions that the family would have made anyway in future years. The defined value clause, with the "residue" passing to a donor advised fund, coordinated well with the family goals in that situation.

The $6,910,932.52 number is rather curious. Apparently, the taxpayers had a detailed appraisal prepared, and they wanted to leave a targeted significant interest to the "residual" gift to the Communities Foundation. They worked backwards in setting the dollar amount gift to the sons, in order to leave the anticipated targeted amount to the charity. In retrospect, the planners would probably use round figures in future transactions (for example, $7.0 million instead of $6,910,932.52).

d. Did McCord Actually Recognize Defined Value Clause? Some commentators have concluded that the Fifth Circuit case merely held that the Commissioner did not meet its burden of proof, and that it was error to use the Confirmation Agreement to impact the determination of the gift tax.

The Current Developments outline by Richard Covey and Dan Hastings concludes: "Given the Fifth Circuit's recognition that this [defined value] issue was at the 'heart' of the case and 'fractionated' the Tax Court, one might have expected a direct discussion of whether such clauses work or do not work. No such discussion occurs. Instead the Fifth Circuit assumes they work…"

(The Fifth Circuit did not address the public policy concern, because that argument was dropped by the IRS.)

John Porter (and others) respond that courts do not bless and broadly validate the use of general tax planning strategies. Instead, courts just decide based on the facts of a particular case before them—and that is what the Fifth Circuit did. Courts do not say, "Estate planners, start your engines—you can now safely use this new strategy."

e. IRS Reaction to These Clauses. The IRS did not request a rehearing or en banc review, or appeal to the Supreme Court. The IRS national office has informally reported to some attorneys that the Fifth Circuit had the opportunity to bless specifically the use of defined value clauses and declined to do so. However, some IRS agents (in the Fifth Circuit) have indicated that while they may not like the result, the Fifth Circuit has spoken and the agents will recognize defined value transfers that follow the format of the fact situation in McCord (including that the clause uses a "willing buyer-willing seller" valuation standard rather than using "values as finally determined for federal gift tax purposes," that the pourover transfer is to a charity that is independent of the donor, that there was no collusion with the independent charity over the value issue, and that the charity exercises reasonable due diligence in determining the interests that pass under the defined value clause.)

Speakers and other attorneys at the seminar told me of a broad number of audit situations where they have used defined value clauses. Upon explaining to the auditing agent how the clause operates, the valuation issue was disposed of very quickly in the audit. (Another attorney has described an audit situation in which the existence of the clause complicated the audit because the agent somehow [inexplicably, in my view] took the position that the clause made the entire transfer an incomplete gift.)

f. Using Defined Value Clauses in Sales Transactions.

Using defined value clauses would seem to be practical mainly in cases involving relatively large transfers. Therefore, it may be more likely to see them in sales transactions than in gift transactions, because most clients transfer large values only in sales transactions and not in gift transactions.

g. No Excuse for Sloppy Planning. Using a defined value clause is not an excuse to avoid getting a good appraisal.

h. Formula Disclaimer Approach. The IRS is currently litigating a somewhat similar post-mortem planning approach involving a formula disclaimer. One such case that settled was Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding "x" dollars (before payment of debts, expenses and taxes) in which the decedent's will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate's appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. The case was settled prior to trial. John Porter, who represented the taxpayer in Morfeld, reports that he is handling another case involving a similar formula disclaimer in which the IRS is again arguing that the disclaimer violates public policy under the Procter rationale.

4. **GRAT Planning**.

a. Deferred Payment GRAT. Assume that an asset will have no cash flow for 2 or 3 years, but will have great appreciation potential after that time. One way around this problem is to use a long-term GRAT. For example, a 20 year GRAT with an annuity that increases 20% per year would have very low annuity payments in the first several years. The early annuity payments could be paid from cash funded into the GRAT up front. Another way is using a "Deferred Payment GRAT." The GRAT would provide that annuity payments would not begin for 3 years. For example, with a 6 year GRAT, with payments beginning in the 4^{th} year, the initial annuity payment would be about 36%. This seems consistent with the statute and the regulations. Section 2702(b) says that fixed payments are required, payable not less frequently than annually. That does not say when the payments must start. [Query: Since payments must be paid annually, does that imply that a payment must be made in year one?] The regulations dealing with that section also seem to allow deferred payments. Reg. 25.2702-3(d)(2) is titled "Contingencies." It says that the payment cannot be subject to any contingency other than the right to revoke the qualified interest of the transferor's spouse or "the survival of the holder until the *commencement*, or throughout the term, of that holder's interest." That seems explicitly to sanction deferred payment GRATs.

Carlyn McCaffrey thinks this should work under the statute and regulations, but she is not aware of any cases or audits that have addressed a deferred payment GRAT.

b. Spousal Annuity-Helpful if Spouse Has Shortened Life Expectancy. If the grantor's spouse has a shortened life expectancy (but still has a greater than 50% chance of living at least one year), consider using a GRAT with a contingent revocable interest for the remaining lifetime of the spouse who has the shortened life expectancy. Lower annuity payments can be used in the initial term in light of the fact that the remainder interest is reduced by the assumed value of the contingent spousal interest. If the spouse actually dies early, more passes to remaindermen.

c. Grantor Has Shortened Life Expectancy. If the grantor has a shortened life expectancy, the possible planning is not as clear cut. If the GRAT continues until grantor's death, §2036 would apply. But if the grantor creates the GRAT based on the grantor's life expectancy and simultaneously sells the remainder interest to a grantor trust set up previously, then §2036 arguably would not apply.

d. IRS Looking At Annuity Payments. There may be a trend of the IRS looking to see if annuity payments are made timely and how annuity payments are valued.

One speaker called six GRAT clients who had family members as the GRAT trustee to ask when the annuity payments were made. One of the six made the annuity payments on a timely basis. One of the clients said that he never made a payment and GRAT term had ended. (The client said "if IRS comes after me, I will sue you, because you had a duty to make sure the trustee did his job right.")

One possible response is to do an assignment of each annuity payment at the creation of the GRAT, taking effect at the payment date UNLESS the trustee changes it before that time. This solves possible problem that the trustee will not cut the check on the payment date (or 105 days later). There should be an ordering rule of what GRAT assets to use first in satisfying the assignment (i.e. cash first, then lowest basis assets, etc.) If there is a securities law §16b problem with stock, that would be the last asset to be paid. A similar approach would be to provide in the trust agreement that payments would vest in the grantor on the annuity payment date even if not paid and the trustee would act as agent for the grantor with respect to such vested amounts. See Blattmachr, Zeydel & Bramwell, Drafting and Administration to Maximize GRAT Performance, 20 Probate & Property 16, 22-23 (Nov./Dec. 2006)

e. Revocable GRAT. Some planners have suggested making a GRAT revocable until all funds have been retitled in the name of the GRAT. At that time the grantor would release the revocation right. That would avoid a possible argument by the IRS that additional contributions are being made to the trust (which is prohibited) if all assets are not funded into the GRAT on the date that it is signed. Manigault & Hatcher, Revocable GRATs, Trusts & Estates 30 (Nov. 2006).

f. Spendthrift Clause. Do not include a spendthrift clause because it may not do much good anyway, and more importantly, it prevents the remainder beneficiary from assigning its interest in the GRAT. There are two reasons this may be important: 1. In several recent cases, the IRS was forced to value lottery annuity payments using a lower value than the §7520 value because the annuity payments are nontransferable. Could the IRS argue that the existence of the spendthrift clause means the annuity payments are nontransferable, so that the grantor could not rely on §7520 in placing a high value on the retained annuity payments? 2. It may be helpful for remainder beneficiaries to transfer their interests in the trust (for example, to a GST exempt trust or to the grantor).

g. GST Exemption Allocation at End of GRAT Term. Using a GRAT is a good way to utilize the client's GST exemption during the client's lifetime without making a taxable gift. Potential concern: At the termination of the GRAT, if the GRAT document says to transfer the portion of the remaining assets that do not exceed the grantor's remaining GST exemption to a GST exempt trust and the balance to the grantor's children outright, does it create an argument that the grantor has retained the right to designate how the assets pass meaning that the initial transfer to the GRAT was an incomplete gift? An alternative is not to define the transfer in terms of the grantor's remaining GST exemption, but to leave the GRAT assets to a trust and use a qualified severance to sever out the portion of the trust that can be covered by allocation of the grantor's GST exemption. There is an excellent discussion of this issue in Manigault & Hatcher, GRATs and GST Planning: Potential Pitfall and Possible Planning Opportunity, 20 Probate & Property 28 (Nov./Dec. 2006).

h. Purchase of Remainder Interest by Grantor. If there is a really successful GRAT and there is a worry that client might die before the end of the GRAT term, the grantor might consider purchasing the remainder interest from the remainder beneficiary for its present value. If the grantor dies during the term of the GRAT, all assets in the GRAT will (likely) be included in the estate. But now, the remainder beneficiary trust has the dollars paid for the remainder interest that is excluded from the grantor's estate. The grantor has no interest in it and has no control over it, so it is excluded from the grantor's estate for estate tax purposes.

A potential risk is that the IRS might argue that this is in effect a prohibited commutation. Presumably that might raise the risk of an argument that the GRAT does not create qualified interests under §2702, so the entire initial transfer to the GRAT would be treated as a gift. To avoid that possible argument, wait to purchase the remainder interest until after the statute of limitations has run on the gift tax return for the year the GRAT was created (of course, that would not be possible with a two or three year GRAT).

One attorney at a seminar this fall reported doing this in a transaction where the grantor of the GRAT was about to die and the grantor purchased the remainder interest from the grantor trust that owned the remainder interest. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn't like it, but it passed the audit.

i. <u>Loan to Grantor's Spouse</u>. If the grantor or the grantor's spouse needs access to value in the GRAT before an annuity payment is made, may the trustee loan assets to the grantor's spouse? This should be permissible. The reason for the borrowing should not matter—as long as the loan is a legitimate loan and not a disguised distribution to the spouse. The trustee should be able to use the §7872 rates. A potential concern is that if the loan is too favorable to the spouse, it could be treated as an impermissible distribution to someone other than the grantor, and if the loan is too favorable to the trust, it could be treated as a prohibited additional contribution to the trust.

j. <u>Possibility That GRAT Does Not Trigger an ETIP Period; If So, Risk of Automatic GST Exemption Allocation at Creation of GRAT Unless Election Out of Automatic Allocation</u>.

(i) <u>Does the ETIP Rule Apply Before the Termination of the GRAT?</u> GST exemption cannot be allocated to a trust during the "estate tax inclusion period" (or ETIP). The traditional thinking is that there is an ETIP during the term of a GRAT, because the assets would be included in the gross estate of the donor if the donor dies during the trust term. However, there is a strange regulation saying that the ETIP rules do not apply "if the possibility that the property will be included [in the gross estate of the grantor or the grantor's spouse] is so remote as to be negligible." Treas. Reg. §26.2632-1(c)(2)(ii)(A). The regulation says that the risk of inclusion "is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate." There is probably less than a 5% chance that the grantor will die within two years (unless the grantor is older than about age 68). The regulation might suggest that the GRAT is therefore not subject to the ETIP rules. (Various attorneys pointed out this potential problem when this regulation was proposed, but the regulation was finalized without any change.)

However, the context of the definition of an ETIP in the regulation before the "so remote as to be negligible" clause may suggest that the intent is to inquire whether there is a 5% chance that the value would be included in the grantor's estate if the grantor were to die within the GRAT term. But, the regulation does not literally say that. As a practical matter, attorneys are not relying on this possible interpretation to allocate GST exemption at the creation of GRATs.

(ii) <u>If the ETIP Rule Does Not Apply to GRATs, How Much GST Exemption Would Have to Be Allocated To Achieve an Inclusion Ratio of Zero?</u> If $10 million is contributed to a GRAT with a $10 gift, can the grantor just allocate $10 of GST exemption to cover all of the remainder interest? Probably not. IRC §2642(a)(2)(B) says that the denominator of the applicable fraction is "the value of the property transferred to the trust" (reduced by taxes and the charitable deduction). The statute and regulations do not refer to reducing the denominator by the amount of the grantor's retained interest.

The counter argument is that if there is a part gift, part sale, the donor should not have to allocate GST exemption to the sale portion. Under this approach, the "value of the property transferred" is impliedly the net value of the property. Some GRATs with highly speculative assets are expected to result in a zero transfer or a <u>huge</u> transfer. In that situation, a planner may want to consider allocating GST exemption to the initial transfer equal to the "net value" of the transfer [i.e., the value of the remainder interest] when the GRAT is created. For example, a formula allocation could be made of "so much as is necessary to achieve a zero inclusion ratio, but not more than the value of the remainder." In light of the uncertainty over the amount of GST exemption needed in this circumstance, if GST exemption is allocated at the creation of a GRAT, it is essential to put a cap on the amount allocated.

An outline and article in 1987 had a long discussion of this issue, before the 1988 revisions that brought the ETIP rules. Before the ETIP rules were passed, planners thought that this kind of leveraging with the GST exemption was available for trusts like GRATs (although they weren't typically referred to as "GRATs" back then). If GST exemption had to be allocated based on the full amount transferred to the trust, why were the ETIP rules needed in the first place?

There is an excellent discussion of this issue in Manigault & Hatcher, GRATs and GST Planning: Potential Pitfall and Possible Planning Opportunity, 20 Probate & Property 28 (Nov./Dec. 2006). The authors suggest the following approach:

- Make a formula GST exemption allocation, with a cap (perhaps $100) when the GRAT is created.
- Allocate GST exemption on the gift tax return on which the GRAT is first reported.
- As a "belt and suspenders" approach, at the end of the annuity period, the grantor would make a protective formula GST allocation (again, perhaps with a cap depending on the circumstances) on a gift tax return.

(iii) Risk of Automatic Allocation of GST Exemption. If the GRAT remainder will pass in a manner that could potentially have distributions to skip persons, and IF the ETIP rule does not apply, there would be automatic GST exemption allocation when the GRAT is created. It is likely that the amount allocated would be the entire value of the property transferred to the trust, even though all of that current value (and more) will be distributed back to the donor—thus likely wasting GST exemption. To be sure of preventing this result, an election against automatic allocation of GST exemption could be filed when the GRAT is created. (However, some of the nationally respected attorneys who have been aware of this particular potential concern for years have not been electing out of automatic allocation upon the creation of the GRAT, although I spoke with one such attorney who may start doing so out of an abundance of caution.)

