ACTEC 2014 Annual Meeting Musings

March 2014

The American College of Trust and Estate Counsel is a national organization of approximately 2,600 lawyers elected to membership. One of its central purposes is to study and improve trust, estate and tax laws, procedures and professional responsibility. Learn more about ACTEC and access the roster of ACTEC Fellows at www.actec.org.

This summary reflects the individual observations of Steve Akers from the seminars at the 2014 Annual Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Item 110-112 are observations from a seminar by Deborah Green, Deborah Tedford, and Margaret Murphy, The Affordable Care Act and Social Security: Where Do They Fit In Estate Planning?

April 28, 2014

Important Information Regarding This Summary
This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

INTRODUCTION

Some of my observations from the 2014 ACTEC Annual Meeting Seminars in Tucson, Arizona on March 6-9, 2014 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues from the seminars that I attended. (Recordings of all of the seminars are not yet available.) The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-18 are observations from a seminar by Sarah Butters, Charles D. Fox, IV and Ellen K. Harrison, Hot Topics

1. LEGISLATIVE AND REGULATORY DEVELOPMENTS

a. ***Priority Guidance Plan.*** The Plan had no real surprises this year. One new item is to provide guidance about QTIP elections made solely to elect portability in light of Rev. Proc. 2001-38, as requested by ACTEC and other organizations. The Rev. Proc. 2001-38 issue is discussed at Item 5.g of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.

   Being on the "business plan" does not matter much. The average time the transfer tax items have remained on the business plan is 6 ½ years.

b. ***Administration's Fiscal Year 2015 Revenue Proposals—Generally.*** The estate and gift tax provisions are disappointing; they are much the same as last year. Transfer tax items are summarized at Item 5.g of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor. ACTEC representatives have met with the Joint Committee on Taxation staff and addressed various technical issues with the proposals, but have received no response so far.

c. ***Administration's Fiscal Year 2015 Revenue Proposals—Proposal to Simplify Gift Tax Annual Exclusion.*** Referencing the complexity of administering *Crummey* trusts and the potential abuse of having multiple beneficiaries with withdrawal powers "most of whom would never receive a distribution from the trust," the administration proposes deleting the present interest requirement for annual exclusion gifts, allowing $14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a $50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment.

   This proposal appears to have arisen from reports about possible transfer tax reform proposals, some of which have included ACTEC as a participant. Possible alternatives for simplifying the annual exclusion were presented in a 2012 report from the ABA Tax Section and Real Property Trust & Estate Law Sections.

   The Greenbook describes the proposal in very brief terms as follows:

   > The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to

> the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The reference to "transfers of interests in passthrough entities" probably relates to the complexities of whether interests in partnerships or LLCs constitute present interests (which the IRS has had success in attacking, as reflected in the *Hackl*, *Price*, and *Fisher* cases).

The effect of the proposal is to allow gift tax annual exclusions for:

- Gifts paid directly for tuition or medical expenses, §2503(e);
- Gifts of $14,000 per year (in 2014, indexed amount) (but not including gifts to trusts [other than "vested" trusts, as discussed immediately below], passthrough entity interest gifts, transfers subject to sale prohibitions, and transfers that cannot immediately be liquidated by the donee) for (i) outright gifts and (ii) gifts to "vested" trusts (described in §2642(c)(2), which has the effect of allowing a trust similar to §2503(c) trusts but without the requirement of terminating at age 21); and
- Gifts of up to $50,000 annually in the aggregate (regardless how many donees enjoy such gifts) for (i) trust transfers (other than transfers to "vested" trusts, for which the $14,000 per donee exclusion would apply), (ii) passthrough entity interest gifts, (iii) transfers subject to sale prohibitions, and (iv) transfers that cannot immediately be liquidated by the donee.

(Estimated ten-year revenue: $2.924 billion)

d. ***Administration's Fiscal Year 2015 Revenue Proposals—Expand Definition of Executor.*** The definition of "executor" in the Internal Revenue Code applies only for purposes of the estate tax. No one has explicit authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent's death. This includes actions such as extending the statute of limitations, claiming a refund, agreeing to a compromise or assessment, or pursing judicial relief regarding a tax liability. The proposal would make the Code's definition of "executor" applicable for all tax purposes "and authorize such executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or obligations that the decedent could have done if still living." Regulations could provide rules to resolve conflicts among multiple executors. The proposal would be effective upon enactment, regardless of a decedent's date of death. (Estimate ten-year revenue: Zero)

e. ***Retirement Plan Proposals.*** Holdover proposals from last year are sweeping. One proposal is the "no stretch IRA" provision requiring that IRAs and retirement plan benefits be paid out over 5 years (with a few exceptions, including for surviving spouses). A change from last year's proposal is that the "no stretch IRA" proposal and the minimum required distribution requirements would also apply to Roth IRAs. (The Roth IRA provision is significant. One of the main objections to making Roth conversions, requiring the payment of substantial current income taxes in return for long-term benefits, is that Congress could later change the rules to extinguish the advantages. This proposal does significantly cut into the anticipated long-term advantages of Roth IRAs.)

Another holdover from last year is to place a cap on contributions to qualified plans, equating to about $3 million of benefits. No further deductible contributions would be permitted unless the investment performance declined to the point that the projected benefits fell under the threshold. ACTEC submitted comments on the proposal last year, primarily pointing out that the proposal would be very difficult to administer. There has been no response to the comments. Perhaps ACTEC can have more influence if and when this proposal is considered by Congressional tax-writing committees.

2. Late Portability Elections

Rev. Proc. 2014-18 (issued January 27, 2014) allows a simplified relief procedure (with no user fee being required) for estates below the filing threshold who did not file the election return timely. Perhaps they were unaware of the need to file the return in light of the newness of the regulations or were those same-sex couples who were retroactively recognized as spouses in Rev. Rul. 2013-17, 2013-38 I.R.B. 201. It grants an automatic extension for filing the estate tax return making the portability election until December 31, 2014 as long as several conditions of the procedure are satisfied. This Revenue Procedure is discussed in more detail in Item 5.b of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.

3. Same-Sex Marriage Issues

Developments are occurring weekly regarding state law recognition of same-sex marriage (the most recent developments being court cases finding various state same-sex marriage prohibitions to be unconstitutional). The Kentucky case is interesting in that the Kentucky attorney general has refused to appeal the case. The Kentucky governor wants to appeal anyway, and is seeking approval for independent counsel to appeal the case.

The federal government continues to indicate that it will follow a state of celebration standard for various purposes, including for purposes of recognizing the spousal privilege from testifying in federal proceedings. The Department of Defense has announced that it will apply a state of celebration standard for military benefits for active military (even though the Veterans Administration does not apply a state of celebration standard for retired military). (Similarly, the Social Security Administration does not apply a state of celebration test; the statutes underlying the Social Security and Veterans Administrations appear to preclude using a state of celebration standard.)

For a more detailed discussion of same-sex marriage issues, see Item 29 of the Hot Topics and Current Developments Summary (December 2013) found here and available under Insights at www.bessemer.com/advisor.

4. Self-Canceling Installment Note Sale Transaction Attacked in *Estate of William Davidson*

The IRS is attacking several sales of hundreds of millions of dollars worth of closely held stock to grantor trusts for self-canceling installment notes (SCINs) in *Estate of William Davidson*, Tax Court Cause No. 013748-13 (filed June 14, 2013). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over **$2.6 billion (**although the IRS acknowledges in its answer that it "did not calculate certain deductions and credits to which [the estate] may be entitled."). The trial was set for April 14, 2014, but on the joint motion of the parties for continuance, the court on December 4, 2013 removed the trial date from the court calendar and ordered the parties to file joint status reports with the court every three months, beginning September 14, 2014. The trial judge is Judge Gustafson.

For a more detailed discussion of the facts in Estate of Davidson and the legal issues that the court will address, see Item 39.g of the Hot Topics and Current Developments Summary (December 2013) found here and available under Insights at www.bessemer.com/advisor.

5. Installment Sale to Grantor Trust Transaction Attacked in *Estates of Woelbing*

The IRS is also attacking an installment sale to grantor trust transaction (involving "standard" notes) in *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13 (filed December 26, 2013). In 2006 Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin that produces Carmex lip balm) to a trust (presumably a grantor trust) in return for a promissory note having a face value of about $59 million, bearing interest at the AFR. The note contained a defined value provision stating that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note. (Observe: Interestingly, the planners were using a "Wandry-type" defined value clause back in 2006 in this sale transaction.) The purchasing trust owned life insurance policies (subject to split dollar agreements) and Mr. Woelbing's three sons provided personal guarantees to the trust for 10% of the purchase price. The spouses filed gift tax returns for the year of the sale (and subsequent years) making the split gift election.

The IRS Notices of Deficiency for both Mr. and Mrs. Woelbing takes the position that the $59 million note should be valued at zero because of §2702 (without further explanation), or alternatively that stock was worth more than $59 million and the excess value should be treated as a gift. In addition, the Notice of Deficiency for Mr. Woelbing alleges that the note should not be included in his estate but the stock that was sold should be included at its date of death value under §§2036 and 2038. (The Notices do not discuss what facts might support inclusion under §2038.) The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over $125 million and penalties over $25 million (asserting both gift and estate tax understatement 20% penalties).

This case is illustrative of the danger of making the split gift election for a transaction that might have §2036/2038 implications. If the transferred asset is included in the donor's gross estate, there is no relief for the gift tax paid by the consenting spouse as to her one-half of the gift amount.

There seems to be a trend of IRS attacks on installment sales to grantor trusts, but is this primarily just a valuation case? (The IRS contends that the value of the transferred units was $116.8 million compared to the $59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin,* T.C. Docket No. 2127-03, filed Feb. 10, 2003) or drops the §§2702, 2036 and 2038 arguments (as it did in *Dallas v. Commissioner*, T.C. Memo. 2006-212). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller's estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale-to-grantor-trust transaction.

For a more detailed discussion of the *Woelbing* cases, see Item 13 of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.

6. Planning for Surviving Spouse Who is Beneficiary of QTIP Trust; Sale of Assets for Deferred Private Annuity, *Estate of Kite*

In *Kite v. Commissioner,* T.C. Memo. 2013-43 (decision by Judge Paris), the IRS addressed a case in which assets of a QTIP trust were distributed to the surviving spouse, who sold the assets the following day to her children for a deferred private annuity (payments would not begin for 10 years). The spouse died before any of the annuity payments became due and received no annuity payments. The court held that the sale of the assets for the deferred private annuity was for full consideration (using the Treasury's mortality tables because the decedent was not "terminally ill" as described in Reg. §1.7520-3(b)(3)). However, the court held that the combination of the distribution from the QTIP and the sale of the assets constituted a disposition under §2519 triggering a deemed gift of the remainder interest. (Prof. Pennell at the 2014 Heckerling Institute said that the §2519 ruling "is as wrong as it can possibly be.")

The court subsequently issued an Order and Decision regarding the Rule 155 computations of the gift tax as a result of the decision in *Kite* (Cause No. 6772-08, unpublished op. Oct. 25, 2013). The estate argued that no gift resulted from the deemed transfer of the remainder interest under §2519 because of the court's decision in *Kite* that the surviving spouse's sale of assets that she received from the QTIP trust in return for a deferred private annuity was a bona fide sale for adequate and full consideration. Neither the statute nor regulations make clear whether the gift that results from a deemed transfer of the QTIP remainder interest under §2519 is the full value of the remainder interest or whether it is reduced (under traditional gift tax principles) by any amounts paid to the spouse to replace the value of the remainder interest in his or her estate. One sentence in the legislative history to §2519 states that the gift amount would be determined after subtracting any amounts paid to the spouse. However, the court in the Rule 155 Order interpreted §2519 to mean that the full amount of the deemed transfer of the QTIP trust remainder interest is a gift, regardless of any consideration received by the surviving spouse. "[A] deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration." Prof. Pennell at the Heckerling 2014 Institute concluded "That makes no sense. It is completely wrong." A panelist at the ACTEC Hot Topics discussion concluded: "I'm not sure this is the last we have heard on that." (Interestingly, the Rule 155 Order is no longer available on the Tax Court website.)

A detailed discussion of the Kite Rule 155 Order (including a hearty criticism of the reasoning in the Order), is available here or under Insights at www.bessemer.com/advisor.

7. Family Limited Partnership Attack for Estate Inclusion Without Any Discounts, *Estate of Williams*

The IRS assessed about $1.5 million in estate taxes and $300,000 penalties regarding a property that was transferred to a family limited partnership by the decedent four years before his death. *Estate of Jack Williams,* T.C. No. 29735-13 (petition filed December 19, 2013). The partnership owned real properties, and business and investment assets. The IRS appears to have "thrown the kitchen sink" at the estate with a wide variety of arguments including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction occurring at the decedent's death, undervaluation of the underlying partnership assets, the partnership lacked a valid business purpose or economic substance, the decedent retained enjoyment of the partnership assets triggering estate inclusion of the assets under §2036, ignoring restrictions on the right to use or sell the partnership interest under §2703(a), ignoring liquidation restrictions under §§2703, 2704(a) and 2704(b), any lapse of voting or liquidation rights in partnership is a transfer under §2704(a), and that gifts of partnership interests should be brought back into the estate under §2036 and should be removed from the decedent's adjusted taxable gifts.

The estate maintains that the partnership had various non-tax purposes including limiting future potential personal liability of the decedent, limiting litigation risks associated with future improvements and maintenance on various real properties, pooling of income in one entity to provide centralized and continuous management of properties and to diversify and reduce investment risk, facilitating transfers without having to fractionalize real property interests, providing a structure of ownership and operation of real properties to permit continuity and minimal interruption upon the death of a partner, minimizing litigation among family members or spouses and preserving family harmony, increasing the marketability of the partnership and an affiliate company that was the lessee of commercial property owned by the partnership. The estate maintains that the transfers to the partnership were bona fide and for full consideration, that the decedent retained assets outside the partnership that were more than adequate to maintain his then current lifestyle, and that §2036 should not apply. The estate also argues that it adequately disclosed gifts of the partnership interests on gift tax returns. (Attorneys for the estate are John Thornton and Kevin Belew, Boise, Idaho)

In summary, the IRS is attempting to increase the value attributable to the decedent's limited partnership interest from $4.5 million to $7.7 million.

"The IRS seems to have FLPs in its headlights."

8. Valuation of Real Property in 2009 (When Comparables Were Not Available Reflecting Depressed Values Following the 2008 "Crash" Because Properties Were Not Selling), *Estate of Lovins*

The valuation of various real estate interests owned by decedent's estate is at issue in *Estate of James David Lovins, Sr.*, T.C. Docket # 002071-14 (petition filed February 5, 2014). The IRS is alleging an estate tax deficiency of $6.8 million and a penalty of $1 million. The basic dispute is how to value real estate interests when the decedent died in 2009. To what extent in valuing real property should the impact of the "Great Recession of 2008" and its impact on the real estate market be considered? Appraisers valuing depressed real estate in 2009 often were unable find any comparables at low values, because properties were not selling at all in the immediate aftermath of the recession.

9. Valuation of Investment Holding Company, Valuation Method, Built-In Gains Adjustment, Lack of Control and Marketability Discounts, and Undervaluation Penalty, *Estate of Richmond v. Commissioner*

The decedent's 23.44% interest in a closely-held investment holding company (a C corporation) that owned $52 million of publicly traded securities was determined. *Estate of Helen P. Richmond v. Commissioner,* T.C. Memo 2014-26 (February 11, 2014) (Judge Gustafson). The court rejected the estate's approach of valuing the company based on a capitalization of the dividends, reasoning that the net asset value approach was more appropriate for a non-operating company that held publicly-traded stock.

The court determined the present value of the built-in gains ("BIG") tax at the entity level, rather than just including a BIG tax discount as part of the marketability discount. A dollar-for-dollar liability offset was not allowed (the case is not appealable to either the 5th or 11th Circuits, which allow dollar-for-dollar discounts). The court examined the present value of the BIG tax by assuming the stock portfolio would be sold over 20 and 30-year periods and by using various discount rate assumptions. (The court did not consider the built-in gains tax on future appreciation in its analysis.) The BIG liability allowed by the court was 43.16% of the total BIG tax liability of the corporation if all of the assets had been sold immediately at the date of the decedent's death.

The lack-of-control discount (7.75%) was determined by reference to closed-end fund studies (both parties agreed to that approach).

The lack-of-marketability discount (32.1%) was determined based on data from restricted stock/pre-IPO stock studies (which produced discounts ranging from 26.4% to 35.6%, with an average of 32.1%). Both sides' experts used on those same studies.

The estate did not meet its burden of proving reasonable cause to avoid a 20% undervaluation penalty. The Form 706 used as the value for the stock the value conclusion on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but who did not have any appraiser certifications.

Observations from panel: "The IRS seems to be aggressive in addressing valuations and in its willingness to apply accuracy related penalties. They really are out to get us."

A detailed summary of *Estate of Richmond* is in Item 37 of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.