A separate issue, of which most planners are aware, is that the gift tax return that is filed for the GRAT when it is created can elect out of automatic allocation at the end of the ETIP—to avoid automatically allocating an undetermined amount of GST exemption when the GRAT terminates. See Treas. Reg. §26.2632-1(b)(2)(iii)(A)(1).

k. Distributions From or Redemptions of Interests in Entities Transferred to GRATs. What if a discounted limited partnership interest is transferred to a GRAT, and large distributions are made from the partnership to the GRAT in order that the GRAT could make cash payments (undiscounted) to the grantor in making the annuity payments? To avoid an argument that the legal entity is just a sham for tax purposes, consider using a 5 or 6 year GRAT, and funding the GRAT with liquid assets (that could be used to make the annuity payments during the first three years and) as well as discounted interests in partnerships or other entities. After the statute of limitations has run on the gift value passing to the GRAT, distributions from or redemptions of interests in the partnership would not run the risk of a revaluation of the interest transferred to the GRAT under a sham analysis.

l. Assets Subject to Blockage Discount. If a large block of stock that is subject to a blockage discount is contributed to a GRAT, there may be a large discount on the value going into the GRAT (which would lower the annuity payments). If smaller blocks are distributed each year, the blockage discount may not apply to those payments, thus allowing a discount arbitrage advantage that could result in a successful GRAT even if the combined appreciation and income of the assets do not beat the §7520 rate.

m. Rolling GRATs With Single Instrument. The GRAT trust instrument could provide that annuity payments would be automatically transferred back into a new GRAT under the terms of the original instrument, unless the grantor directed the trust at the time of the termination to make the annuity payment distribution directly to the grantor. This would avoid the necessity of drafting a new GRAT instrument each year when an annuity payment is received. [Query whether this might give rise to an IRS argument that the intent is to create a continuing GRAT (and retained interest) until the grantor’s death, and that all appreciation in the terminated GRATs that presumably passed to other trusts should be brought back into the grantor’s gross estate.]

5. Sale to Grantor Trust Planning.

a. Debt vs. Equity. If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller’s gross estate under §2036. Miller v. Commissioner, 71 T.C.M. 1975 (1996), aff’d, 113 F.3d 1241 (9th Cir. 1997) identified nine objective factors to determine if the transfer was made with a real expectation of repayment and an intention to enforce the debt. See also Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104. Jude

Laro extended Miller and Santa Monica by six new factors in Rosen, T.C. Memo. 2006-115. (Among the factors mentioned by Judge Laro to disregard treating partnership distributions as mere advances under loans are that the decedent never intended to repay the advances, there was no fixed maturity date or payment schedule, no interest (or principal) payments were made, the decedent had no ability to honor a demand for payment, repayment of the note depended solely on the FLP's success, transfers were made to meet the decedent's daily needs, and there was no collateral. He also questioned the adequacy of interest on the note.)

b. Sections 2701-2702. In Karmazin, (T.C. Docket No. 2127-03, filed Feb. 10, 2003) the IRS made a number of arguments to avoid respecting a sale of limited partnership units to a grantor trust, including §2701 and 2702. That case was ultimately settled (favorably to the taxpayer). In the Dallas case [T.C. Memo 2006-212], the IRS agent made arguments under §2701 and 2702 in the audit negotiations to disregard a sale to grantor trust transaction, but the IRS dropped that argument before trial and tried the case as a valuation dispute. In Dallas, the IRS respected the note as debt.

c. Valuation Risk. If the value of the transferred assets exceeds the value of the note, a gift results. One "defined value" approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial "seed gift" to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to incomplete gift trust.

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

d. Required Seed Gift Amount. There is lore that the value of equity inside the grantor trust must be 10% of the total value in order for the sale to be respected. Several speakers said that is not required, and some respected national speakers said that the equity amount could be as low as 1%--depending on the situation.

One speaker typically adds the grantor's spouse as a beneficiary and has the spouse give a guarantee to help support the "seed" cushion. There are cases indicating that a guarantee by a beneficiary is not a gift. The leading case is Bradford [34 T.C. 1059 (1960)], in which the IRS acquiesced.

6. Deductibility of Investment Expenses of Trusts, §67.

The taxpayer sought an en banc review of the full Second Circuit in the Rudkin case, but the court denied the request on January 19, 2007. The order said that not a single judge on the Second Circuit requested that a vote be taken on whether to grant the en banc review. Section 67 is on the regulatory agenda, so regulations may, in effect, pre-empt the Rudkin line of cases for future years.

Planning Pointer: As more distributions are made from the trust, the AGI of the trust is lower because of distribution deductions, so the impact of §67 (tied to 2% of AGI) is lower.

7. Private Annuity Proposed Regulation.

On October 18, 2006, the IRS issued a proposed regulation providing that sales for private annuities will result in immediate gain recognition—the fair market value of the annuity is treated as the amount realized in the transaction. All private annuities, whether commercial or private and whether secured or unsecured will be taxed the same—immediate recognition. Prop. Treas. Reg. §1.1001-1(j).

The IRS has gone too far in just providing for immediate gain recognition. As a practical matter, the seller does not receive immediate payments and may have no way to pay the income tax all at the outset. The IRS has bludgeoned the issue with a sledge hammer. Its concerns could be addressed by applying the concept of installment sales under §453. (That is not as good for the seller, because the installment sales rules do not apply to marketable securities, there is a 2 year rule on resales, and there is an interest charge on the deferred tax in some circumstances.) Applying the installment sales rules should alleviate many of the IRS's concerns with perceived income tax abuses of private annuities.

Even though there is immediate gain recognition, private annuity transactions may still be appealing after the death of the first spouse. Because of stepped up basis, there would be no gain to recognize. In addition, private annuities may be desirable with grantor trusts, because there would be no gain to report, no interest income, no interest deduction, etc.

Further planning strategies with private annuities are discussed in Item 17.

8. <u>Life Insurance Planning</u>.

a. <u>Investor-Initiated Life Insurance</u>. Various proposals have been circulating, pitched as "free" insurance for two years. A lender loans money to pay premiums on a non-recourse basis, and the insured at the end of two years can keep the policy (by paying back loans to the lender for the first two years of premium payments) or may walk away from the policy—in which event outside investors would own the policy. Some situations will even pay the client up to 30-40% of the amount of the insurance coverage to do this—in addition to having free insurance for two years.

Is it a free lunch, or a prelude to acid indigestion?

Investors get information about insured's medical history. The investors' assumptions about when insured will die are often better than even the insured's assumptions.

Disadvantages to the insured include:

(i) <u>Selling unused insurance capacity</u>. A major downside is that the insured is selling his or her unused insurance capacity. The insured could not buy another insurance policy.
(ii) <u>Any incentive payment is ordinary income</u>.
(iii) <u>Split dollar rules</u>. The split dollar regulations may apply to the economic value of the "free insurance." The AALU agrees with that.
(iv) <u>Debt forgiveness</u>. There is no definitive answer on how the IRS will treat discharge of indebtedness, but there may be significant taxable income to the extent that the forgiveness exceeds the value of the policy given up.
(v) <u>Taxable income if sell policy to a settlement company</u>. If the owner sells the policy to a settlement company, there can be substantial income. Is the owner's basis in the policy reduced by the cost of the "free insurance?" (That is crucial. Basis may be reduced almost to zero. A recent law review article by Gans and Solid says that is the case, and taxable gain could be the entire amount received.)
(vi) <u>Rescission</u>. Free insurance is tempting. The insured might be tempted to shade the truth on representations as to reasons for buying the policy. If the application says the intent is for family purposes, but the company later proves that the intent was to resell the policy, the company may rescind the policy.
(vii) <u>Potential liability to investors</u>. The documents are designed to protect the investors' interests. The insured may

be asked to guarantee that the investors have insurable interest. If that turns out not so, the investors may sue the insured's estate for millions. The legal documents are complex and are stacked in the favor of the investors.

(viii) Economics of sale to investors. The investors are not bound to purchase the policy at the end of two years, or they may be willing to pay much less than originally anticipated (for example, if the insured still has excellent health at the end of two years). The sale proceeds may not be enough to pay off the loan, and walking away from the deal may result in significant discharge of indebtedness income.

(ix) "Ickyness" Factor. Lou Harrison calls this the "ickyness factor." After the insured sells the policy, only the insured hopes to live a long time. It is unlikely that investor groups will take steps to cause early death, but there are litigated insurance cases where that HAS happened. The policy can end up in the hands of anyone (even just one person) and the insured will never know it. There is very little preventing a Columbia cartel from owning an interest in a corporation that purchases mortality contracts from a legitimate company. Murder for insurance begs the question—The objection is that investors benefit only from the insured's death. Sound underwriting is based on the opposite—that the insured and the insurance company are BOTH better off if the insured lives.

Recent Developments

(i) A New York General Counsel Opinion on January 9, 2006 concludes that there is no insurable interest and that the transactions are not permissible under NY law. That opinion is technically binding only in NY, but other states are following this trend.

(ii) New York Life Insurance Company on July 5, 2006 rescinded a policy, finding that the insured's family would only get 10% of the death proceeds with investors receiving 90%. The policy was issued under the assumption that the policy was for the exclusive benefit of persons having a familial or economic interest in the insured's life.

(iii) The Utah Insurance Department on July 10, 2006 issued a bulletin emphasizing the insurable interest requirement and that investor-initiated life insurance raises danger flags because the third party does not have a lawful and substantial interest in having the life of the insured continue; "in fact there is a substantial interest in not having the life of the person continue."

(iv) The Louisiana Insurance Department on September 5, 2006 issued Department Bulletin 06-05 concluding that investor-initiated insurance may violate Louisiana statutes or case law involving insurable interest and other policy concerns.

(v) On December 11, 2006, the Life Insurance and Annuities (A) Committee of the National Association of Insurance Commissioners (NAIC) adopted highly debated amendments to the Viatical Settlements Model Regulation that would impose a five year ban on a policy that is financed with the specific intent to be sold to investors - unless the viator can satisfy certain specified exceptions.

b. Corporate Owned Life Insurance (COLI) Developments. In Mayo v. Hartford Life Ins. Co., Civil Action No. H-01-2139 (U.S. S.D. Texas 2002), Wal-Mart bought policies on many employees' lives. When Mr. Mayo died, his estate sued to receive the proceeds because Wal-Mart did not have an insurable interest. Wal-Mart replied that the policy was bought under Georgia law and Georgia has a broad insurable interest rule. The estate responded that Mr. Mayo lived in Texas and the Texas insurable interest rule should apply. The result of the case was that Wal-Mart had to give the proceeds to the insured's estate. Wal-Mart subsequently sued various insurance companies, saying that the companies failed to fully disclose the risks associated with COLI plans and that some state regulators had disapproved COLI plans. Wal-Mart has prevailed in some of those cases (but some of the cases have been reversed.)

This series of cases raises several issues about the insurable interest requirement.
(i) Whose state law applies. In Mayo, the trust agreement chose Georgia law, but the court said that the state of the insured's domicile governs unless another state has a more significant relationship to the transactions or parties.
(ii) Employment alone does not give the employer an insurable interest.

c. Pension Protection Act Changes for "EOLI". The COLI cases gave rise to the new requirements for "Employer Owned Life Insurance" (or EOLI) in new §101(j) under the Pension Protection Act. This Act provides an additional hurdle—in addition to the state insurable interest requirements—because if the Pension Protection Act requirements are not met, the insurance death proceeds will be taxable (at least in part). This is a huge trap for the unwary. Many policies purchased by employers will be subject to these rules even though none of the parties think they are involved with COLI policies.

Section 101(j) is added to the Internal Revenue Code, providing that life insurance owned by an employer on the lives of "employees" is no longer fully excluded from income. There is a special definition of "employee"—an "officer, director, or highly compensated employee (within the meaning of section 414q))." There are various exceptions, including exceptions where the insured was an "employee" within 12 months of death, where the insured was a director or highly compensated employee or individual at the time the policy was issued, if the policy is paid to a member of the insured's family, or if the policy is used to purchase an equity interest in the company that owns the policy (i.e., used to fund a buy-sell agreement).

- While the exceptions will cover many common situations, it is important to note that the employer must give written notice to the employee that the employer intends to purchase the policy naming the employer as beneficiary and that describes the maximum face amount for which the employee could be insured and the employee must give written consent to being insured on such terms and that the coverage may continue after the insured's employment terminates or else the exception does not apply. I.R.C. §101(j)(4).
- In addition, the employer is required to file an information return with the IRS describing information about policies owned on the lives of employees.
- The new provisions apply to contracts issued after the date of enactment (i.e., August 17, 2006) and to preexisting policies with significant increases after the date of enactment. [Observe that policies used to fund entity-purchase buy sell agreements are often increased in face amount over the years as the value of the company—and therefore the buy-out price—increases.]

Planning Pointer: Howard Zaritsky suggests including a provision in the buy-sell agreement itself that satisfies the notice and consent requirements.

d. Insurable Interest in ILITs—Chawla. The 4th Circuit Court of Appeals affirmed the district court decision invalidating an insurance policy on the grounds of misstatements in the policy application, but vacated the alternative ruling that the trust lacked insurable interest. [440 F.3d 639 (4th Cir. 2006)] After the district court decision, the state of Maryland passed a statute saying that a trust has an insurable interest if (i) the insured is the grantor, a person related to grantor, or an individual in whom grantor has insurable interest; and (ii) the proceeds are for the benefit of trust beneficiaries having an insurable interest in the life of the insured. [Query, what if there are multiple discretionary beneficiaries, and some of them do not have an insurable interest?]

As a practical matter, the speakers have not found planners to be doing anything different regarding ILIT planning based on this concern. One possible approach is to ask the insurance company to represent that it will not raise insurable interest as a defense. (That same thing is sometimes done in COLI cases.)

e. Basis in Insurance Policy. Do you have to reduce the owner's basis by the cost of insurance? ILM 200504001 and PLR 9443020 take the position that the owner's basis equals premiums paid minus any nontaxable dividends AND MINUS the value of the life insurance protection the owner has enjoyed. That is like saying that if someone sells a residence, the basis is what was paid minus the fair rental value of having lived in the house. (Even IRS would not suggest that.) There should not be a different result here. Furthermore, the IRS's approach to determining the value of the coverage is to subtract the policy cash value from the full amount of premiums paid unless the owner can prove otherwise. (The rulings do not cite any support for that position.) Under that approach, the basis of a very low cash value policy would be reduced by almost the full amount of premium payments. That presumption approach seems overreaching.

Will IRS go the court on that? No one knows. But most commentators think they are dead wrong. Gallun v. Comm'r, T.C. Memo. 1963-167 did not reduce the basis of a policy that was sold by the use value of the insurance, and the provision of §72 relevant to the surrender of a policy to an insurance company does not reduce the "investment in the contract" by the use value.

This issue is important in any sale or other life settlement of an insurance policy.

f. Moving Policies from One ILIT to Another. PLRs 200518061 and 200606027 both held that an exchange of policy between grantor trusts was not a taxable event and did not trigger the transfer for value rule because the grantor was the treated as the owner of both trusts for income tax purposes.

There are several reasons to be cautious with these kinds of transfers between trusts.
(i) The sale should be at fair market values, and the life settlement industry might suggest higher prices than just the cash surrender value.
(ii) If a beneficiary thinks the trust sold the policy for too low a price, there are fiduciary liability possibilities.
(iii) Make sure that the trusts are grantor trusts or else the transfer for value rule may cause the proceeds to become taxable.
(iv) A typical plan is to move a policy from an old "bad" trust to a new "good" trust. If the "good" trust is better because it

cuts out certain beneficiaries or restricts the rights of beneficiaries, there may be fiduciary liability concerns that individual trustees often totally overlook.

g. Sale of Policy to Avoid Three Year Rule of §2035. The IRS has not raised this in any ruling or case, but one speaker raises a possible lack of economic effect argument. If the insured gives cash to a new trust, and the trust uses the cash that same day to purchase the insured's policy, the IRS may argue that there is no economic substance to differentiate this from a gift of a policy directly to the trust (in which event the three year rule would apply). (One way to plan around the three year rule that often is the most expedient is to forget the complicated planning to avoid §2035 and just purchase a "cheap" term policy for the 3 year term at risk that could be used to pay the estate tax if the insured dies within three years.)

h. Life Insurance Subtrust. A strategy that has been suggested for years by some planners is to have a subtrust inside a retirement plan purchase life insurance. The goal is to be able to use assets in the retirement plan to pay the premiums (because that's where the available cash is), but to have the policy proceeds excluded from the insured's gross estate for estate tax purposes (by providing that the employee/insured has no incidents of ownership over the subtrust). Debate has raged for decades about whether this works, and the IRS has remained conspicuously silent. A recently issued but unpublished TAM says that the subtrust disqualifies the retirement plan. However, just irrevocably naming a beneficiary of the policy owned by the plan does not disqualify the plan. Conclusion: The subtrust strategy is too risky to use. (Steve Leimberg has posted the unpublished TAM on the LISI website [under the "Actual Texts" tab].)

9. Retirement Plan and IRA Issues.

a. Funding Pecuniary Bequest by Transfer of Interest in IRA. In CCM 2006-44020, a trust made a pecuniary bequest of $100,000 to charities. The trustee directed the IRA provider to put $100,000 of the IRA into the names of the charities (hoping to get the $100,000 IRA to the charity without anyone ever having to pay income tax on the $100,000 because of the charity's tax exempt status.) The IRS said that the distribution would trigger ordinary income to the trust, reasoning that a transfer of an IRA to a pecuniary fixed dollar legatee accelerates income recognition under §691(a)(2). There is a split among planners as to whether this is correct. Natalie Choate thinks the IRS may have been right. The trustee had a choice of assets to use to fund the bequest, and because the trustee chose to use the IRA, that could be an assignment of income under §691(a)(2). Section 691(a)(2) says that after death of an owner of an "income in respect of a decedent" asset, a transfer of the IRD to someone else triggers immediate realization of income UNLESS the person is entitled to the asset under the decedent's will or trust. The ruling reasoned that the charity was not entitled to that particular asset. (The CCM went too far, though, in citing a 60 year old case that does not even mention §691(a)(2) as support for its conclusion.)

Planning Pointer: This ruling should not apply if the trust document says the trustee MUST satisfy the bequest with the IRA—even if it is a pecuniary bequest.

b. Transfer from IRA to Charity. The provision in the Pension Protection Act permitting a transfer of an IRA directly to charity without triggering income recognition is the first time that a tax free transfer has been permitted out of an IRA. Congress is dipping its toes into charitable rollovers. This is a first step, but one speaker says that the limitations in this provision are stupid. It is temporary (only applying for two years—2006 and 2007) and it only applies to IRAs.

c. Post Death Rollovers by Nonspouse Beneficiaries. This provision in the Pension Protection Act is long overdue. Tax law has always said that children who inherit from a retirement plan can withdraw over their life expectancies. However, plans don't have to offer that, and most just permit lump sum withdrawals by beneficiaries other than surviving spouses. Non-spouse beneficiaries now have another option; they can transfer the account to the new inherited IRA. This must be a direct rollover to an "inherited IRA," established specifically to receive the distribution, in the name of the deceased participant and payable to the beneficiary. §402(c)(11), added by the Pension Protection Act.

This new provision is only available for "designated beneficiaries." The new provision does NOT enable you to "fix" the beneficiary designation after the employee has died.

d. Health Savings Account. The Tax Relief and Health Care Act of 2006 provides that if an individual has the right kind of health insurance coverage (a high deductible health plan—the deductible must be about $1,100), the individual can contribute tax deducible to health savings account, to be used later tax free to pay medical expenses. This is a unique tax advantage because there is an up front tax deduction for contributions AND future distributions are tax-free. However, public reaction has not been overwhelming, partly because small amounts are involved—only about $3,000 per year. But, for those that qualify, they make sense.

e. Rev. Rul. 2006-26—Impact of Accounting Rules on Marital Deduction for Retirement Plans. Under the Uniform Principal and Income Act, the portion of retirement plan distributions that is income is 10% of the minimum required distribution. For example, assume the only asset in a marital trust (requiring mandatory income payments to the surviving spouse) is a $1 million IRA. Assume the IRA has a 20 year payout, and in the first year, $50,000 is distributed. How much is income to be distributed to the spouse? Ten percent of the $50,000, or $5,000. The spouse will not be happy with that answer, and the IRS agrees that amount is too low. The Ruling says that acceptable income from an IRA is either the actual internal income of the retirement plan or a unitrust percentage between 3-5%.

This will not create problems for most plans because since 1989, the IRS has made clear that they view the marital trust and the IRA payable to the marital trust as totally separate and both must satisfy the "all income" requirement. Since 1989, planners have drafted marital trusts to add a clause requiring the trustee to distribute the income of the trust AND to distribute all income of any retirement plan of which the trust is the beneficiary. The Revenue Ruling makes clear that if the trust contains that provision, nothing has to be changed. Also, the Ruling makes clear that if the spouse has the right to force the trustee to withdraw the IRA income, the trust can qualify for the marital deduction.

f. Designated Roth Account. The Pension Protection Act makes permanent a provision allowing a taxpayer to elect to have a contribution go into a designated Roth account rather than a traditional 401(k) or 403(b) account. The maximum is $15,000 (with cost of living adjustments after 2006—about $15,500 in 2007) plus $5,000 if the individual is over 50 by the end of the year. The effect of making the election is that the individual will pay income tax now (no deduction is allowed for the contribution) but future distributions are tax free. There is no income ceiling or age limit or limit based on whether the individual is a participant in another retirement plan. It is a great opportunity, but the election is irrevocable once the money is contributed.

Who should be doing that? The answer is generally not based on running a spread sheet, but on an overriding theme not based on numbers or statistics. Some factors to consider: (1) Tax laws may change; (2) Hedge bets by putting some assets in a Roth account; (3) Pack the plan—if someone puts money in a traditional plan, the government really owns a third of it; (4) Easier to pay taxes now when the individual is working; (5) In effect, it is a manner of forced savings; (6) Conspiracy theory—tax rates now are cheap, so pay the tax now before taxes go up to pay the health care needs of retiring baby boomers (but the competing "conspiracy theory" is that baby boomers are such a large part of the population that they control legislative agenda and will force Congress to make all pensions tax free.)

10. Malpractice Issues for Estate Planning Attorneys.

a. Best Defense: No Breach of Duty. The best defense in front of a jury is that the attorney did not breach a duty (i.e., that the attorney did nothing wrong) rather than to argue lack of a duty (an expert can always be found to testify that the duty exists), no damages, etc.

b. How the Jury Will View the Attorney? "Lawyers are like politicians. They're all crooks—except my own." Jurors will be forgiving even in the case of a mistake. But if, in addition to a mistake, the plaintiff can argue that the mistake is compounded by greed (additional fees) or conflict of interest or trying to hide the error, the manageable case becomes much more dangerous.

Jurors expect attorneys to know everything in their area. Jurors expects their own lawyer to be their protector—so they expect the lawyer to be the plaintiff's protector, and the estate and trust lawyer is expected to be the super-protector. Jurors will view estate and trust lawyers as owing an even more expansive duty to protect the client—because they are privy to so much personal and financial information from the client.

There are often various advisors, but jurors make it clear that the lawyer is in charge and is primarily responsible, even though there are some issues more in the realm of other advisors (for example, universal life vs. other types of life insurance).

c. Who is the Client? This is the most important substantive area that gives rise to claims (raising issues about confidentiality and conflicts), and this area will be construed against the lawyer. For example, is just one spouse the client or are both spouses clients? Under the Model Rules, when conflicts arise, the lawyer should make clear his relationship to the parties involved. Conflicts will be used against the lawyer in any litigation.

(i) Engagement letter. How to deal with the problems? The best approach is a good engagement letter. State ethics rules typically require that anyway. This is the opportunity to make clear who the attorney does and does not represent. It is important to have documents contemporaneous to events as they happen—so there is no possibility of concluding they were created after the fact to protect from problems that arise.

(ii) Ending engagement. At the end of the matter, an "I'm not your attorney" letter can also be helpful. When estate planning work is done, send a letter saying the work is done. The attorney is happy to do more work if desired. The letter might refer to the final invoice in light of the completion of this work.

(iii) When do duties to client end? This has become more significant because of a Georgia case, Barnes v Turner [278 Ga. 788, 606 S.E.2d 849 (2004)]. The Georgia court extended the obligation of lawyers beyond the project at hand. The lawyer was hired to perfect a security interest by filing a UCC filing statement. It must be renewed every 5 years, but apparently, the lawyer did not advise the client of the renewal requirement. The client did not renew the filing statement, and sued the lawyer. The lawyer defended that the breach of duty to inform the client of the renewal requirement in five years was barred by the four year statute of limitations. However, the Georgia Supreme Court said that the plaintiff had a viable claim—where there are ongoing obligations in connection with the project, the lawyer must either do those ongoing things or advise the client what they are. The ABA Commission on Ethics also says this issue gets resolved against the lawyer, and that any doubt about whether a lawyer client relationship still exists should be clarified by the lawyer (preferably in writing) so the client will not mistakenly think the lawyer is continuing to look after the client's affairs. This is also important for statute of limitations purposes; the statute of limitations will be tolled if lawyer continues to represent the client.

d. Attorney Naming Self as Fiduciary. Attorneys are sensitive to not naming themselves as beneficiaries—but naming themselves as fiduciaries can be viewed the same way, because the attorneys would receive fees for serving as fiduciary. Attorneys should understand these risks before agreeing to name themselves as fiduciaries. Even if there is technically not a conflict, in the eyes of the jury there will be a conflict. The jury will believe the attorney named himself just to profit himself. If the attorney is also a fiduciary, the duties are expanded because the attorney has duties to the beneficiaries as well as to the client. The attorney-fiduciary would be in the position of constantly reconciling duties to client and the beneficiaries regarding the duty of confidentiality and conflicts of interest, often placing the attorney in a quagmire. This may also create malpractice insurance concerns, because most malpractice policies do not cover acts as fiduciaries.

For larger firms, a good policy is to require that someone other than the attorney or someone outside the department must approve before a lawyer in the firm can agree to take on a fiduciary responsibility. The lawyer may feel personal pressure from the client to be the fiduciary, and it is helpful to be able to blame the refusal on a formal policy.

e. Judgmental Immunity. If the law in a particular area is uncertain, judgmental immunity can be a defense. There are two elements to the defense: (1) Exercise of judgment, and (2) the judgment is informed. The attorney must be able to prove that he or she made an effort to fully understand the law and inform the client of that. There is a tension there, because research memos cause additional cost to client. But keep this in mind during the representation—"could I document down the road that I looked at the law."

f. Testator's Intent. States often have very similar rules regarding admissibility of extrinsic evidence and parol evidence. Contemporaneous documentation to confirm the testator's intent is very helpful. Problems arise either because the client has selective memory later or beneficiaries will argue that "of course, dad would have wanted to reduce the estate taxes and give up control." (In the corporate context—there is often a memorandum of understanding.) It is best if the client signs off on that expression of intent.

g. Privilege. Attorneys often assume that all conversations with a client are privileged unless the client raises a claim, but those communications may eventually see the light of day. Communications with a trustee may also be disclosed. If the trustee is sued by beneficiaries, the trustee will defend that "I did it on advice of counsel." Then the communication is no longer privileged.

h. Privilege for Internal Discussions Regarding Possible Conflicts Issues? There is an evolving body of law that internal communications within a law firm about conflicts issues are not privileged. Four cases have held that as long as the attorney continues the relationship with a client, the fiduciary relationship to the client overrides any privilege that might exist regarding internal communications in the law firm about the relationship.

11. GST Planning Issues Involving Charitable Planning.

a. Allocation of GST Exemption to CLAT. Even if GST exemption is allocated upfront to a CLAT, the inclusion ratio is not determined until the end of the CLAT. At that time, the numerator of the applicable fraction is the GST exemption, augmented by the §7520 rate. The denominator is the remaining value of the trust assets at that time (after the charitable distributions) not reduced by any charitable deduction.