10. Interest on Graegin Loan Not Deductible; Majority Interest in LLC Valued With Low Marketability Discount, *Estate of Koons v. Commissioner*

a. ***Low 7.5% Lack-of-Marketability Discount.*** *Estate of Koons v. Commissioner* allowed only a 7.5% marketability discount in valuing the stock in a closely held company owned by the decedent's revocable trust. The low discount was largely based on the fact that the decedent's children had agreed to have their interests redeemed before the decedent's death; when the redemption was completed soon after the decedent's death, the decedent's revocable trust owned a controlling interest.

b. ***Taxpayer's Appraiser Is Someone Who Often Testifies for IRS.*** The estate used as its appraiser Dr. Mukesh Bajaj, who has testified for the IRS in a number of other cases. Planners might think that using an appraiser who is often used by the IRS would provide additional credibility and persuasiveness in dealing with the IRS. It did not work in this case—the IRS did attack the appraiser and the estate received a very low discount (though with a variety of countervailing factors).

c. ***No Interest Deduction Allowed on Graegin Note.*** In addition, the court disallowed a $71.4 million interest deduction for estate tax purposes on a $10.75 million note documenting a loan that the estate borrowed from an LLC controlled by the decedent's revocable trust. The note provided for interest at 9.5% per year with principal and interest due in equal installments to be paid over 6 ½ years, but the payments would not begin for over 18 years. The court reasoned that the revocable trust could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years "hinders the 'proper settlement' of the Estate."

For a more complete description of *Estate of Koons v. Commissioner*, T.C. Memo. 2013-94, see Item 38 of the Hot Topics and Current Developments Summary (December 2013) found here and available under Insights at www.bessemer.com/advisor.

11. Appraiser Failed to Testify; Estate Arguing Lower Value Than on Form 706, *Estate of Tanenblatt*

The value of a 16.67% member interest in an LLC owning a commercial building in Manhattan was determined in *Estate of Tanenblatt*, T.C. Memo 2013-263 (opinion by Judge Halpern). The estate initially used Management Planning, Inc. (MPI) to value the LLC interest, which was valued at $1.8 million using a 20% lack of control discount and a 35% lack of marketability discount. The IRS accepted the net asset value in the MPI appraisal but said that the discounts should have only been 10% and 20% respectively, resulting in a value of $2.46 million. The estate countered at trial by getting a new appraisal valuing the interest at about $1 million.

The estate merely attached the new appraisal to its petition for redetermination but did not serve a copy of the report on other parties as required under Tax Court rules (and the estate did not qualify the new appraiser as an expert), so the appraisal was not in evidence. The new appraiser did not testify because of a fee dispute. The estate attacked the MPI appraisal (the appraisal it used to support the value on the Form 706) as well as the IRS appraisal.

This case raises the issue of taking a position at trial that a value is lower than stated on the estate tax return. The court noted that "values or discounts reported or claimed on an estate tax return may be considered admissions and, to some extent binding or probative, restricting an estate from substituting a lower value without cogent proof that those admissions are wrong." There was "no cogent proof" in this case that the valued reported on the estate tax return was wrong.

Ultimately, the court concluded that a 10% lack of control discount and 26% lack of marketability discount was appropriate, valuing the interest at $2.3 million.

12. Appraisal Basing Values on Discounts Allowed in Prior Cases Not Accepted, *Scheidelman*

A façade easement was valued for charitable deduction purposes in *Scheidelman v. Commissioner*, T.C. Memo 2013-18, on remand from 682 F.3d 189 (2d Cir. 2012). The taxpayer's appraiser based its discount not on comparables but on an analysis of discounts that the courts and IRS had allowed in prior cases. That approach was rejected, and the court adopted the IRS expert's conclusion that the imposition of the facade conservation easement did not materially affect the value of the underlying properties, and that the easement had no value for charitable deduction purposes.

13. Early Termination of Charitable Remainder Trusts

a. ***Commutation of Interests Allowed, PLRs 201325018-201325021 .*** Private letter rulings 201325018-201325021 are notable as providing guidelines for terminating a charitable remainder trust (CRT) early with the parties each receiving amounts equal to their actuarial values in the CRTs. Few of these rulings are now issued in light of a no-ruling position first announced in 2008. These rulings requests were submitted before that no-ruling position was first announced in Rev. Proc. 2008-4, 2008-1 C.B. 121. (Has it really taken ***7 years*** to consider these ruling requests???)

   Husband and wife were the unitrust beneficiaries of NIMCRUTs that were to last until the surviving spouse's death. The spouses were unhappy with the investment returns and the spouse and the charity wished to have the trusts terminated, distributing the actuarial value of the unitrust interests to the spouses and the remaining value to the charity. The value of the unitrust interests was determined using the §7520 rate and the Treasury life expectancies using the methodology in Reg. §1.664-4. The rulings concluded that even though the spouses were disqualified persons, the terminating payments to the spouses were not direct or indirect acts of self-dealing because the allocation method was reasonable. Any capital gain recognized by the spouses on the termination of the trust would be capital gain. The private foundation termination tax under §507 does not apply similarly because the values passing to the spouses and the charity, respectively, were determined appropriately under Reg. §1.664-4.

b. ***Transfer of All Non-Charitable Interests to Charitable Remainder Beneficiary, PLR 201321012.*** In private letter ruling 201321012 husband and wife had created separate CRTs, paying unitrust amounts to the spouses until the death of the survivor. They each retained the right to change the charitable remainder beneficiary. They both decided to terminate their respective CRTs by relinquishing the right to change the charitable remainder beneficiary and by conveying their remaining unitrust interests to the charitable beneficiary. They received a gift tax charitable deduction for the value of the remainder interests and they received gift and income tax charitable deductions for the value of their unitrust interests that conveyed currently to charity.

14. Transfer to Charitable Lead Trust Was a Completed Gift and Was Not in Donor's Gross Estate Because Donor Was Precluded From Participating in Private Foundation That Was the Beneficiary of Charitable Lead Interest

In private letter ruling 201323007, the donor contributed assets to a charitable lead annuity trust (CLAT) with a family private foundation as the recipient of the annuity payments. The bylaws of the foundation were amended to provide that during any time the foundation was the beneficiary of a CLT, CRT or other charitable trust established by a director, officer or substantial contributor to the foundation, such individual establishing the charitable trust would be prohibited from participating in matters concerning the receipt, investment, grant or distribution of funds received by the foundation from such charitable trust. Furthermore, any funds received from such a trust would be segregated from the other funds of the foundation. The ruling concluded that the transfer to the CLAT would be a completed gift and that assets in the CLAT at the donor's death would not be included in the donor's estate under §§2036 or 2038.

15. Strict Review of Conservation Easements

Various recent cases have denied or greatly reduced charitable deductions for façade easements or other conservations easements. *Scheidelman v. Commissioner,* T.C. Memo 2013-18 (discussed above for its observation that basing appraised values on prior court cases is not an appropriate valuation approach); *Belk v. Commissioner,* 140 T.C. No. 1 (2013)(taxpayers could remove the property subject to the easement [on a golf course] from the easement); *Mountanos v. Commissioner,* T.C. Memo 2013-138 (easement added nothing to state law restrictions on use of property); *Graev v. Commissioner*, 140 T.C. No. 17 (no deduction for grant of façade easement to National Architectural Trust because it promised to unwind the transaction if the deduction was disallowed); *Gorra v. Commissioner*, T.C. Memo 20-13-254 (greatly reduced deduction allowed for historic preservation easement to National Architectural Trust and 40% penalty for gross valuation misstatement).

16. ASSET PROTECTION DEVELOPMENTS

a. ***Ohio DAPT.*** Ohio has passed domestic asset protection trust legislation, becoming the 14th DAPT state. The trust must be irrevocable and have an Ohio trustee. Various interests and powers may be reserved to the grantor including the right to veto distributions from the trust, to withdraw up to 5% each year, to live in a residence held in the trust, and to possess a limited power of appointment.

b. ***Transfer to Trust Not Successful in Avoiding Prior Tax Liens***. In *United States v. Melone,* __ F. Supp.2d __ D. Mass. 2013), the court ruled that the transfer of real estate to a trust with the primary purpose of insulating the property from liability was just a legal fiction to evade taxes. The settlor had a long history of not paying self-employment taxes; federal tax liens were assessed against the seller for five years prior to his transfer to the trust.

c. ***Transfer to Alaska DAPT by Washington Resident Not Respected in Bankruptcy***. A transfer by a Washington state resident to an Alaska DAPT trust was found to be a fraudulent transfer voidable in bankruptcy. *In re Huber*, 2013 WL 2154218 (Bankr. W.D. Wash., May 17, 2013). The court also reasoned under a conflict of laws analysis that the laws of Washington should apply and it has a strong policy against asset protection trusts. See Item 54 for further discussion of *Huber.*

d. ***Creditor Allowed to Garnish Any Distributions to Discretionary Beneficiary.*** A recent Florida district court of appeals case has reversed the trend of states that do not allow garnishment of distributions made from a discretionary trust. *Berlinger v. Casselberry,* Case No. 2D12-6470 (Fla. 2d Dist. Ct. App. Nov. 27, 2013).