If there is a late allocation, the regulations say that the numerator grows at the §7520 rate *beginning on the date of the allocation*. However, the Code clearly says that the numerator should be augmented by the §7520 rate "for the actual period of the charitable lead annuity"—i.e., from the *beginning of the trust*. However, no one has tested that regulation.

b. CLAT; GST Effects of "Negative" Inclusion Ratio. GST exemption can be allocated up front. The numerator of the applicable fraction grows at the §7520 rate. If the assets do not have an income/appreciation growth rate as high as the §7520 rate, the applicable fraction will be greater that 1, so the inclusion ratio will be less than zero. The regulations do not anticipate what will happen if subsequent additions are made to the trust or if the trust combines with another trust. Can the additional assets utilize the "negative portion" of the inclusion ratio?

The regulations do not speak to it, and the statute suggests that can happen (but the issue is not clear.) So if there is a CLAT with an inclusion ratio of less than zero (because the assets have grown at less than the §7520 rate), if additional assets could be added to the trust (with no additional GST exemption allocation), the numerator of the applicable fraction (as augmented by the §7520 rate) might equal the denominator after the addition; however, no additional contributions may be made to a CLAT. However, a non-exempt trust could be combined with the CLAT so that the denominator of the applicable fraction would equal the augmented numerator.

c. CLAT; Trust Grows At More Than §7520 Rate So That It Is No Longer Fully GST Exempt. If this happens, the CLAT could be severed to create a fully exempt and fully non-exempt trust.

d. <u>CLAT vs. GRAT</u>. If a client is charitably inclined and makes large annual charitable gifts, a CLAT can operate much as a GRAT would for that individual, and the distributions from the CLAT would replace charitable gifts that the individual would otherwise make that year. An advantage of the CLAT is that GST exemption can be allocated up front (but the trust will no longer be fully exempt if the trust has income/appreciation of more than the §7520 rate.). There is no ETIP rule for a CLAT.

e. <u>CLAT vs. CLUT</u>. A CLUT provides more certainty of the GST effect. There is no risk that the trust will become partly non-exempt in future years (if the trust assets have income/appreciation of more than the §7520 rate). However, charities will share in the appreciation or depreciation of the trust.

f. <u>CLT—No Direct Skip</u>. There can never be a direct skip to a charitable lead trust (either because the charity-which is treated as a non-skip person-has an “interest” in the trust or because no person has an “interest” and a distribution may be made to a non-skip person (i.e., the charitable lead payments).)

g. <u>Interesting Aspects of Subtracting Charitable Deduction in Applicable Fraction Denominator</u>. Section 2642(d)(2)(B) says that the denominator of the applicable fraction is the value of the property involved in the transfer reduced by federal or state death taxes actually recovered from the trust attributable to such property AND reduced by any charitable deduction allowed under section 2055 or 2522 with respect to such property. Neither the Code nor the regulations contemplate how this rule will operate if there is a late allocation of GST exemption to a CLUT sometime after the trust has been operating. What if the asset has gone down in value (partly as a result of charitable distributions of the lead interest payments)? Is the denominator the value of the trust assets at that time reduced by the charitable deduction allowed when the trust was created?

h. <u>CLT-Designing So No Taxable Termination Can Occur</u>. If the trustee has the discretion to choose which charities receive the lead charitable payments from the CLT, no specific charity has a current right to receive distributions, so no non-skip person has an “interest” in the trust. Therefore, termination of the CLT would cause a taxable distribution rather than a taxable termination. This was the result of the <u>Robertson</u> case (discussed at the 2006 Heckerling Institute (¶116.1).) An advantage is that there may be the ability to control when the taxable distribution occurs. If the trust must terminate at the end of the charitable period, there is an issue of whether the taxable distribution occurs on the actual termination date or when the assets are actually distributed. Reg. §26.2612-1(f) Ex. 13 would suggest that the actual date of distribution controls. (If the tax rate has gone down by that subsequent date, savings will occur. Or if the assets have gone down in value at that time [perhaps because assets have been invested in an FLP?] the taxable distributions would also be reduced. (The government apparently did not argue in Robertson that the taxable distribution occurred on the actual termination date, not the date that the assets were later distributed to a trust for grandchildren.)

Better planning would be to have the CLT continue after the end of the charitable lead payments—in the same trust—for the benefit of grandchildren. The taxable distributions would not occur until the actual payments were later made to skip persons.

i. Using Charitable Trust In Connection With Making Tuition/Medical Payments for Grandchildren/ Great Grandchildren to Completely Avoid GST Tax. "This is a very common desire among wealthy clients. No matter how conflicted they are about leaving too much wealth to descendants and depriving them of an incentive to work or to develop good family values, they are always concerned about providing access to good education and health care for grandchildren and descendants. Education is the goal foremost over health care. But as the health care situation gets worse and worse, unless it corrects itself, health care will become equally or more important." –Pam Schneider

If the trust is only for skip persons and distributions can be made immediately, there is a direct skip when the trust is created. Similarly, if children and more remote descendants are beneficiaries, there will be a taxable termination when the oldest generation dies out. So, optimal planning to minimize GST taxes requires the design of techniques to avoid either a direct skip or taxable termination. There are two types of trust that can be considered, both involving charitable interests, from which medical/tuition payments could be made on a long term basis for future generations without GST tax (because of the exclusion under §2611(b)(1) for tuition/medical payments). (These techniques are based heavily on the technicalities of the definitions in the GST provisions.)

(1) Long Term Charitable Interest in Trust. The trust might provide for making distributions for the medical and tuition expenses of children and grandchildren. After the death of all children, 25% of the trust income would be paid to charities, and the trustee would have the discretion to make distributions for

tuition or medical care (or for even broader purposes, as discussed below) of descendants. The trust could last for a very long time—up to the applicable perpetuities period. When the grantor dies, charity and children and other descendants are beneficiaries. Because the charities are non-skip persons, no taxable termination occurs when the children die (unless the charity's interest was created "primarily to avoid or postpone" the GST tax.) Distributions to grandchildren/great grandchildren for medical/tuition expenses would be exempt from GST tax. (The trust could also provide additional flexibility by authorizing the trustee to make distributions beyond just medical expenses and tuition. The trust could balloon in value and it may make sense at some point to use the trust for additional purposes, realizing that any distributions to grandchildren or more remote descendants for purposes other than tuition of health expenses would be taxable distributions.   At least give someone the power within limits to amend the trust document in order to provide flexibility.)

This strategy has been suggested for many years, and there have been articles about this arrangement in the public press, sometimes referring to this as a "HEET Trust" (i.e., Health Education Exclusion Trust).

The IRS should not be able to treat 25% of the trust as a separate trust from the remaining portion that would have no charitable beneficiary under the current separate share regulations. Current regulations have a huge bias against separate trust treatment. In anticipation of those regulations sometime changing (i.e., the IRS coming to its senses), perhaps the payment to charity could be of a fixed dollar amount possibly with a cost of living adjustment or a portion of the income with a cap—because there would be no way to identify what separate share of the trust would produce that amount.

This approach leaves a perpetual interest payable to charity for a very long time—so the grantor has to have a strong charitable motive to create this type of trust. Indeed, if the charity is entitled to receive 25% of the income over a very long time frame, this in effect becomes 25% of the present value of the trust at the creation of the trust (because the value of an income stream "forever" is equal to 100% of the present value of the property.) Some planners believe that is too high a price to pay just to avoid a GST tax many years in the future following the deaths of all of the grantor's children—unless the grantor is truly charitably motivated. Even then, this arrangement would leave a substantial value to charity but the grantor would not be entitled to an upfront charitable deduction. One might argue that the income could be manipulated so the charity in fact receives few distributions, but there would be a concern in that event that the charity or attorney general would complain. Bottom line from this line of thinking: Carol Harrington is not a fan of this type of trust. She thinks this planning is "tax phobic."

The charity should not have to receive all income. However, if the charity receives less than 100% of the income, one can never get complete comfort (because of the risk of "separate trust" treatment). Accordingly, the next alternative may be more conservative.

(2) Shorter Term Trust/Payment Ultimately to Charity. An alternate arrangement would be to create a trust during life (so the donor would have to pay gift tax or use gift exemption) that would begin making medical/tuition payments for the grantor's grandchildren (and even more remote descendants) after the grantor's death. When all of the grandchildren have died, the trust would terminate and would pass to a charity. When the trust is created, no one has an interest in the trust (because no one can receive current distributions when created), so the creation of the trust is not a direct skip. The trust assets will eventually pass to a charity-the only non skip person who will never die. The terminating distribution should be made outright to be a specified charity, not just a charity chosen by the trustee. Also, make sure no other non-skip person has an interest in the trust. The trust would terminate at the death of the last surviving grandchild, but tuition/health distributions could be made to grandchildren and more remote descendants; by the time the last of the grandchildren die, all of the great grandchildren's education tuition payments could probably be paid before the trust terminated and passed to the named charity.

(As with the prior alternative, the trust could also provide additional flexibility by authorizing the trustee to make distributions beyond just medical expenses and tuition, realizing that any distributions to grandchildren or more remote descendants for purposes other than tuition of health expenses would be taxable distributions. Alternatively, give someone the power within limits to amend the trust document in order to provide flexibility.)

The trust might be funded with an amount anticipated to provide education and health care needs of the grandchildren and not leave much at the termination to pass to charity. (If the trust is intentionally pushed to the limit of anticipating that no assets would ultimately pass to charity, could the IRS argue that the charity's interest was created "primarily to avoid or postpone" the GST tax, and ignore the charity's interest? Even so, what would be the effect? There would not be an upfront direct skip, and distributions during the term of the trust for tuition/health purposes would not be taxable distributions. When the trust ended, the assets would actually be passing to a non-skip person—the charity—but could the IRS subject the trust to GST tax as if the assets passed to a skip person and did not pass to a charity? That would seem a very strange result.)

How long of a delay is needed? Technically, no one would have an interest when the trust is created (avoiding a direct skip) if distributions cannot be made to anyone initially, for example, even 1 year. But how short of a time period will work without the arrangement being treated as a "sham?" To be conservative Pam Schneider likes using the life of the grantor because trusts are often geared to change at the grantor's death. Also, during the grantor's life, the grantor can make these distributions directly without gift or GST effects. Also, the trust fund can accumulate after the gift, so the gift (subject to gift tax) does not have to be as large.

While not as "sexy" as the other trust that can last for the perpetuities period, this arrangement satisfies the goals of many clients. Pam Schneider thinks this arrangement is more conservative than the alternative longer term trust arrangement—and it still satisfies the goals of most clients to provide for education and health payment for grandchildren and great grandchildren (at least until all grandchildren have died). Indeed, the trust may run out of money and the charity may not receive anything at the trust termination.

12. Other GST Planning Issues.

a. Grandparent Transfer to UTMA Account for Grandchild; Grandparent is Custodian. Having the grantor serve as custodian of an UTMA account will require inclusion of the account in the grantor's gross estate for estate tax purposes. However, clients sometime do that without consulting advisors. If the custodial account is for grandchildren, there are bad GST results because the §2038 inclusion means that an ETIP period exists and GST exemption cannot be allocated until the death of the transferor, the event that causes estate inclusion ends (for example, three years after the custodian's resignation), or a distribution out of the custodianship. There is no direct skip up front when the account is created, but there is a direct skip transfer whenever there is a distribution from the account to a grandchild (unless the distribution falls within the tuition/medical care exclusion).

The GST tax can become very large if the account has substantial appreciation.

What "clean-up" planning alternatives are available? If the transferor resigns as custodian, the asset will no longer be included in the estate after three years has elapsed (§2038 has its own 3-year rule, separate from §2035), and the ETIP would end at that time—which would cause a direct skip to happen at that time. A drastic alternative might be to argue for state law rescission on the grounds that the account was created by mistake. Summary—it is likely that the transferor cannot get rid of the problem. This really does happen in the real world, and it is a nightmare.

b. Death of Child Before Termination of Trust Previously Created for Grantor's Descendants. For example, assume that a trust was created in 1990 with $600,000 providing for discretionary distributions to the grantor's spouse, and following the deaths of the grantor and grantor's spouse, the trust would pass to the grantor's issue, per stirpes. Assume the grantor has 4 children and one of them dies in 2007 survived by children, when the trust has a value of $1.0 million. If nothing is done, at the termination of the trust, assets will pass in part to the deceased child's children, causing GST tax from a taxable termination. A combination of (1) the retroactive allocation rule passed in 2001, and (2) a qualified severance can be quite helpful in this situation.

Under the retroactive allocation rule of §2632(d), a retroactive GST allocation (based on values at the time of the initial contribution) can be made in certain situations when there is an unusual order of deaths, such as a child of the transferor dying before the transferor.

In the example, a two step process would be used. First, allocate GST exemption under the retroactive allocation rule of §2632(d). The transferor would file a timely filed gift return for the year of the child's death (§2632(d)(2)) allocating ¼ of the original $600,000 gift amount, or $150,000. This would create an inclusion ratio of 75% (and the "taxable" portion, or the applicable fraction, would be 25%). Second, make a qualified severance under §2642(a)(3), to create a trust with $250,000 (i.e., one-fourth of the trust) for the predeceased child's family and another trust with the remaining $750,000 for the remaining descendants. Bottom line: Only $150,000 of exemption had to be allocated to protect a $250,000 trust (and subsequent appreciation) that will eventually pass to the predeceased child's family. (A regular late allocation may be preferable if the assets are worth less than the gift amounts when the GST exemption allocation is made; for example, this may be the case with ILITs. Also, if the original gift was a split gift, each spouse is treated as a transferor of half of the trust, and if the child predeceases just one of the parents, the retroactive allocation would only work for one-half of the trust.)

(Both of these steps were added by the 2001 Tax Act, and will sunset after 2010 unless extended.)

c. Qualified Severance. A qualified severance is made by filing a Form 706-GS(T) with "Qualified Severance" hand written at the top in red ink [the IRS has informally indicated that it will delete the red ink requirement when final regulations are issued] and attaching a "Notice of Qualified Severance" containing the information contained in the proposed regulations. Carol Harrington also likes to attach a severance agreement memorializing what was done—especially if the terms of the new trust are not identical to terms of old trust. (The severance is being done for a reason, so typically the terms of the severed trusts will not be identical. For example, the trusts may have identical terms except that distributions to a non- skip person come first from exempt trust and vice versa.) The changed terms cannot change the "succession of interests." It is helpful if the trust document gives the trustee the authority to change terms of severed trusts as long as the changes do not change the overall succession of interests. Pages II-D 3-5 of the Workshop materials include sample trust clauses illustrating ways to change the trust terms without changing the "succession of interests."

d. Reforming Grandfathered or Exempt Trusts.

(1) Grandfathered Trusts. Trusts that were irrevocable on 9/25/1985 (and a narrow category of other trusts described in Reg. §26.2601-1(b)(2-3)) are "grandfathered" from the GST tax. Regulation §2601-1(b)(4) describes modifications that may be made to such trusts without destroying their protected status. The regulation does not purport to say that those are the only ways that grandfathered trust can be amended without affecting their protected status. Those are just safe harbor modifications that are permitted.

If a grandfathered trust has been modified in a manner that is not covered by one of the safe harbors, it is hard to "undo" the modification or fix the possible loss of grandfathered status. But don't just concede that a modification outside a safe harbor is bad. As a practical matter, the IRS doesn't want to litigate this. “They would rather just terrify the rest of us with uncertainty than risk a court loss.”

(2) New Ruling Policy on Reformations of Grandfathered Trusts. There have been a number of private rulings dealing with permissible modifications of grandfathered trusts. Rev. Proc. 2007-3, 2007-1 IRB 108 provides that the IRS will not rule on a proposed modification of a grandfathered trust if the modification is “similar to a factual scenario set forth in one or more of the examples” of Regulation §2601-1(b)(4)(i)(E). That ruling policy only applies to grandfathered trusts. Presumably, the IRS will still rule on the effects of modifications to exempt trusts as a result of GST exemption allocations (and indeed there are a host of tax issues—income, gift, and estate inclusion issues—that may arise other than just the effect on the GST exempt status of the trust.)

(3) Reforming Exempt Trusts. There is no regulation or other formal guidance dealing with the effects of modifying exempt trusts. There have been several private rulings (PLRs 200615001 & 200417014) acknowledging that no formal guidance has been issued and stating that “at a minimum,” a modification that would not affect the exempt status of a grandfathered trust should not change the exempt status of a zero inclusion trust. (The “at a minimum” phrase implies that it may be possible to make even more permissible changes to a zero inclusion trust than to a grandfathered trust.)

e. GRAT ETIP Rule and GST Exemption Allocation Planning Opportunity. This issue is discussed in Item 4.j above.

13. Trustee Delegation.

a. Summary. Trustee delegation of various responsibilities will increase. The process of deciding to delegate or not delegate is very important. (If the trustee decides not to delegate, the trustee should document that it has the investment expertise and that delegation is unnecessary.)
Steps:
(a) Determine if the delegation is proper, considering the purpose of the trust, the impact of fees on the trust and its beneficiaries.
(b) Select the agent.
(c) Determine the scope and terms of the delegated functions.
(d) Monitor the acts of the agent.
(e) The trustee has a duty to act reasonably in taking those steps.

(f) As to fees, consider the fee impact of bundling vs. unbundling the trust advisor's fee into the trustee's commission and the income tax consequences (under §67(e)).

b. Investment Guidelines. The investment manager will want investment allocation guidelines. For smaller trusts, the investment policy may merely be to invest as a prudent person would, and to outline the investment horizon and spending policy. Investment guidelines might give a range of investment allocations (e.g., 40-60% in equities with no more than x% in one stock). If the trustee does not have sufficient expertise to even set investment objectives, the trustee may want to hire an advisor to do that.

c. Delegation Agreement. Sample delegation agreements are in the Workshop materials on page III-C-6-15.

d. Relative as Investment Manager. If the beneficiaries are demanding the trustee to name a brother in law as investment manager, the trustee should consider resigning. The trustee is still liable under Prudent Investor Rule for the failure to select a qualified agent, clearly define the scope of the delegation and monitor the agent's performance. The trustee should make sure that the investment adviser is properly registered and meets regulatory requirements.

e. Disclosure of Documents to the Investment Advisors? One planner says to disclose the trust document to the investment advisor, so the advisor has the exact investment standards and distribution authorities. Another planner says not to give the full agreement to the investment advisor because it is not a public document, but just to quote the relevant provisions of the agreement in the Investment Policy Statement.

f. Duty to Monitor Investment Advisor's Actions. Make sure that the delegation document discloses the investment style of the manager, and monitor to make sure that is consistent with what the manager is doing. Investment performance is not irrelevant—but it's not what you start with. The primary focus is to monitor that the investment manager is acting within the scope of the delegation.

g. Individual Trustee. The speakers strongly recommend having the individual trustee hire an investment advisor.

h. Notification. The Delegation Agreement should require that the advisor give notice of important changes. For example, departures and changes in key investment personnel should be disclosed.

i. Indemnification. Can the bank agree to indemnify the investment advisor? That is unwise; if the bank does so, the indemnification would come out of the bank's own funds.

j. Can the Trustee Delegate to an Affiliate? Usually yes. A wholly owned subsidiary is usually a registered advisor. Disclosure of the delegation and the fee structure is important.

14. Directed Trustees.

a. Summary. The trust instrument (or a court ordered modification of a trust) may specify that a third party (often referred to as the "Trust Advisor") directs certain actions of the trustee. Under the Uniform Trust Code, the trustee must monitor the third party's actions to see if they are authorized and not a breach of trust. Some states are more protective of trustees in relying on directions of a Trust Advisor, including Delaware. Even though the trustee may be acting under directions as to a wide range of activities, the directed trustee is still a trustee. In most cases, the Trust Advisor acts as a fiduciary.

A directed trust arrangement may be the best way of carrying out the settlor's intent. For example, if an asset is an interest in a closely held company, the settlor may want to have someone who is highly knowledgeable about the business having the power to decide whether to sell the interest—and the trustee may insist on having a Trust Advisor for that purpose, especially if the trust owns a minority interest in the business.

b. Historical. A 1965 Harvard Law Review article noted that the concept of directed trusts has been around a long time. Historically, they have commonly been used with foreign trusts and ERISA trusts.

c. Drafting Considerations. The advisor clauses in the trust instrument should address (1) whether the advisor acts as a fiduciary or not, (2) the scope of actions that are to be directed by the trust advisor, (3) the duty of the trustee to supervise and monitor the advisor, (4) the procedure for the trustee to question the directions given by the advisor, and (5) the limitation on the liability of the directed trustee for following the advisor's directions.

d. State Law Approaches to Liability of the Directed Trustee.

(1) Restatement (Second) of Trusts. The directed trustee must follow directions of the advisor unless the directions "violate the terms of the trust or is violation of a fiduciary duty to which such person is subject in the exercise of the power." Particularly if the advisor acts as a fiduciary, the directed trustee must verify that the directions do not violate a fiduciary duty that the advisor has to the beneficiaries of the trust. This does not give much comfort to a directed trustee.

(2) Uniform Trust Code. The directed trustee can follow directions of the advisor unless they are "manifestly contrary to the terms of trust or the trustee knows that the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust." There is some degree of a duty of monitoring the directions given by the advisor.

(3) More Protective States. An example is Delaware. The advisor is generally a fiduciary. The directed trustee must follow the directions from the advisor except for willful misconduct. That is a very high standard allowing the trustee to rely on directions of the advisor. The directed trustee has more protection in Delaware than in UTC states. Most institutions prefer to serve as directed trustees under Delaware law than under a UTC state law.

e. Case Law Regarding Directed Trustees.

(1) Duemler (Delaware) Grantor named a securities lawyer as the advisor for investment decisions. The bank trustee received a prospectus for a bond redemption, and sent it to the advisor, but the advisor did not give any directions. No action was taken and there were investment losses. The advisor and the trustee were sued. The case (an unreported and unwritten decision) held that the bank trustee was not liable because there was no evidence of "willful misconduct" and that the statute requires the advisor to make investment decisions in isolation without oversight from the trustee.

Planning Pointer—Don't let a communication with the advisor go unanswered.

(2) Rollins v. Branch Banking and Trust Company of Virginia. The trust held publicly traded shares of a textile company, and the decision to sell the stock was in the hands of 4 children. All communications from the trustee were with the father. The father died and the children sued the bank for $25 million for losses in the value of the stock. The court (a Virginia circuit

court decision) held that the bank trustee did not have investment responsibility and was not liable for failure to diversify the stock. However, the court did not dismiss the lawsuit with respect to the trustee's other duties, such as the duty to inform and all common law duties. [56 Va. Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002).] The case subsequently settled. That case is often cited to say the directed trustee was not protected, but it just says that the directed trustee is never totally protected.

(3) McGinley v. Bank of America, N.A. This case is not a directed trustee case, but a case involving retained investment powers by the settlor. The trust agreement provided that the trustee had to consult with and abide by the grantor's decisions regarding any purchase or sale unless the grantor was incapable of managing her affairs. The grantor funded the trust with Enron stock and directed the trustee to retain the securities (and relieved the bank of responsibility for analyzing or monitoring the stock and indemnified the bank for any losses that it incurred as a result of retaining the Enron stock). The grantor never revoked the letter instructing the retention of the Enron stock and was at all times competent. The Enron stock lost its value and the grantor sued the trustee for the loss. The trial court granted summary judgment to the trustee and the Kansas Supreme Court agreed. 279 Kan. 426, 109 P.3d 1146 (2005). It summarized the relevant law by concluding that a trustee that reasonably and in good faith relies on the express provisions of a trust instrument-including modifications of the prudent investor rule-is not liable to a beneficiary for breach of trust. It stated that a trustee of a revocable trust who follows directions from the grantor is deemed to have complied with the prudent investor rule and is authorized to follow the directions.

(4) Anecdotal Cases. One speaker described an actual case from 15 years ago where there was a swearing match between the advisor and trustee as to whether the advisor had given directions to submit a bond for redemption, and the parties ultimately settled with both the trustee and the advisor accepting responsibility for some of the financial loss.

Another speaker described a case in which a couple retained authority over asset concentration regarding high tech stock under an agency agreement. The investment company periodically advised the couple they should allow diversification. They did not do so, the stock value tanked, and the client sued the bank for not making them diversify. The claims survived summary judgment, and the case was ultimately settled. The case illustrates the perils of just relying on directions from persons who are given authority over investments in the underlying documents.

f. Practical Planning Suggestions. The documentation should clearly specify that the advisor has all investment authority over the listed assets and that the trustee has no responsibility to monitor the investment or to advise the advisor or beneficiaries about the investment and whether to sell the investment. In light of the inherent legal uncertainties, there should be a broad exculpatory clause for relying on the directions of the advisor. It would be helpful to have in the file ongoing letters concerning the benefits of diversification and the risks of concentration. The file should include repeated directions by the advisor to retain the asset. Perhaps it would be helpful to have an analysis of the stock on a regular basis (but bank is not being paid for that), and one speaker said that it is dangerous to monitor the stock performance because doing so might suggest that the trustee is accepting the duty to do that. That speaker believes it is better for the trustee to just send general information and make clear that the trustee is not monitoring the underlying asset.

15. Co-Trustees; Failure to Agree to Take Action.

A speaker told of an actual case of a testamentary trust having a bank co-trustee and two individual co-trustees. For 24 years, the trust held one stock. The company was eventually sold to Borden’s and the Borden’s stock continued as a substantial part of the portfolio. One co-trustee wanted to sell all of the Borden’s stock and invest all of the trust assets in fixed income—he was the income beneficiary. The bank co-trustee wanted to diversify. There was a stalemate and no Borden’s stock was sold. The Borden’s stock declined substantially in value (however, even with the decline in that stock, the annualized return of the trust net of all distributions was about 12%.) The trustee meetings were so contentious, that both individual trustees were represented by counsel and there was a court reporter at the meetings. The co-trustee who wanted to sell the stock sued the bank for failure to diversify. The court found the bank liable and computed damages as if the stock had all been sold on day 1 of the accounting period. The court held that the bank co-trustee had to a) educate the individual co-trustees (even though they were represented by counsel and the bank co-trustee repeatedly tried to get the co-trustees to agree to diversify), b) seek instructions of the court, and if neither of those works, c) resign. This actual case illustrates the dangers of a stalemate among co-trustees.

Planning Pointers in Dealing With Co-Trustees. If co-trustees fail to approve appropriate diversification, if a co-trustee is convinced there is a duty to diversify, it should a) take several months trying to educate other co-trustees of the perils of failing to diversify, b) consider having the trust hire a completely separate attorney to represent the two individual co-trustees to give them to get a legal opinion on the duty to diversify, and if that does not work, c) the trustee should develop a plan of diversification over a multiple year period and present the plan to a court for approval. If the case blows up and there is eventually a suit for damages and if there are some individual co-trustees who agreed to diversify, the lawyer might be tempted to represent both the bank and the individual co-trustee who wanted to sell. Don't do it; there's lots of potential for conflict.

16. Reliance on Asset Retention Power in Trust Agreement; Ruth Lilly Estate Recent Case.

The conservator for Ruth Lilly was directed by the court to develop an estate plan. A provision was added into two CRATs funded with Eli Lilly stock stating that the trustee could "retain indefinitely any property received by the trustee" and that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments." Two months later, the bank implemented an Investment Policy Statement and began diversifying by selling Eli Lilly Stock. A significant portion of the stock was sold six months later when the stock price had dropped from $75 per share to $47-57 per share. The bank was sued for delaying diversification, constituting negligence and breach of fiduciary duty. The Indiana Court of Appeals held that the bank was not liable, primarily on the grounds that the UPIA requirements can be relaxed by a trust document, and the clause in the trust agreement did so. Americans for the Arts, et al. v. Ruth Lilly Charitable Remainder Annuity Trust, et al, 855 N.E.2d 592 (Ct. App. Indiana Oct 19, 2006).

17. Private Annuity Planning.

a. Negative Income Tax Consequences Outweigh Income Tax Advantage of Deferral. Before the issuance of the private annuity proposed regulation, some planners suggested selling appreciated assets to a family member for a private annuity just to defer gain recognition; the family member would typically immediately resell the asset, but the family member would have a stepped up basis and not recognize gain, and the original seller would only recognize gain on the private annuity sale pro rata as the payments were made. However, even before the recently proposed private annuity regulation was issued, that gain deferral transaction typically did not make sense, because the negative income tax consequences outweighed the benefits of deferral. The family eventually would be worse financially than if the owner had just sold the asset and recognized the capital gain all up front—largely because of the ordinary income element taxed to the seller without an offsetting interest deduction for the purchaser.

b. Example Situation Where Private Annuity Sale to Irrevocable Grantor Trust Makes Sense. Parents are willing to transfer a portion of their assets, but they need to maintain an income stream for life for support expenses. Typical planning strategies, such as gifts, GRATs, or sales do not make sense because eventually the cash flow stream to the parents may end and the parents need to live off the income of their assets. One planning strategy would be to sell enough assets for a private annuity to generate the needed annual consumption level.