   The general rule is that a creditor (including an ex-spouse) of a discretionary beneficiary of a "discretionary trust" cannot "reach or otherwise attach" the assets of the trust. A Nevada law says that does not preclude a garnishment of any distributions that are made to the beneficiary, but courts in various states have made clear that a creditor cannot garnish distributions from such a trust and the trustee cannot be held liable for making distributions.

   There are several relevant statues in Florida. A statute addressing spendthrift trusts generally provides that trust assets are *not* exempt from the claims of spouses or claims for child support. FL. TRUST CODE §736.0503(2)(a). A separate statute dealing specifically with "discretionary trusts" does not have that exception. For discretionary trusts, a creditor cannot compel a distribution nor can a creditor "attach or otherwise reach" the interest, if any, which the beneficiary might have as a result of the trustee's authority to make discretionary distributions to or for the benefit of the beneficiary. FL. TRUST CODE §736.0504. In *Berlinger* the ex-wife argued that she was not trying to "reach or otherwise attach" the beneficiary's interest in the trust, but merely to garnish any distribution that the trustee decided to make to the beneficiary. The Florida supreme court had previously allowed garnishment of distributions made to a beneficiary from a discretionary trust in *Bacardi v. White*, 463 So. 2d 218 (Fla. 1985). Many Florida planners thought that case had been superseded by the discretionary trust statute cited above. The court, however, ruled that *Bacardi* is controlling, and allowed the garnishment. A request for rehearing has been filed in the case. There is a good chance this case will ultimately be decided by the Florida supreme court.

In the meantime, if an individual wants to provide strong creditor protection for beneficiaries of third-party discretionary trusts, consider establishing sufficient contacts with and applying the law of a state that has strong spendthrift protection and that specifically mentions garnishment.

17. Net Investment Income Tax Final Regulations

Final regulations under §1411 were released on November 26, 2013 (scheduled for official publication on December 2, 2013). In addition, the IRS released a new set of proposed regulations regarding various topics that are not covered in the final regulations. Among other issues in the final regulations: (1) There is no guidance regarding how a trust or estate "materially participates" in a trade or business, but the IRS may provide additional guidance regarding that topic for purposes of §469 as well as §1411; (2) Special rules are added for tracking the net investment income within each class of the income of a CRT; and (3) The preamble confirms that no "fresh start" is allowed for making a determination that distributions of trust principal include realized capital gains. In addition new proposed regulations (1) provide additional detail regarding the determination of the amount of net investment income arising as a result of dispositions of certain interests in partnerships or S corporations, and (2) determine material participation by a QSST at the trust level with respect to a gain realized on the sale of the S corporation stock (for a further discussion of this issue, see Item 62.c below)

For a detailed discussion of planning considerations in light of the new 3.8% tax on net investment income, see Item 9 of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.

18. State Trust Income Taxation

Some states tax the undistributed income of non-grantor trusts simply because the settlor or testator resided in the state when the trust became irrevocable. Three state court cases in 2013 have been successful in attacking those kinds of state taxing systems on constitutional grounds—finding that Illinois, New Jersey and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. For a brief summary of these cases, see Item 56 below. See Item 20.d of the 2012 Heckerling Musings found here and available under Insights at www.bessemer.com/advisor for a summary of the court cases (through 2011) that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settler of an inter vivos trust residing in the state.

Items 19-30 are observations from a symposium by Judith Black, MD, Keith B. Gallant, Marilyn J. Maag, and Robert B. Wolf, The Physician Orders For Life-Sustaining Treatment (POLST)—Coming Soon to a Health Care Community Near You

19. POLST Description and Overview

a. ***Brief Description.*** The POLST (Physician Orders for Life-Sustaining Treatment) program began in Oregon in 1991 and is being adopted by states across the country. The process of preparing a POLST occurs when a patient is in an advanced state of illness or frailty. It requires a conversation or series of conversations between health care professionals (physicians, physician's assistants, or nurse practitioners) and the patient or the patient's authorized surrogate. The conversation results in actionable medical orders that are recorded in a standardized POLST form, which is kept in the front of the patient's medical records or in the patient's home. The POLST always addresses cardiopulmonary resuscitation, and also can address other end-of-life health care issues, such as the level of medical intervention desired in an emergency, the use of artificially supplied nutrition and hydration, the use of antibiotics, and the use of ventilation. They are designed to be recognized across the health care community.

b. ***Key Elements.*** (1) POLST complements the advance directive, it does not replace it. (2) POLST does not just stipulate withholding treatment; it can list the types of care that are wanted or not wanted. (3) POLST is not just a form; it is a program including education, training, and a quality improvement process.

   POLST is entirely voluntary. The medical care institution may offer a POLST form, but it is voluntary. The POLST can be revoked at any time. A new POLST can be prepared at any time. Having more than one POLST is not unusual as a disease progresses. Studies have shown that all of the components of a POLST are honored about 90% of the time.

c. ***Distinctions from Advance Directives.*** Advance directives may be considered by all persons, not just patients with a serious illness. Advance directives are often completed in an attorney's office rather than in a medical setting. Advance directives state preferences and a surrogate whereas POLST results in medical orders based on shared decision-making with the patient and medical care professionals. A surrogate cannot complete an advance directive for a patient. Periodic review responsibility is up to the patient, whereas the medical care provider has the responsibility to initiate reviews of the POLST.

   Preferences expressed in advance directives are not consistently followed. An advance directive does not help clarify the patient's wishes if it has not been discussed with the family, close friends, and the patient's physician. Also, advance directives cannot be read and interpreted in an emergency. Another problem is that advance directives apply in the event of "terminal" or "irreversible" conditions and physicians, agents and loved ones will have differing interpretations of what that means in a particular situation.

20. Constitutionality

The constitutionality of POLST is beyond doubt. State courts struggled for some years to provide a rationale for sustaining the constitutional right of an individual to refuse medical treatment. The key Supreme Court case is *Cruzan v. Director, Missouri Department of Health*, 497 U.S. 261 (1990). The issue in *Cruzan* was the constitutionality of a Missouri supreme court decision that Missouri state law requires "clear and convincing" proof of an incompetent individual's wishes not to receive apparently futile life-prolonging treatment as a prerequisite to the discontinuation of such measures. The U.S. Supreme Court upheld the Missouri's court application of a "clear and convincing" standard.

Much of the Supreme Court's discussion revolved around a "privacy-liberty" rational and the informed consent doctrine, even though much of that discussion was dicta since Nancy Cruzan was incapable of expressing her wishes. Justice O'Connor's concurrence establishes the constitutional principle for which *Cruzan* is known: "... the liberty guaranteed by the Due Process Clause must protect, if it protects anything, an individual's deeply personal decision to reject medical treatment." Her view, essential in the Court's five to four decision, is that *Cruzan* merely establishes a state's constitutional authority to establish its own evidentiary standard for the withdrawal or withholding of life-prolonging medical treatment: "Today we decide only that one State's practice does not violate the Constitution; the more challenging task of crafting appropriate procedures for safeguarding incompetents' liberty interests is entrusted to the 'laboratory' of the States."

21. POLST Form

a. ***State by State Variances.*** The POLST forms vary from state to state. All of the states have some type of POLST program other than Alabama, Alaska, Arkansas, Mississippi, Nebraska, Oklahoma, South Dakota, and the District of Columbia.

b. ***Brightly Colored Forms.*** The form is typically on brightly colored paper, so it will stand out in the patient's medical records or other records.

c. ***Major Form Elements.*** The Oregon form is illustrative of forms that have been adopted across the country. It addresses three main categories of treatment decisions: (1) CPR measures (if the patient has no pulse and is not breathing); (2) medical interventions desired (comfort, limited additional interventions, or full treatment); and (3) artificially administered nutrition. There is also a documentation of who participated in the discussion, and signature by the patient (or surrogate) and the medical care provider (physician, physician's assistant, or nurse practitioner).

d. ***CPR Section.*** Only rarely do patients revive under CPR in the same shape as before the medical crisis. Most of the time, CPR will not work.

e. ***Medical Interventions.*** The first alternative is to receive only comfort management and not to be transferred to a hospital for life-sustaining treatments unless comfort needs cannot be provided in the patient's current location.