One possibility is to contribute assets to an FLP and sell LP interests for a private annuity (taking a discount). The advantage is simple--regardless of when the clients die, none of the principal is subject to estate tax. They can completely eliminate substantial estate tax exposure with very little risk. The plan also operates as an estate freeze because the annuity is of a fixed amount and all future appreciation passes to the family member who purchased the assets for a private annuity. A disadvantage is that the purchasing trust is a grantor trust (to avoid gain recognition, ordinary income recognition without interest deductions, etc.) and if the assets appreciate substantially over time, the parents' income taxes on the grantor trust income could become substantial.

Problems with private annuity sale to grantor trust:
1. The annuity payment is almost exactly equal to the income from the property, creating a factual hurdle. There are several cases that have treated a private annuity as a trust substitute if the income is tied to the annuity payment. (Lazarus 58 TC 854; Rev Rul.68-183.) Avoid that result by not planning the annuity payment to equal to the income.
2. Income tax burden on the grantor from the continuing grantor trust status.
3. Exhaustion Test. The trust must have enough assets so that, if the assets produce income at the §7520 rate, the trust can pay the annuity payments for up to age 110. Substantial value in the trust may be required to satisfy that test. Perhaps guarantees by the trust beneficiaries could satisfy the exhaustion test. (If there is a private annuity sale to an individual there is no

exhaustion test. Similarly, having a guarantee by an individual should mean that the exhaustion test does not apply.)

4. Are the parents willing to sell their assets for 100% nonrecourse financing when there is a real possibility the purchaser will go bankrupt and not be able make all payments? The parents must have substantial faith that the trust beneficiaries will assure that annuity payment can continue for life.

5. If the trust runs out of money at life expectancy, this puts the beneficiaries who guaranteed the annuities in a difficult economic position of having to pay annuities over long time. This is reverse estate planning. (But discount arbitrage on the sale to the trust may help reduce the likelihood of that.)

Another approach is to use a SCIN with a grantor trust. That yields about the same economic treatment, and there is an argument that SCIN payments are not annuity payments for purposes of exhaustion test in the §7520 regulations.

18. Funding Bypass Trust If Poor Spouse (Or Other Family Member) Dies First, Using Trusts With General Powers of Appointment.

a. Significance; Applications. Being able to fund the bypass trust if the poorer spouse dies first is important for estate tax, GST tax, and creditor protection purposes. John Bergner points out that this is not just limited to the situation of a wealthy spouse and a poor spouse who does not own enough assets to fully fund a bypass trust. Other applications can be to avoid having to use retirement plan benefits to fund a bypass trust, or to fund all of the spouses' interest in a vacation home to a bypass trust. The same approach can be used for domestic partners so the poor partner could utilize some of the wealthy partner's assets to fund a bypass trust for the wealthy partner.

b. Mining Unused Estate Exemptions of Older Relatives. The approach can be used similarly in a parent/child or grandparent/grandchild relationship, to utilize the older individual's remaining estate tax exemption amount to leave some of the child's or grandchild's assets back into a bypass trust for the benefit of that child/grandchild. (As described in Item 18.c below, this will use up all or part of the younger person's gift exemption, but this is a terrific use of his or her gift exemption. It allows the younger person's assets to pass into a trust of which the younger person is trustee and a discretionary beneficiary and would also permit distributions to others without any gift, estate or GST consequences (assuming the older person would also have GST exemption to allocate to the trust).)

c. Private Letter Rulings. There have been four private letter rulings (PLRs 200101021, 200210051, 200403094, and 200604028) all involving the following elements:

- Wealthy spouse and poor spouse;
- The wealthy spouse created a revocable trust (in two of the rulings, both spouses contributed assets to a joint revocable trust) during lifetime;
- If the poor spouse predeceases, that spouse has a general power of appointment over all or a formula amount of assets (designed to utilize all of the poorer spouse's estate tax exemption amount) owned by the wealthy spouse;
- The poor spouse directs the assets back to a bypass trust for the wealthy spouse (either through exercise of the power or by allowing the assets to pass to the trust in default of exercise of the general power).

(The following discussion sometimes refers to the wealthy spouse in this scenario as the "donor" and the poor spouse as the "donee.")

IRS gave favorable conclusions on tax results (except for the basis issue).
1. Initial incomplete gift. When the donor creates the trust, there is an incomplete gift to the donee, because the donor can revoke the trust at any time.
2. Completed gift at death that qualifies for marital deduction. When the donee dies, there is a completed gift from the donor to the donee that qualifies for the marital deduction. (Some commentators have indicated that the marital deduction conclusion may be questionable.)
3. No estate inclusion of bypass trust at second spouse's death. The donee is deemed to be the transferor of assets to the bypass trust, so the bypass trust is not included in the donor's estate at his or her subsequent death under §2036 (even though the assets originally came from the donor).
4. No stepped up basis. In first two rulings, the IRS ruled that there would not a stepped up basis for the assets passing from the donee to the donor or bypass trust at the donee's death. The last two rulings did not address this issue.

d. Structure in Non-Marital Situations. In the domestic partners situation, provide that if the poor partner (i.e., the donee as described above) dies first, the poor partner will have a general power of appointment over the lesser of the amount to gross up the estate to the full estate tax exemption amount *or the wealthy partner's remaining gift exemption.* Limiting the general power to the wealthy partner's remaining gift exemption is necessary to avoid having a taxable gift at the poor partner's death (because the marital deduction would not be available in that situation.) This plan is even more conservative than the letter rulings—because there is no question about the marital deduction issue. The wealthy partner has to utilize his or her $1 million lifetime exemption—but the property comes back in a trust that is protected from creditors and for estate and GST purposes. That is a great result.

The same approach applies in a poor parent or poor grandparent situation, to utilize the remaining balance of that person's estate tax exemption to fund a bypass trust for a child or grandchild with that child or grandchild's assets. Again, the child or grandchild would utilize all of his or her gift tax exemption when the parent/grandparent dies, but that is a great use of the exemption—to create a trust that is creditor protected and from which distributions can be made free of estate, gift or GST tax implications.

e. Building Best Case for Avoiding Estate Inclusion At Second Spouse's Death. The IRS conceivably could change its position, and assert that the wealthy spouse is indirectly the grantor of the bypass trust for his or her benefit, thus triggering §2036. There are cases and rulings that the IRS could conceivably point to in order to support that conclusion. Estate of Sinclaire v. Comm'r, 13 T.C. 742 (1949); Rev. Rul. 81-166, 1081-1 C.B. 477; TAM 9518002. To rebut such a possible change of position, take steps to bolster the donee's independence. Make sure the donee knows of the existence of the power, consults independent counsel for advice, and affirmatively chooses to whether to exercise or not exercise the power. (Of course, there is always the risk that the donee spouse may exercise the power to leave the assets to persons other than the donor spouse.)

Another way to bolster this argument would be to structure the trust so that the poor spouse has a mandatory income interest in the trust at the poor spouse's death and so that the completed gift to the poor spouse at the poor spouse's death qualifies for the marital deduction as a QTIP trust under §2523(f) rather than as a "general power of appointment trust" under §2523(e). (This might be accomplished by saying that the poor spouse would have a general power of appointment only if he or she meets certain conditions (such as being under age 110) so that it will not be exercisable by the donee "alone and in all events," which is a requirement under §2523(e).) The regulations make clear that for QTIP assets that are includible in the donee's estate under §2044, the donee is treated as the transferor of those assets for estate and gift tax purposes. See Reg. §25.2523(f)-1(f), Ex. 11. See generally Gans & Blattmachr, Making Spousal Estate Tax

Exemptions Transferable, 19 Probate & Property 10, 15 (Nov/Dec 2005).

f. Notification of Power. Cases hold that a person with a power does not have to be aware of the power in order for it to be a general power of appointment. Nevertheless, the poor person should be informed of the power to help establish the bona fides of the overall transaction. (Again, the risk is that the person might exercise the power to leave the assets to someone else. See subparagraph i below.)

g. Structure to Avoid Gain on Funding. If the formula general power of appointment is a pecuniary formula and trustee of the trust can select which assets are subject to the power of appointment, will transfer of appreciated assets from the donor's revocable trust upon the exercise or upon default of exercise of the power result in gain recognition? The four private letter rulings do not address this address, but John Bergner says the answer is likely yes—consistent with using appreciated assets to satisfy any pecuniary obligation. If the donor and donee parties are spouses, there will be no gain on funding as a result of §1041. In non-spousal situations, planning alternatives would be to fund the appointive assets with cash or non-appreciated assets, extend the power of appointment only to specific assets (so that it would mirror a specific bequest), define the power as a fractional share, or give the donee a power over all of the assets in the trust (anticipating that assets in excess of the estate tax exemption amount would be appointed outright back to the donor).

h. Should You Get a PLR? The filing fee is $10,000, plus there would legal costs. An alternative is to try to structure the transaction in a manner so that even if the IRS reverses course, the client is no worse off than if he or she did nothing. (For example, give the donor a limited power of appointment in the bypass trust—so that there is no completed gift if the IRS were to view the original donor as having funded the bypass trust.) Significant legal issues include (i) availability of a gift tax marital deduction for the completed gift to the donee at the donee's death, and (ii) exclusion of the bypass trust from the donor's gross estate at the donor's subsequent death.

i. Requests for Revenue Ruling. ACTEC and the ABA Tax Section have requested IRS to issue a formal Revenue Ruling that planners could rely on without the necessity of seeking private rulings.

j. Risk That Donee Exercises Power in Unintended Way. One way of reducing this risk would be to require the consent of a non adverse party other than the donor to the exercise of the power. That would not prevent the power from being a general power of appointment under §2041. But do not use that approach if the intent is to qualify the deemed gift for the marital deduction as a "general power of appointment trust" under §2053(e) because that section requires that the power be exercisable "alone and in all events." (The gift may also qualify for the marital deduction as an outright gift or as a QTIP trust.)

k. Creditors' Rights. The donee's creditors may be able to reach assets that are appointed under a general power of appointment, although some cases have limited that result. Restatement of Property (Second) – Donative Transfers §13.4 (1986). (This Restatement is referred to in the section below as the "Restatement.") The donee's creditors generally cannot reach unappointed assets under a general testamentary power of appointment, although some state statutes have changed that result. Restatement §13.2 & 13.6.

As to the donor's creditors, the creditors may definitely reach the assets in the revocable trust before the donee's death. Upon exercise or default of exercise of the general power of appointment, fraudulent transfer statutes would suggest that the present creditors of the donor may be able to reach assets left to a bypass trust to the extent the transfer was made with actual intent to defraud, renders the donor insolvent, or is made at a time when the donor was incurring debts beyond his ability to pay. Even if the donee is treated as the transferor to the bypass trust for creditor purposes, having a third party trustee with discretion over distributions back to the donor may help in protecting assets in a bypass trust from the donor's creditors. ("Discretionary trusts" are typically protected from a beneficiary's creditors' claims where the beneficiary cannot force a distribution, but "support trusts" may be reached by a beneficiary's creditors to the extent the beneficiary can force distributions for support of the beneficiary. There have been some suggestions that a beneficiary's creditors may be able to reach trust assets of a spendthrift trust if the beneficiary is the sole trustee, though some state legislatures are passing statutes to negate that possible result.)

19. Credit Shelter Trust That Is Grantor Trust as to Surviving Spouse.

At a Workshop, Professor Mitchell Gans discussed the concept of a credit shelter trust that is a grantor trust as to the surviving spouse. (Professor Gans called this a "supercharged credit shelter trust.') He, Jonathan Blattmachr and Diana Zeydel are writing an article about this that will be published in the near future in *Probate & Property* magazine.

a. Goal. Create a standard bypass trust for the surviving spouse that is treated as a grantor trust as to the surviving spouse for income tax purposes. *[Another possible way of achieving that goal—in appropriate circumstances—might be for the bypass trust to consist of ownership in an S corporation in which the surviving spouse consents to a QSST election so that the trust is treated as a grantor trust as to the spouse under §678.]*

b. Advantages.
(1) Assets in the bypass trust could compound income tax free (assuming the surviving spouse has sufficient assets to pay the income taxes on the bypass trust's income).
(2) The surviving spouse can enter into income tax free transactions with the bypass trust (for example, swapping cash for appreciated assets before the surviving spouse's death so that the appreciated assets would be in the surviving spouse's estate and get a stepped up basis).
(3) The bypass trust can be created utilizing the deceased spouse's estate tax and GST exemptions.
(4) Distributions could be made to other family members after the first spouse's death without gift tax consequences. Perhaps the surviving spouse could also have a broad limited testamentary power of appointment over the trust.

c. Approach. For simplicity, assume husband is expected to predecease wife. Wife would create a revocable inter vivos QTIP trust for husband. The power to revoke the trust lapses at the husband's death; the trust becomes irrevocable, and provides that the assets pass to a bypass trust for wife that allows discretionary distributions for health, education support and maintenance of the first spouse and other family members (and if assets in the trust exceed husband's remaining estate tax exemption, the excess would pass to a QTIP trust for wife or outright back to wife).

d. Tax Effects.
(1) Wife does not make a completed gift when the trust is created because of her power of revocation.

(2) The gift from wife to husband is completed at husband's death, when the revocation power lapses. (Support: PLRs 200604028, 200403094, 200210051, 200101021; cf. Estate of Sarah Greve v. Comm'r, T.C. Memo. 2004-91 (decedent could withdraw assets from trust only with consent of adverse party, which meant it was not a general power of appointment, but requirement to get consent of adverse party terminated at the decedent's death; held that the general power of appointment came into being *at the moment of death* and the property was includible in the decedent's gross estate).) The PLRs say that the gift is complete the moment before death so the gift is to a spouse that qualifies for the marital deduction. The theory here is similar-that the completed gift occurs the moment before death when there is a surviving spouse for whom a QTIP trust could be created. *[To avoid the risk that the IRS would change its position on the "metaphysical"*

concept of the gift being completed by reason of the death of the spouse and whether the QTIP election can be made if the spouse is not alive the instant the gift to the trust is completed, wife could relinquish her revocation right—and complete the gift to the QTIP trust—sometime clearly before husband dies (for example, when he is critically ill). However, that approach would likely remove any argument for a stepped up basis at husband's death in light of §1014(e)-except to the extent that assets passing from a donor to a decedent and back to a trust with discretionary distributions for the donor is not subject to §1014(e).]

(3) The completed gift to the QTIP trust for husband should qualify for the gift tax marital deduction if the QTIP election is made for the year of the gift to the trust. (Observe that if wife is given power of appointment over the bypass trust, a question could be raised as to whether the gift tax marital deduction is available. A literal reading of §2523(b)(2) might suggest that giving a surviving spouse a power of appointment—even a testamentary power—might raise a marital deduction risk. However, commentators have said that interpretation of the literal wording of §2523(b)(2) does not make sense, e.g., Pennell, Estate Tax Marital Deduction, BNA Tax Mgt,Portfolio 843, n. 542. Legislative history for the 1981 Act that enacted the QTIP provision suggests that powers of appointment that only become exercisable after the death of the original donee spouse are permissible.)

(4) Wife will file a Form 709 for the year of husband's death, making the QTIP election for the trust.

(5) The trust assets are included in husband's estate under §2044.

(6) Under the trust, assets up to husband's remaining estate tax exemption amount pass to a bypass trust for wife; assets over that pass to a QTIP trust for wife or to wife outright. Thus, there is no estate tax in husband's estate on assets passing to the bypass trust.

(7) Husband can allocate his GST exemption to the bypass trust (i.e., wife would not make the "reverse QTIP" election). Thus, the bypass trust can be GST exempt, using husband's GST exemption.

(8) If distributions are made from the bypass trust to persons other than the surviving spouse, husband should not be making a gift (especially if there are ascertainable standards on distributions). See Treas. Reg. § 25.2511-1(g)(2).

(9) Trust assets are not includible in wife's estate at wife's subsequent death under §2036 or 2038 despite her retained beneficial interest or powers because of Treas. Reg. § 25.2523(f)-1(f) Ex. 11 ("because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038") [Mitchell Gans says "Example 11 is the biggest inadvertent giveaway the IRS has ever done."]

(10) The risk of inclusion under §2041 is not addressed in Treas. Reg. § 25.2523(f)-1(f) Ex. 11. To forestall the risk that the IRS might argue that wife's creditors might be able to reach the trust assets (because she contributed her assets to fund what eventually passed to the trust), and that wife's ability to allow trust assets to be used to satisfy her creditors might be a §2041 general power of appointment, provide that distributions may only be made to wife or her creditors for health, education, support and maintenance, thus falling within the HEMS exception under §2041. *[However, under some state's laws, the entire trust might still be reachable by wife's creditors despite the existence of the standard, thus raising the possibility of a §2041 risk.]*

(11) Assets in the bypass trust are treated as a grantor trust as to wife because there is a disconnect in the way the regulations treat as the transferor of the trust that is created as passing under a QTIP trust for estate vs. income tax purposes. While the first decedent spouse is treated as the transferor for estate tax purposes (as to §§2036 and 2038), the original donor spouse continues to be treated as the grantor for purposes of the grantor trust rules. **Treas. Reg. §671-2(e)(5)** provides:

> "**If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.** However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code [i.e., the grantor trust rules]."

The second sentence does not apply because husband does not have a general power of appointment over the trust (let alone exercise a general power of appointment). Therefore, the first sentence clearly says that the person who was the grantor of the original trust (i.e., wife in our example) is also treated as the grantor any trust to which those trust assets pass (including the bypass trust as well as a QTIP trust if part of the assets pass to a QTIP trust for wife).

(12) Wife does not make a taxable gift when she pays the income taxes of the bypass trust. Rev. Rul 2004-64.

e. <u>Reciprocal Trusts</u>. Because we never know which spouse will die first, should each spouse create a revocable QTIP trust for the other spouse? (At the first spouse's death, the surviving spouse would simply revoke the trust that had been created by that spouse.) Arguably there should not be a "reciprocal trust" doctrine problem under the <u>Grace</u> case, but that risk could apparently be avoided by building in differences in the trust terms . <u>Estate of Levy v. Comm'r</u>, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; trusts were not substantially identical and reciprocal trust doctrine did not apply); Letter Ruling 200426008 (citation to and apparent acceptance of Estate of Levy). Alternatively, husband and wife could create their respective trusts at different times (say more than one year apart).

f. Caveat. It may be impossible to "toggle off" the grantor trust treatment, and the surviving spouse could potentially be saddled for life with paying income taxes on an ever growing very large trust. (A subsequent relinquishment by wife of her right to receive discretionary distributions from the bypass trust may have potential gift implications.)

20. Ethics Issues for Estate Planning Attorneys.

a. Limits on Being Advocate for Client. Tax attorneys are not just the hired guns of their clients. While they are members of state bars (with ethical duties under state law), they are also "practitioners" before the IRS and are subject to additional ethical principles in Circular 230. (In this regard, realize that someone can be a "preparer" of a return and owe duties of a return preparer if the person gave advice regarding positions on the return, even if the person did not sign the return.)

b. Revealing Confidences; Conflict of Interests. Satisfying the tax ethical requirements of Circular 230 may put the attorney in conflict with the client. The attorney may be placed in the situation of disclosing confidences or giving advice because of what is in the attorney's best interest [i.e., to meet the requirements of Circular 230], not what is in client's best interest. In that case, the attorney might have to withdraw from representing client. Both the Model Rules and Circular 230 (§10.29) say that if there is a conflict between attorney's best interest and the client's best interest, the attorney must withdraw.

Circular 230 requires disclosure of information in various places. Section 10.20 details information that practitioners have to disclose. What if the client says not to tell the IRS (for example, not to tell where documents are located)? Section 10.20b deals with "ratting out" partners and friends. If the Office of Professional Responsibility ("OPR") makes a lawful request, the practitioner must provide any information in the inquiry about an alleged violation of Circular 230 by any person and must testify if asked. There is a privilege against self incrimination, but that may not protect against testifying about what the attorney's partner did.

On the other hand, the Model Rules (§1.6) require informed consent by clients before revealing confidential information. The Model Rules say that an attorney may reveal information if necessary to comply with another law. If Circular 230 is "another law" for that purpose, then the attorney could reveal the information. (The ACTEC Commentaries on the Model Rules of Professional Conduct in relation to estate planning and probate matters say that whether the requirements of Circular 230 circumvent the Model Rules is a matter of state law not covered by the ACTEC Commentary.)

In any event, prior to revealing any confidences, the lawyer MUST discuss the situation with the client.

c. Knowledge of Client's Omission; Duty to Amend Incorrect Returns. If the attorney knows of an omission, the practitioner must advise the client promptly of the fact of the noncompliance. That's all §10.21 of Circular 230 requires. It does NOT say the attorney must inform the IRS. When the attorney advises the client about the omission, the attorney must also tell the client about the consequences of not disclosing the error. However, there is no requirement on the practitioner to file an amended return to correct the omission. One approach: "Do you want to tell the IRS, or do you want us to be in the position of having to tell the IRS at some point that we knew of the error but could not report it."

The practitioner cannot lie to the IRS, cannot allow a misstatement to go the IRS, and cannot knowingly allow a client to mislead the IRS.

If a client does not allow the practitioner to amend a return, and if that affects another return—the practitioner cannot participate in the preparation of the other return (for example, a gift tax return or estate tax return is based in part on prior gift tax returns).

d. Advice Regarding Tax Positions and Penalty Effects. This is covered by §10.34 of Circular 230—which is almost as important as the highly publicized covered opinion rules of §10.35. Section 10.34 applies to both written AND ORAL advice; it is broader than §10.35 in that respect. Section 10.34 applies both to persons signing returns and persons giving advice about positions on returns.

As an example, if there is a sale to a grantor trust, no return is required to report the transaction. But if the seller will file a gift tax return to report a sale non-gift transaction, the advisers are subject to §10.34.

Section 10.34(a) says that a practitioner can sign or give advice about a return only if positions taken on the return either (1) have a realistic possibility of being sustained on the merits (meaning a 1 in 3 chance of succeeding, §10.34(d)(1)), or (2) are not frivolous (i.e., "patently improper," §10.34(d)(2)) and are adequately disclosed to the IRS. If a position does not satisfy the realistic possibility standard, the adviser must advise the client of the opportunity to avoid accuracy-related penalties by adequately disclosing the position and the requirements for adequate disclosure.

Section 10.34(b) requires that a practitioner advising about a position on a return must inform the client of penalties reasonably likely to apply and inform the client of the opportunity to avoid such penalty by disclosure. The advice requirement applies even if the practitioner is not subject to a penalty with respect to the position.

Section 10.34(c) addresses when the practitioner might rely upon information furnished by the client. The practitioner may not ignore information known by the practitioner and must make reasonable inquiries if the furnished information appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

Most attorneys probably don't discuss penalty protection with clients, but §10.34 requires it. Consider preparing a penalty protection statement and give it to all clients. Perhaps put it in the engagement letter. Of course, consider also including a penalty protection statement in actual advice given to clients. Mary Ann Mancini says that attorneys have gone way overboard on §10.35, the "covered opinion" section of Circular 230, (including putting disclaimer provisions on all e-mails, including transmittals of jokes), but are ignoring the important penalty protection notice requirements of §10.34.

21. Long Term Health Care Insurance.

a. Significance. Forty three percent of people age 65 and older will spend some time in a nursing home, but many of them are short term stays. Only about 5% of the overall population will be in a nursing home more than 3 years. Nursing home costs average $71,000 per year. There are severe limits on what will be paid by Medicare, Medigap policies, or Medicaid, and long term health care insurance is becoming increasingly significant. There are certainly negative features and concerns of long term health care insurance, but clients should at least consider it while they are still able to get it (the programs are selective and medical underwriting is required).

b. Limits of Medicare Coverage. Medicare was established in 1965 and has not been adjusted much since then. Requirements include:
1. The patient must have gone to hospital within the prior 30 days.
2. The hospital stay must be at least 3 days not counting the day of discharge.
3. The facility must be Medicare approved; that is not a difficult hurdle.
4. In the nursing home, the patient must receive skilled nursing care (under a doctor's care) on a daily basis for the health problem for which they were hospitalized. About 90% of care in nursing home is not skilled care. This is a huge trap for the unwary.
5. Duration of stay: Even if the other requirements are satisfied, Medicare pays only for the first 20 days, and thereafter just pays costs beyond a per day deductible ($124 per day in 2007) . (In 1965, it may have been true that most patients in nursing homes either went home after 20 days or died. But that is not the case now.)

Sometimes Medicare will pay some home health care costs. But it is limited to 28 hours per week—or only 4 hours per day. The care must be skilled care pursuant to doctor's order that is reviewed every two months.

c. Medigap Limits. For long term health care, the only optional benefit that applies under supplemental "Medigap" policies is to cover the per day deductible ($124/day in 2007) for skilled care in days 21-100. For that to be covered, all the other requirements of Medicare coverage must be met. After 100 days, there is no coverage for skilled care under the Medigap coverage. There is no coverage at all for custodian care or intermediate care.

d. Medicaid Limits. Adult children often push their older parents to get long term health needs provided by Medicaid. However, there are very harsh requirements. A substantial limitation is that nursing homes severely limit the number of Medicaid patients. If someone calls a nursing home about placing a patient, the nursing home will ask if payment will be paid privately or by Medicaid. If by private pay, the patient can come tomorrow. If by Medicaid, "we'll get back to you." There are also severe eligibility requirements. For example, the patient can only have "countable" assets of $2,000, and under recent legislation there are heightened restrictions on transfers to be able to meet the strict eligibility requirements.

e. Long Term Care Insurance. It is too late to look for it after you need it. A frequent response is that “I may not need it”—but that is the point of insurance.

22. Vacation Property.

a. Family Meeting to Address Long Term Intent. It is important to have a family meeting to determine if children and grandchildren really intend to keep the property or sell it. If they intend to sell it, complicated ownership and management structures can be avoided (and planning to get a stepped-up basis may be emphasized). There can be a whole range of emotions involved in this decision. Sometimes family members will end up selling the property either because they can't afford it or find there is no strong attachment to the property after the parents’ deaths. There should be family consensus on a master plan to deal with the property. As far as transferring ownership, the younger generation may not realize this, but the parents can SELL the property to family members—they do not have to give it away. In any event, the family should understand that disagreements very often arise among family members over a long term basis with issues that arise in the ongoing operation of the property. They should anticipate that eventually there will be a “blowup.”

b. Endowment Typically Insufficient. Often trusts or other ownership structures are established with an endowment to maintain the property, but rarely is it enough to maintain the property. Property taxes and insurance constantly increase as the property appreciates, and the family's lifestyle is increasing—for example, younger family members now expect to have a wireless network in the cabin.

c. Inflexibility of Trusts. Wendy Goff says that irrevocable trusts are inflexible and difficult to amend. There are fiduciary duty issues if the trustee is also a family member who uses the property.

d. LLCs. Wendy Goffe prefers an LLC ownership rather than an irrevocable trust ownership structure.

- Management. Parents can initially be the initial mangers and transfer management over time.
- Ownership Transfers. Parents can transfer units and get minority and marketability discounts, and discounts may be available for interests still owned at death.

- Creditors. The property is protected from creditors' claims of the members. The LLC shelters the family from liability attributable to the property—which is especially worrisome if there are extended periods with no one on site to manage the property.
- Perpetual existence.
- Flexibility; easy to amend.
- Be careful to avoid having the LLC disregarded for a lack of business purpose. Business purposes can include management of the property, and even actual operation of a business if the property is rented.

Disadvantage of LLC Structure—No §121 Exclusion. If the senior generation continues to own than the entity and the property is later sold, the clients lose out on the opportunity to exclude gain under §121.

e. Revocable Trust. A "training wheels" approach is to contribute the property to a revocable trust and work out the management of the cabin over time. If that does not work, the trust can be revoked or amended as needed. If it is working, the revocable trust can continue owning the property and it could become irrevocable at the parents' deaths.

f. Management Agreement.

Appendix A has a sample management agreement. The primary goal of the agreement is to facilitate the ongoing use of the property and to resolve potential conflict issues. Issues that should be addressed include the following. (This is a terrific list for letting the family know of the myriad issues they will need to address if they want to keep the property in the family for common use on a long term basis.)