   The second alternative is for limited additional interventions. Some people want to go to a hospital for a limited time but not be on a breathing machine.

   The third alternative calls for full treatment including intubation, advanced airway interventions, and mechanical ventilation as indicated.

f. ***Nutrition.*** The nutrition section is very important. The providers will always offer food and water by mouth. The major artificial nutrition options are no artificial nutrition by tube, defined trial period of artificial nutrition by tube, or long-term artificial nutrition by tube. (End stage Alzheimer's patients actually die more quickly with feeding tubes, because complications frequently arise.)

g. ***Antibiotics.*** Some states also have a section addressing whether antibiotics should be used. Options include no antibiotics, use of antibiotics with comfort as the goal, or use of antibiotics to prolong life. Many states (such as Oregon) have deleted the antibiotics section from their forms.

h. ***Entire Form Need Not Be Completed.*** The patient only has to complete the portions of the form that are desired. For example, the patient could just complete the No CPR section and nothing else but the signature. (That is the best choice if there is not the opportunity of having a full discussion with medical care providers about the impact of the various choices.)

22. Estate Planner's Role in Implementing POLST

The estate planning attorney will not even be present when the patient has the POLST discussion with the medical care provider (and hopefully together with family members and health care agents). But the attorney often starts the conversation about health care powers of attorney and advance directives. Attorneys should advise clients about the POLST during their normal discussions with clients about health care powers of attorneys, to let them know of the possibility of implementing a POLST when the person has a serious illness or is of advanced age.

If the attorney knows that the client has a serious medical condition, the attorney should specifically mention the opportunity to prepare a POLST. It is the physician's role to suggest it, but many physicians do not know about POLST either.

When the attorney discovers that a client has signed a POLST, the attorney should ask about the process of its preparation. It is not just another routine admission form.

The attorney can encourage the client to review the POLST as his or her medical conditions change. "The bull looks different when you are out of the ring."

One Fellow expressed concern with providing treatment directions as to any of these issues outside of any particular situation. If he is not competent to make a decision, he would want his wife to consider all the circumstances and he would trust her decision—better than any decision that he could make in advance without knowing the exact situation. A response is that the process of having a conversation with his wife and a medical care provider about the decisions could be helpful.

23. Development of POLST Programs

Estate planning attorneys may become involved in the development of POLST programs in their states. Legislation may be necessary for some purposes (immunity, uniformity, recognition, etc.), but details of the program are better worked out by clinical consensus.

Issues for consideration if there is legislation:

- Less is more
- Do not put the POLST form in the statute, but just provide a legislative framework
- Create a system for adjustments without legislative action to allow flexibility

- Structural issues for legislative consideration: Basics, immunity, portability, signature requirements, regulatory authority
- Whether pre-existing conditions are required before a POLST can be signed
- What health care professional can sign the POLST
- The obligation of medical care providers to follow the POLST and whether there are any conscience exceptions
- Recognition of out-of-state POLST forms

24. Resources

Resources about POLST include the following.

- National POLST Paradigm Task Force
- Respecting Choices, internationally recognized advance care planning program operated by the Gunderson Lutheran Medical Foundation, La Crosse, Wisconsin
- www.polst.org
- Coalition for Compassionate Care of California (www.coalitionccc.org)
- www.prepareforyourcare.org (an excellent educational resource)
- Aging Institute of UPMC Senior Services

Items 25-30 are observations from a symposium by Paulette Brown (on track to become the first woman of color as the President of the American Bar Association), Patricia H. Char, Professor David M. English, Terrence M. Franklin, and Paula A. Kohut, Diversity: Serving 21st Century Clients With More Than Just Good Wills and Great Trusts

25. ACTEC Focus

In 2012, President Lou Mezzullo established the Diversity Task Force to develop strategies for the College to become more diverse. The Mission Statement of the Task Force is as follows.

> The mission of the ACTEC Diversity Task Force is to develop strategies, recommendations and a comprehensive plan to help ACTEC become a more diverse College (consistent with ACTEC's purposes as set forth in Article I of the ACTEC Bylaws). The Task Force seeks to create a stronger and better College through implementation of such strategies, recommendations and a strategic plan, with the goal of promoting the full participation of groups historically underrepresented in the College and in the estates and trusts legal community. The Task Force will work with the College to identify and encourage women, racial and ethnic minorities, lesbian, gay, bisexual and transgender persons and persons with disabilities to qualify and be nominated for Fellowship in the College, and, if elected, to actively participate in the activities of the College. The Task Force will also work to encourage the elimination of bias in the College.

26. Inclusion, Bias, and Diversity

a. ***Inclusion.*** Paulette Brown speaks to groups often about diversity issues. She never likes to discuss diversity without including the word "inclusion." There can be a diverse group of people who are still not included in the organization in a meaningful way. Conscious thought is required to insure that an organization is inclusive. Diversity + Inclusion = Improved business outcomes.

b. ***Inherent Bias.*** The Implicit Association Test is a test exploring the unconscious roots of thinking and feeling. It explores a person's inherent biases and measures implicit attitudes. There is a specific test measuring attitudes toward Blacks relative to Whites, but there are other generic tests as well.

   To refer to "adding diversity without lowering our standards" by itself expresses bias.

c. ***Embrace Differences; Better Solutions.*** Explore differences and embrace the differences. Diverse individuals begin this by talking with each other to discover things the individuals have in common. Finding connections facilitates finding what makes the individuals different and why those differences are important in their everyday lives. "Different people thinking different ways can help come to better solutions to problems."

d. ***Bias Confirmation.*** As an example of bias confirmation, there are few people of color who practice in the estate planning area. The estate planning partners in a practice may believe that there are tax and complex issues that people of ethnic backgrounds do not tend to study. Therefore, the partners tend not to give the ethnically diverse new associate they same degree of complex projects and mentoring as others. The person fails over time, confirming the bias that the person should not have been hired into the estate planning group.

e. ***Substantive Committees and Activities***. Law firms hiring diverse associates tend to put them on the firm's diversity committee. The firm should make sure to include them on substantive committees and activities.

f. ***Good Intentions.*** Biases are not inherently bad. Biases can help people avoid troubles or difficulties. Individuals do not intentionally impose biases. When someone says something or acts in a way that is insensitive, others can point out how that action could be hurtful to others.

g. ***Gender Bias.*** Paula Kohut is a transgender individual. She practiced for 27 years as Paul, and several years ago she underwent transgender surgery to become Paula. She has personally experienced the differences between walking into a boardroom as a man and then as a woman. She believes there is definite gender bias.

27. Businss Case for Diversity

a. ***Demographics***. By 2050, whites will be in the minority in this country. The percentage of Hispanics and Asians will double in that time frame.

b. ***Rapidly Changing Environment.*** Consider the concerns of estate planning attorneys in the 19th century. There were dramatic changes from 1960 to 2005, and even more dramatic changes will likely occur over the next 35 years. One hundred years ago, estate planners would not have considered certain ethnic groups as clients. Biases about who will be clients and colleagues in the future can be dramatically skewed as well.

c. ***Institutional Changes in Legal Profession.*** California is an example of institutional changes that are happening in the legal profession regarding diversity. California recently passed a law requiring that family law judges receive training in LGBT education and sensitivity. California now requires as part of its CLE requirement 1 hour of instruction on "Elimination of Bias in the Legal Profession."

28. Bequests or Gifts or Trust Transfers With Conditions Based on Race or Ethnicity

a. ***Summary.*** When asked to draft provisions based on race, ethnicity, religion, sexual preferences, etc., attorneys should be mindful to explore with clients their intentions, whether those intentions will be upheld by future court challenges regarding their validity on policy grounds, and how best to draft to carry out that intent. One drafting approach is to state that restrictions are included to remedy a prior inequity and to positively support a particular group.

   Examples of restrictions that might be requested: scholarships for high school students who are young men of color who are raised by single mothers; gift for immigrants from a specific country fleeing civil unrest; trust beneficiary on the condition that the beneficiary is married to someone of the Jewish faith.

b. ***Cases.*** There have been a wide variety of cases addressing trust restrictions involving gender, racial, religious, or other restrictions. As one example, early 20^{th} century bequests to promote women's rights were a euphemism for suffrage, which a court refused to enforce as not being a charitable purpose.

   Restrictions may have been included with good intentions but later seem repulsive on policy grounds. For example, there may be restrictions on using trusts just for Protestant boys, male high school graduates, refugees from the Ukraine, etc. The intent may be to do something good and positive. But in the future someone may look back and challenge the restriction as unenforceable because it is based on gender, race or ethnicity.