- Schedule for use. (This gets to be dicey when kids are school age; spring breaks and holidays are in demand).
- Can outsiders use, and on what basis?
- Rules that will be enforced for using the property
- Limits on smoking, pets, strong perfume
- Provisions for management dues and assessments
- Penalties for nonpayment of dues or assessments (Beneficiaries typically have a right of contribution among themselves if someone does not pay.)
- Repairs—what if there are disputes over what repairs are appropriate?
- Rent
- Managers and successor managers
- Can outsiders become owners?

- Can family members withdraw? What value do they receive? Will that place a huge burden on the rest of family? (Example—buyout at 80% of fair market value with a long term payout. Members may be able to buy out nonfamily member if awarded in divorce.)
- Periodic replacement of improvements like docks or decks
- Addressing potential financial or other crises of owners, such as divorce or bankruptcy.
- How to resolve disputes
- Transfer restrictions (for example, allow transfers to descendants of a specified common ancestor; What about spouses of those persons? What about stepchildren?)
- Voting procedures on unusual events—such as selling the property or amending the rules
- Balance against arbitrary management by allowing members to call meetings

Responsibilities of the manager may include the following:
- It is often best to have a family manager to with the responsibility to maintain the property in its current condition.
- Capital improvements are typically made only with consent—except for emergency situations
- Maintain insurance within specified limits
- Pay taxes
- Lease the property
- Account and report to family members
- There are provisions for compensation and reimbursement of expenses

The use schedule can take various approaches and priorities. Alternatives include a fixed rotation system, priority for the manager, priority based on age or length of travel required, longer use periods allowed if the person is willing to open the cabin at the beginning of the season or close it at the end of the season, and longer use periods during "off times".

g. Family Homeowners Association. If there are large parcels and multiple cabins, a family homeowners association may be appropriate. The association could be responsible for common improvements—dock, swimming pool, tennis court etc. The association could provide a procedure for subdividing the property and causing each lot to be subject to covenants; development restrictions and guidelines; design standards; use restrictions; penalties for compliance; restrictions on transfers, etc. The association could be formed as a partnership, LLC, or not-for-profit association. (If organized as a not-for-profit entity, it can qualify for an income tax exemption for revenue received from its members under IRC §§501(c)(6) or 528.)

h. Be Wary of Family Dysfunction. "You can't patch up family dysfunction by buying a cabin."

23. Impact of Societal Megatrends on Estate Planners.

Mark Edwards thoughtfully explored changes in the estate planning practice in light of huge societal changes.

a. Perfect Storm of Forces of Change.

(1) Tax Reform. There have been substantial changes in wealth transfer taxes and there is considerable uncertainty over ongoing changes.

(2) Financial Situation. From the losses of 2000, clients have lost six years of compounding-and they will never be regained. The Dow is now at a high. Clients' willingness to engage in estate planning is related to their net worth and feeling of security. Clients used to look at 10-12% gain per year from their investment portfolio, and now only anticipate about 6-7% per year. There are now 50 year lows in terms of interest and dividend yields on financial assets. Financial forces will make capital much harder to acquire in the future.

(3) Aging of the Boomers. From now to 2020, persons over 65 in the U.S. will increase by 44%. In the same period, the number of persons under 19 will grow by 13%. So either there will be an 80% increase in FICA taxes or there will be cuts in what the old people get. Neither is a good political solution.

(4) Natural Anxiety as People Age. The major focus of many people will be: Can I preserve my dignity and independence for the rest of my lifetime?

b. Summary of Changed Focus for Estate Planners. Traditional estate planning has been to focus on the "snapshot" of values at the date of death and to reduce the amount of assets in that snapshot. In the future, clients will be less interested in the "snapshot" than a "long range video" of how they get from 65 to 95 and how to take care of themselves if they become incapacitated. "I want to make sure my money lasts as long as I do. I want to make sure my capital is used wisely."

This changed focus will lead to various changes in planning: (1) More targeted giving; (2) More concern about selves rather than heirs; (3) More concern about incapacity issues.

c. Targeted Giving. Targeted giving will become paramount. The aging of the boomers creates a huge burden on "sandwiched" clients—taking care of parents while also sending children to college. For example, clients will be more interested in providing for the education of grandchildren than just making general wealth transfers. "In many families, grandparents are the secret ingredient that makes the difference between a life of struggle and a life of relative ease." Clients want to make sure that their capital is used to make life better for their children and grandchildren rather than just writing checks.

d. More Concern With Own Support. People will be more concerned about themselves than their heirs. Traditionally, family financial planning has involved three phases: accumulation, conservation, and distribution. Many clients in the future won't even visualize a distribution phase.

e. Capacity Concerns. Dementia is the normal cause of lack of capacity. It is a condition, not a disease. The most common cause is Alzheimer's disease. The incidence of dementia is estimated to double every 5 yrs after age 60, ranging from 1% at age 60 to 35% at age 85.

Identifying Incapacity. We think of incapacity as a sudden event, but it is usually like the fog in San Francisco that builds slowly until one can't see anything. People are very good with making up for a lack of incapacity. They take clues from the context of conversations and cover up. Many people suffer from dementia two to three years before family members realize it.

Wonderful Resource—Assessment of Older Adults With Diminished Capacity: A Handbook for Lawyers (April 2005) costs $25. Mark Edwards urges everyone to get it. "It is the best single resource for dealing with clients who may be incapacitated."

"Short Portable Mental Status Questionnaire." There are 10 questions—and many of those can be woven into any estate planning conference. (1) Date (2) day of the week (3) name of this place (4) telephone number (5) age (6) birth date (7) current President (8) President before him (or her) (9) mother's maiden name (10) subtract three from 20, and keep subtracting three from each new number all the way down. Scoring scale: 0-2 errors-normal; 3-4 errors-mild cognitive impairment; 5-7 errorsmoderate cognitive impairment; 8-10 errors-severe cognitive impairment.

Dealing with incapacity raises difficult issues for the attorney. If the attorney addresses potential incapacity with the client's adult child, the client may sue the attorney for violating confidentiality. The ACTEC Commentaries say that if the attorney has an established relationship with the client, ask the client- "if at some point in the relationship you don't seem quite right, can I call Dorothy and ask?"

f. Power of Attorney. Most attorneys just use a single form. However, the power of attorney for a 45 year old can be far more rote than the power of attorney for the 73 year old who is starting to show signs of going downhill. Powers of attorney will have to be more customized—and attorneys should charge more for them in light of the planning required to customize them.

g. Revocable Trust. The revocable trust can also be used to deal with incapacity. How does an agent under a power of attorney deal with the revocable trust? UTC-the agent can take whatever actions with regard to the trust that are set out in the power of attorney and the trust. Whatever is put in the power of attorney regarding the trust should also be put in the trust agreement.

24. Selected Resources and Forms.

Page references with a roman numeral are from the Workshop materials. Page references with a Chapter number are from the main podium speech materials.

a. Estate, gift, and GST tax laws in 50 pages. The first 50 pages of the Fundamentals Program Materials consist of an excerpt from Pennell & Newman, Estate and Trust Planning (ABA 2005). It is a terrific primer and all estate planners may want to have this handy as a desk reference.

b. Buy-Sell Agreement Forms (succinct redemption, cross purchase, and hybrid forms) (Zaritsky) (Fundamentals Program Materials 2-226 to 2-261)

c. Issues for creating private trust companies, including a discussion of firewalls that might be used. (Duncan, Conway) (I-E)

d. Income tax consequences of unwinding partnerships—a concise understandable discussion of the §§704, 731 and 737 rules. (Aucutt, Markstein) (II-B)

e. Potential liability for failure to diversify; Suggested drafting language for investment decisions and principal/income accounting, including directions for diversification or holding concentrated positions and drafting for directed trusts. (Acker, Porter) (II-C 44-61)

f. Uniform Principal and Income Act; Treatment of dividends and liquidations under income/principal allocation rules; Income/principal accounting for partnerships (Acker, Porter) II-C 23-25)

g. GST; Example form for making qualified severance (Form 706-GS(T)) and Severance Agreement. (Schneider, Harrington) (II-D)

h. GST-Modifying grandfathered trusts; Sample trust clauses illustrating ways to change the trust terms without changing the "succession of interests." (Harrington) (II-D)

i. Delegation Agreement Forms (Belcher) (III-C)

j. Discussion of directed trustees and liability of co-trustees and successor trustees (Wernz) (III-C) (This is one of the best resources on this topic that I have ever seen.)

k. Circular 230 (the entire Circular, not just §10.35) (III-E)

l. Derivatives; Excellent simple explanation of derivatives (calls, options, collars, etc.) and tax rules for them. (Albright) (III-F)

m. Forms for revocable trust with general power of appointment for spouses and non-spouses (14 different forms) (Bergner) (IV-C)

n. Real estate law primer for the estate planner (including choice of deeds, effect of title insurance, §121 gain exclusion for principal residence, tax free exchanges, and conservation easements) (Goffe, Osborne) (IV-D)

o. Detailed example of income taxation of private annuities (for both seller and buyer) (Hesch, McGrath) (IV-E)

p. Sample management agreement for managing vacation property (Goffe) (Ch. 16 Appendix A)

25. <u>Interesting Quotes of the Week</u>.

(1) On grandchildren: A client told Stacy Eastland when talking about his grandchildren: “The little darlings are coming Thursday and the little bastards are leaving Sunday.”

(2) Another take on grandchildren: “Grandparents have a special bond with grandchildren: they have a common bond—an enemy between them.” -Mark Edwards

(3) Take what is said from the podium with a grain of salt. Ron Aucutt calls that “podium chloride.”

(4) Summary of differing viewpoints on FLPs by IRS and planners: Ron Aucutt asks how much someone would pay for your FLP with “100” worth of assets. Very few would say 50 or more. The cases all seem to overvalue FLPs based on that. But why did you put in 100 into the partnership? In the family context, you do that because at end of the day will get full value and enhanced value. From the IRS’s perspective, they say you WILL get 100 at the end of the day, so they think courts have valued LP interests too low. The approach toward FLPs “becomes a matter of emotion, rather than analysis.”

(5) Inherent long term uncertainty raised by §2036 in FLP planning. “The only way to start the estate tax statute of limitations is to die.” -Ron Aucutt

(6) “Commentator—someone who does not have to sign a tax return.” -Charles Ratner

(7) Division of assets. If the estate plan calls for division of assets, Jonathan Lurie sometimes uses the “Biblical method.” One party divides the assets into two portions, and the other party gets to pick which of the portions that he or she wants.

(8) Section 2040. Here’s a way to remember how §2040 operates: Between spouses, ½ is included at each spouse’s death, and no problem when created. But for non spouses, 100% of the joint tenancy property is included in each tenant’s estate. Why the rule? “It’s just a mean nasty rule.” -Carol Harrington

(9) Modifying grandfathered trusts. If something has been changed about a grandfathered trust, it is hard to fix it. But don’t just concede that something outside a safe harbor listed in the regulation is bad. The IRS as a practical matter doesn’t want to litigate this. “They would rather just terrify the rest of us with uncertainty and not risk a court loss.” -Carol Harrington

(10) GST complexities. How much case law is there in the GST area? Very slim. It appears that there is not much audit action for the

generation-skipping transfer tax. “So if you know a lot, you end up being a policeman for the IRS when everyone else ignores it”. – Carol Harrington or Pam Schneider (I don’t remember which, but both must be tremendous policemen for the IRS because they both know “A LOT” about the GST tax.)

(11) Diversification. There is an old adage: “To get rich—do not diversify. Put all eggs in one basket and watch that basket. But to stay rich, you must diversify.”
-Dennis Belcher

(12) Predictions. “Predictions are difficult--especially about the future.”
-Someone quoting Yogi Berra

(13) Education and health care. “There is a very common desire among wealthy clients. No matter how conflicted they are about leaving too much wealth to descendants and depriving them of incentive to work or develop good family values, they are always concerned about providing access to good education and health care for grandchildren and descendants. Education is the goal foremost over health care. But as the health care situation gets worse and worse, unless it corrects itself, health care will become equally or more important.” -Pam Schneider

(14) Investments. “No matter what index you look at, only 1 out of 3 stocks in the index beats the mean average.” -Stacy Eastland

(15) On aggressive planning by other planners: “We will defend your client down to his last dollar-----but no further.” -Larry Brody

(16) Jury perception of an attorney-defendant. “Lawyers are like politicians. They’re all crooks—except my own.” -Kevin Rosen

(17) Approach to transfer planning and discounts: “The size of the discount in the long run is the least significant factor in all of the estate transfer techniques. So if your client is audit adverse, take a discount that is typically allowed in the area, and lower the audit risk.” -Jerome Hesch

(18) Vacation home and family planning. “You can’t patch up family dysfunction by buying a cabin.” -Wendy Goff, citing the final episode of the 4th season of “The Sopranos” as Tony bought a cabin to draw the family together and Carmella kicked him out of their house a week later.

(19) On the possibility of leaving assets that were transferred to an inter vivos QTIP trust back into a bypass trust for the original

donor spouse because Reg. §25.2523(f)-1(f) Ex. 11 says the donee spouse is treated as the transferor, not the original donor, so §§2036 and 2038 do not apply: "Example 11 is the biggest inadvertent giveaway the IRS has ever done." -Professor Mitchell Gans

(20) Growing concern of having sufficient living expenses for retirement years: "There will be a growing concern of many people to make sure that they can pay their own support expenses rather than transfer planning. Their main concern is 'trying to avoid a cat food diet and a Wal-Mart greeters pension.' Life is forcing our clients into a different paradigm. They are not as concerned with what happens 'when I die' as concerned with 'how to get to when I die'." -Mark Edwards

(21) Aging population—for the "rest of history." March 27, 2004 Economist Magazine: "This year or next, the proportion of people aged 60 or over will surpass the proportion of under fives. *For the rest of history*, there are unlikely ever again to be more toddlers than gray heads." Mark Edwards adds "…and I defy you to make a pyramid stand on its tip very long."

(22) Resource for attorneys regarding incapacity planning. Assessment of Older Adults With Diminished Capacity: A Handbook for Lawyers (April 2005) costs $25. Mark Edwards urges everyone to get it. "It is the best single resource for dealing with clients who may be incapacitated."