   A 2009 Illinois case has a good example of the different manners in which policy restrictions are addressed by courts. In Estate of Max Feinberg, a grandfather set up a trust for his granddaughter, Michelle, with a condition that she would not be a beneficiary if she was married over one year and her spouse did not convert to the Jewish faith. Michelle challenged her father's accounting as trustee of the trust. He responded that she had no standing because she failed to satisfy the condition and was not a beneficiary. The court of appeals invalidated the restriction. The Illinois Supreme Court reversed, weighing the policies of testamentary freedom against the policy of encouraging marriage. It distinguished between a condition subsequent, which divests an individual's interest and would be void, and a condition precedent, for which a beneficiary's interest was only a mere expectancy and which would be respected. The court concluded that there was a valid condition precedent and no vested interest and the trust was designed to reward grandchildren who embraced the grandparents' religion and values. The approaches by the Illinois intermediate and supreme courts are good examples of the differing approaches by courts to these policy issues.

c. ***Ethical Considerations.*** The Model Rules of Professional Responsibility provide relevant guidance. Rule 1 states that competent representation requires "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." For example, if there is a request to draft a trust with potentially sensitive restrictions, Rule 1 might suggest that the attorney develop an understanding of (1) the particular restriction, (2) the ways in which courts have addressed trust restrictions from a policy viewpoint, and (3) the manner in which the restriction can be included so that it is not likely to be set aside on policy grounds.

   Rule 1.2 provides that an attorney's representation "does not constitute an endorsement of the client's political, economic, social or moral views or activities."

   Rule 1.4(a) requires that an attorney "reasonably consult with the client about the means by which the client's objectives are to be accomplished. Rule 1.4(b) requires that an attorney "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

   Some states have rules that specifically prohibit representation regarding sensitive discriminatory matters. Washington Rule 8(h) prohibits representing a client regarding conduct "that a reasonable person would interpret as manifesting prejudice or bias on the basis of sex, race, age, creed, religion, color, national origin, disability, sexual orientation, or marital status."

   The attorney does not have an obligation to accept the representation. However, once the attorney accepts the representation, the attorney should best carry out the client's intent in a manner that is best likely to succeed.

29. Some General Estate Planning Practice Implications

Do not make assumptions about what clients want. For example, do not assume that everyone wants to or will have children or wants a typical marriage relationship. Sensitivity to framing client discussions will avoid offending clients.

Ask open ended questions without implicit biases built into the questions.

Plans for particular families may need to incorporate specific unique provisions based on the client's religious or cultural background.

Sometimes, the attorney's role as counselor will need to go beyond just the legal aspects, including open discussions with clients about the impact of the provisions of trusts on family relationships in light of diversity issues.

30. Experience of ABA Real Property Trust & Estate Law Section's Diversity Effort

Over the last decade the ABA RPTE Section has focused on diversity issues in various ways. Not all of the Section's experiences will be relevant or appropriate for ACTEC, but some of them may provide ideas for exploration.

a. ***Fellows Program***. About 12 years ago, the RPTE Section began a program to sponsor junior lawyers and recruit them for potential leadership positions. The program started with two new fellows each year, each with a two-year term and a mentor. Each was given $2,000 toward travel expenses (3 meetings a year). They were given leadership projects (speaking, serving as vice-chair of a committee, serving on administrative committees, etc.) If the fellow succeeded, he or she was provided an opportunity to continue in a leadership position. There are now 10 fellows at any given time. Minority candidates receive a little closer look, but the fellows do not have to be minorities. About half of the fellows are minorities, and about 70% of the fellows have remained in the leadership of the Section.

b. ***Community Outreach Program.*** The Section sponsors a "Community Outreach Program" offering a series of CLE programs for minority lawyers. For example, one program consisted of a series of seven sessions to address estate planning practice issues for minority lawyers. Other programs have been designed as day-long or two-day programs for minority lawyers held in the same hotel and at the same time as Section meetings, so that attorneys in the Section could teach various estate planning topics to minority attorneys.

c. ***Pipeline Programs***. Pipeline programs for minority law students consist of an estate planning attorney, elder law attorney, fiduciary litigator, and trust officer describing different opportunities within the estate planning practice area.

d. ***Speaker Database.*** The Section maintains a database of hundreds of names of possible speakers for programs. ACTEC Fellows could use that data base when planning programs for local bar activities.

e. ***Funding.*** The Section's budget on various diversity issues is about $70,000 per year. The Section has many more members than ACTEC (though Section dues are only a fraction of annual ACTEC dues), and may have more funds that can be devoted to a diversity program than in ACTEC, but the funding has paid dividends.

f. ***General Mentoring and Community.*** All of the Section's leadership takes seriously the responsibility of mentoring diverse Section attorneys and creating a general atmosphere in which everyone feels comfortable.

Items 31-42 are observations from the Trachtman Lecture, by Ethan Nadelmann. The lecture is an analysis of the "War on Drugs" in the United States and a discussion of better alternatives. The lecture will be published in an upcoming issue of the ACTEC Law Journal. Mr. Nadelmann was educated at Harvard, served as a professor at Princeton for 8 years and is the founder and executive director of the Drug Policy Alliance, the leading organization in the U.S. promoting alternatives to the war on drugs. He has been consulted by the presidents of Mexico, Columbia, Brazil and Uruguay on drug policy and speaks regularly with U.S. politicians. His insight into the war on drugs and the alternatives cannot be separated from the money laundering concerns addressed by FATF and other governmental actions that increasingly affect our personal and professional lives.

31. Connection with ACTEC

Duncan Osborne, President of ACTEC in 2013-2014, has for the last decade been deeply involved in representing ACTEC on the Financial Action Task Force (FATF). FATF is charged with keeping the financial system safe from money laundering and terrorist financiers. About 10 years ago, FATF began including a focus on nonfinancial businesses and professions—including lawyers. Because of Duncan's deep involvement in those issues, he began exploring money laundering more in depth, and came to the conclusion that a major contributor to money laundering in the U.S. is from the drug trade, with its need to launder billions of dollars that change hands throughout the drug trade industry. Duncan came to the conclusion that our "war on drugs" is fatally flawed and has incidental consequences that are disastrous. He sought out experts who have studied this issue in far more depth—and became acquainted with Dr. Ethan Nadelmann and the Drug Policy Alliance.

32. Someone Else's Problem

When Dr. Nadelmann spoke with a wide variety of experts involved in aspects of the drug trade (including the State Department, FBI, Customs, CIA, banking groups, law enforcement, leadership in South America, etc.) about solutions to the drug problem, each said "the solution does not lie here." For example, the Customs Department and the Coast Guard said that the answer does not lie in preventing drugs from entering the U.S. but rather in reducing the supply and demand for drugs. Each of the experts said the answer does not lie in the area he or she knows best, and rather lies in areas about which he or she knew the least.

33. Past Approaches Are Fundamentally Flawed

The way the U.S. has dealt with drugs is fundamentally flawed. The notion of locking people up in jail and repeatedly drug testing citizens is flawed. The "Just Say No" campaign has not worked. Drug programs presented by law enforcement in schools has not worked. Dealing with drug usage through the criminal justice system has not been effective and has been extremely costly to our society, both financially and on an individual level.

34. Drugs Are Here to Stay

There has never been a drug-free society in history—except for the Eskimos who could not grow anything. We are all drug consumers, including things such as coffee, wine, smoking or prescription drugs.

Being closer to a "drug-free" society is a laudable goal, but not when the result is to pay any price or bear any burden to get closer to that objective. It has become a crusade rather than a rational objective based on the overall purpose of goal. It was always a hypocritical objective, where it did not include everyday drugs such as alcohol, coffee, prescription drugs, etc.

People have been taking marijuana and cocoa for thousands of years. Alcohol is present in all societies; even extremely remote indigenous tribes having no contact with outsiders figured out that fermenting fruit yields a drink with enjoyable qualities.

Andrew Weil authored *The Natural Mind*¸ in which he observes that there seems to be an innate desire to alter our states of consciousness. For example, children spin around really fast to become delightfully disoriented. Drugs are often expeditious ways to change one's consciousness. For example, Demerol can be fabulous in relieving pain—but its use can also be tragic.

35. Addiction

Developing a rational approach to drugs requires understanding the detrimental effects of drugs, including addiction consequences.

Addiction equals dependence plus problems. If someone drinks coffee every day but that does not create a problem, it is not an addiction. However, if someone drinks alcohol or takes cocaine only occasionally but on those occasions problems result—then it is an addiction.

There are two ways that dependence can lead to a problem. First, drugs can do terrible things to our bodies. Smokers have a 30% chance of reducing their life expectancies by 5-10 years. (E-cigarettes reduce the harm by 90%; it is not the nicotine that causes the major health problems.) Cocaine causes heart problems. Alcohol causes liver problems. Second, governmental restrictions make dependence even more dangerous. Drugs can be secured only on the black market where there is no quality control; the drug user cannot get access to clean needles, etc.

36. Drug Policy Should Not be Part of the Criminal Justice System

There is no inherent reason that drugs need to be a part of the criminal justice system, and were not in the 19th century, they were not. Some universal laws clearly belong in the criminal justice system—rape, theft, murder, etc. But having things that grow out of the ground be front and center in our criminal justice system makes no sense.

There is no moral reason to prevent drug usage. For most societies, there is no moral reason not to prohibit growth or use of certain things. (The Mormons are one group that does approach from a moral perspective not ingesting anything that alters their state of consciousness, including not drinking coffee. But they do enjoy "Mormon tea"—which has the same ingredient as methamphetamine, and are big consumers of ice cream—resulting in a sugar rush.)

The inconsistency of applying the criminal justice system to some drugs and not others seems very unjust. Alcohol and tobacco are entirely legal but consumers of other drugs go to jail and subsequently cannot get jobs because of their criminal record for drug use.

Criminalizing drugs has been extremely costly in terms of overfilling the nation's jails (discussed below).

37. History of Prejudice Underlying the Emergence of Criminal Drug Laws Based on Racial and Ethnic Fears and Prejudices

How has our criminal justice emerged such that tobacco and alcohol are allowed but marijuana is not? The number one factor in deciding what drugs are criminalized is who uses (or is perceived to use) the drugs. Many of the policies arose out of fears of various ethnic groups.

Opiates. Opiates were used for thousands of years as effective pain-killing drugs. In some societies throughout history, people were consumers of opiates on a daily basis—like we take coffee every day. The major consumers in the U.S. of heroin and morphine in the 19th century were middle age white women. The percentage of use then was higher than it is today. There was no Motrin, etc. The use of opiates by middle age women in the 19th century did not cause problems for most users. No one thought of making the use of opiates a criminal act because they did not want to put "grandma" behind bars. When Chinese immigrants to the U.S. continued a centuries-old tradition of smoking opium, a fear arose that men running opium dens would turn women into opium slaves. The first California and Nevada opium laws were driven by fear of the Chinese immigrants.

Cocaine. Coca Cola had cocaine until about 1900. It was no more dangerous than the caffeine that is in Coca Cola today. In the beginning of the 20th century, a perception arose that black men using cocaine would present a high threat to white women.

Marijuana. Marijuana was popular among teens in the early 1900s. Concern arose over fear about what Mexican men would do to white children and women. El Paso was the first U.S. city to criminalize marijuana in 1900.

Alcohol. There were differences of opinion about the use of alcohol by white Americans as opposed to its use by the "not-so-white" persons from southern U.S. states and and eastern Europe. Prohibition was not about getting white Americans to stop drinking. The thought was that the laws would be enforced against "those" people, not against "us."

Summary. If the principal consumers of marijuana were older white men and the principal consumers of Viagra were young black men, marijuana would be legal and Viagra would be illegal.

38. Prohibition As An Example of the Societal Ill Effects of Criminalizing Drug Usage

The U.S. was one of the very few countries in the free world to criminalize alcohol usage. As society became more urban, there was more of a problem of people living in close proximity, more cars on the road, etc. The more urban society could not afford having major numbers of drunken people. The 18th Amendment was passed making alcohol illegal.

Alcohol usage actually declined in the initial years of Prohibition. "Then people started getting thirsty." They looked to find who could supply alcoholic beverages, and found supplies from (1) Al Capone and organized crime and (2) backyard stills (usually just for family and neighbors). Some people started going over borders to bring in alcohol.

Corruption was rampant among law enforcement. Jails became overfilled with violators, but there was extreme cynicism because 30-40% of Americans were violating the law and using alcohol regularly. The laws were enforced disproportionately against poor and black people. Cops were only looking for alcohol in their neighborhoods.

In addition, Prohibition led to massive lost revenue. The alcohol tax was a major source of revenue before Prohibition.

Furthermore, thousands were being killed by bootleg liquor. Buyers did not know if they were getting ethyl alcohol (safe drinking alcohol) or methyl alcohol (which can cause blindness, coma and death). Hundreds of thousands of people were paralyzed by "bad" alcohol.

Eventually the 21st Amendment repealed the 18th Amendment.

39. Criminalization and Rational Approach to a Drug Policy

a. ***Objective.*** The Drug Policy Alliance does not advocate legalizing all drugs. The objective of the Drug Policy Alliance is to reduce the role of criminalization and the criminal justice system in drug control to the maximum extent consistent with protecting public health and safety.

   A rational approach to a drug policy requires examining a broad spectrum of possible solutions other than criminalization, including the incredibly harmful side effects of the current policies.

b. ***Extremely High U.S. Incarceration Rate.*** The U.S. has less than 5% of the world's population but 25% of the world's incarcerated citizens. The U.S. has the highest incarceration rate of any society in history. For young black men, the incarceration rate is much more than in apartheid Africa or the Soviet Gulag.

   In 1980, the U.S. had about 50,000 people in jail for drug violations, now there are more than 500,000.

   Until the 1970s, the U.S. had about an average incarceration rate compared to the rest of the world. Our crime rates are similar to other countries. The U.S. per capita rate of drug consumption is only a little higher than the European average. Our extremely high incarceration rate is a result of being faster to arrest people to put them in jail, keeping them longer, and drug testing them after they are released and putting them back in jail. Drug violators released from jail have great difficulties getting jobs because they have a drug conviction.

   The biggest cause of the extremely high incarceration rate is the war on drugs. 50-70% of jail populations are drug offenders, most for low level offenses. The U.S. locks up more people on drug charges that Western Europe locks up for all offenses.

c. ***High Expense***. The U.S. spends over $50 billion annually on the war on drugs. Building new state prisons was one of the fastest growing industries in the 90s.

d. ***Supports Corruption and Drug Cartels.*** Widespread corruption exists in Central America and Africa regarding the drug industry. The extent of the corruption is many times that experienced in Chicago during Prohibition. The biggest impact on gangs would be to take away the market for illegal drugs.

e. ***Spread of HIV***. HIV started to spread in the 1980s, first from heterosexual sex in Africa then largely through homosexual sex. After that a major contributing factor has been the sharing of dirty needles. Some time ago, Britain set up clean needle exchanges, and has been able to keep HIV rates to under 5% among drug users. (In New Jersey, the rate is 50% among drug users.) We have allowed several hundred thousands of our citizens to die—not just the junkies but also their spouses and children.

f. ***Loss of Basic Freedoms.*** Justice O'Connor once referred critically and sarcastically to the "war on drugs exception" to the 4the Amendment ban on unreasonable searches and seizures.

g. ***Impact on Medical Community.*** Doctors have become scared to some degree to prescribe pain medication, only reluctantly and occasionally prescribing morphine.

h. ***Massive Drug Testing in Society.*** Drug tests have become very common place in American industry and society. If someone smokes a joint on Friday, the person will test positive on Monday even though the marijuana has no effect after Saturday morning. On the other hand, an individual can be drunk on Friday night and that does not show up on Monday morning.

i. ***Mandatory Minimum Sentences.*** Federal law imposes mandatory minimum sentences of 10-20 years for relatively small amounts of crack cocaine or heroin. Criminologists say that does not work to deter drug usage. The minimum sentences are sometimes worse than for rapes and murders. We fill our prisons with non-violent persons and doing so has no deterrent effect.

j. ***Societal Stigma.*** The societal stigma on drug users prevents drug consumers from getting treatment to stabilize the effect. The best treatment for a heroin addict is methadone. Oral doses mitigate the withdrawal effects and higher doses can block the euphoric effects of heroin and morphine. Properly dosed patients can reduce or stop altogether their uses of those substances. A person may be dependent for years, but with harmless effects. But users are reluctant to get that treatment. "If my business associates know that I am on methadone, they will be critical of any bad decisions."

k. ***No Increase in Drug Use When Drugs Are Decriminalized.*** Portugal stopped putting people in jail for drug usage about 10 years ago. Drug users are first sent to the mental health system for drug treatment. If that does not work, they still are not jailed. The Portuguese view is that if a person is a really bad person, law enforcement will get them for something else—when they do things that actually hurt other people. After 10 years, an evaluation of the program in Portugal is that there has not been an increase in the number of drug users, and all the bad things that go along with the illicit drug industry have gone down significantly.

l. ***Criminalization Approach Increases Number of Drug Deaths.*** Drug overdose is the number one cause of accidental death in America, especially for middle age people. The government approach to that fact has been to crack down on criminalizing drugs. However, when someone overdoses, death does not occur immediately; that takes an hour or two. People don't wait to call 911 when someone has a suspected heart attack, but they do not call 911 immediately when a friend is suspected of having an overdose. The worry is that everyone at the party will be arrested if someone calls for help, so the people at the party wait to see if the person will "come around." A better approach would be to adopt a policy that police would commit not to arrest bystanders when an overdose is called in for emergency assistance.

Naloxone is a drug overdose antidote for opiates (heroin or morphine). It is classified as a prescription medication though it is not a controlled substance. The Drug Policy Alliance advocates making it available over the counter without a prescription. (Everyone taking pain medication should have it and know how to administer it—it is available as a nasal spray or lozenge.)

m. ***Education.*** People generally do not know that few people die from a drug overdose. Most deaths occur from mixing an opiate with alcohol or valium. The fact that using opiates and alcohol together increases the risks several times is not taught.

n. ***Needle Exchange Programs.*** Needle exchange programs not only prevent deaths or the spread of disease from using dirty needles, but also may be helpful in leading drug users into treatment programs. The experience in Tacoma, Washington is that the needle exchange program was the biggest lead into drug treatment programs. After some time, the drug user starts to ask, "Why am I doing this?"

o. ***Demonizing Drug Users is Counterproductive.*** Demonizing people because of their consumption of opiates is not reasonable. Dr. Nadelmann relates that his father was the fattest dad in the neighborhood and smoked several packs of cigarettes per day. He died of a heart attack at age 58. He was addicted to sugar and cigarettes. If instead he had been addicted to heroin and could get clean heroin everyday—but not the sugar and cigarettes—he would likely still be alive. Heroin in the body becomes morphine. The major health problem of opiates is constipation.

p. ***Drug Treatment Programs.*** With treatment programs, drug users may be stabilized and be able to lead relatively normal lives. A typical treatment program for heroin users is an opiate replacement like methadone. Even though methadone treatment programs are expensive, they significantly reduce overall costs incurred by trials, incarceration, emergency health interventions, and delinquency occasioned by steps taken to obtain illicit heroin. Heroin assisted treatment is fully a part of the national health system in Switzerland, Germany, the Netherlands, Denmark, and the United Kingdom. Trials are being conducted in Canada and Belgium.

q. **Criminalization Is Not the Only Way to Force Users to Get Clean.** Some believe that no one really gets clean from drugs unless the criminal justice system forces them to stop using drugs. But the experience with cigarette addiction proves that is not true. Heroin users respond on surveys that the hardest drug habit to stop is using cigarettes. We all know people addicted to something more addictive than heroin who have quit—without using the criminal justice system.

40. Protection of Children

A major motivation of a drug policy is over concern for the safety of our children. We try to build a moat between those drugs and our kids. But how realistic is that, in light of what is in the medicine cabinets and liquor cabinets in our homes? We justify locking people up as a child protection act.

The concern is that if drugs are legalized for middle age people, young people will abuse them. Realize, however, that teenagers have the best access to drugs and that has been true for 40 years.

Dr. Nadelmann's first message to his children: Don't do drugs. His second message: Don't do drugs-- you're too young and they're illegal. His third message: But if you do use drugs there are some things you should know. "As your parent, my bottom line is not if you do drugs, but if you come home safe at the end of the night, and you grow up and give me grandkids. I will pay for the taxi wherever you are, because I want you home safely."

41. Switzerland Approach

Switzerland had a terrible heroin problem in the late 1980s. The Swiss currency was expensive, so dealers made huge profits from sales in Switzerland. Methadone was made available, but heroin use remained strong. A needle park was established behind the train station (to keep the druggies off the streets). The streets were cleaned up, but violence in the needle park required that it be closed.

A new approach was to create a program in which long time heroin users who could not stop using heroin even with methadone treatment could receive pharmaceutical grade heroin at a center. They could not take it home, but could come up to three times a day and receive all they wanted. Methadone was also offered to help stabilize their lives. The Americans thought they were crazy."You're giving junk to junkies. They'll just take more and more until they are high all day long." But that has not been the experience. At first, the users took more heroin because it was free. But after long usage, the euphoric effect of heroin is greatly diminished and the users realized they were no longer getting high. They just "felt a little calmer." They just took the drug to keep from getting sick. The heroin users stopped getting arrested for other crimes and stopped taking other drugs. They reconnected with families, and started to be able to get part-time work once they were getting a stable dose and were not getting high. There were no side effects of "bad drugs" from the pharmaceutical grade heroin. The Swiss saved money under this program from the reduced cost of criminal trials, incarceration, and emergency room treatments. The police became the biggest champions of the program; it reduced the black market activity.

In the late 1990s, Ed Bradley did a 60 Minutes program about the Swiss experiment. He interviewed a participant in the program in her 30s who seemed vibrant and normal. Bradley asked her parents what they had thought five years earlier when their daughter was living on the streets as a prostitute to support her heroin addiction. The parents teared up and said they actually hoped she was dead because that had to be preferable to living on the streets as a prostitute and junkie. The daughter now has to go to the clinic every day but is fine.

About 20% of the people in the program eventually used methadone treatment to stop their heroin habit. They relayed that their dream had come true—the ability to get all the heroin they wanted for free. Eventually they reached an "ah-ha" moment. They had reached their dream and then asked, "Is that all?" They thought about what else they might want to do with their lives, and decided to put the heroin habit behind them.

42. Relevance for ACTEC Fellows In Dealing With Clients

ACTEC Fellows deal with affluent people. Prevalent drug usage exists typically in either very poor or very affluent neighborhoods. Consider an alternative approach for clients with family members who have drug problems.

A typical response of an affluent parent with a child who has a drug problem, out of a sense of concern for the child's safety, is to restrict the child's access to money. Trusts are drafted with very restrictive distribution provisions or that require drug testing before distributions may be made. The child may have a rebellious attitude and refuse to do "what you want to force me to do." Forcing people works for some, but backfires for others. Instead of focusing on the drug itself, the parents and others trying to assist the child may try focusing not on the drug use itself but on what the child wants to do with his or her life. Focus on the dreams the child can look forward to, and on the things that the drug use prevents them the child from being able to do. Look for incentives to do the things they want to do, so that eventually the child comes to the "ah-ha" moment that the drugs are impeding the child's long term goals.

These same principles apply to the client who has a personal drug problem.

Items 43-56 are observations from a seminar by Jonathan G. Blattmachr, Henry Christensen, III, Robert W. Goldman, and Professor Jeffrey Alan Schoenblum, Home is Where the Heart Is…And It is Everywhere (Addressing Ways of Accessing the Laws of Other Jurisdictions Other Than the Home Jurisdiction)

43. Significance and Overview

a. ***Multiple Contacts.*** Estate planning now is not limited to one jurisdiction. The settlor, trustee (or co-trustees), protectors, advisors, trust assets, current or future beneficiaries, or donees of powers of appointment may all be in different jurisdictions. The multiple contacts may have a detrimental effect (e.g., state income taxes, effectiveness of DAPT provisions outside the DAPT law state, etc.). The multiple contacts also complicate determining what law governs as to various issues.

b. ***Forum Shopping.*** There is now a burgeoning forum shopping market. States have enacted laws attempting to attract settlors, testators and their advisors to use their respective laws (and to use their states as the place of administration). Strategic use of governing law clauses may allow selecting laws that are very beneficial to a client.

c. ***Development of Conflict Rules in Litigation Context, Not a Planning Context.*** The conflict of laws rules regarding governing law has developed from a litigation perspective—what law applies if there is litigation. The rules have not been developed to help decide predictably and efficiently which law will or can apply or to what extent that a particular law can be chosen for a particular purpose. In particular, the Restatement (Second) of the Conflict of Laws was not written to facilitate predictability and planning.

d. ***Routinely Applying Home State Law Should No Longer Be the Norm.*** The days of routinely including a provision applying the laws of the home state are out. That is actually a negative result (as discussed below) and should be resisted.

e. ***Other Resource.*** For a further discussion of choice of laws issues, see a summary of a panel discussion by Peter Gordon and Margaret Sager regarding situs and governing law issues at the ACTEC 2012 Summer Meeting, summarized in Items 76-82 of the ACTEC 2012 Summer Meeting Musings, available here and at www.bessemer.com/advisor.

44. Duty of Lawyers Regarding Governing Law Selection

Professor Schoenblum believes that lawyers do not have the duty to search for the best governing law for particular client situations, but some have argued that such a duty exists and it may to some degree. If another state's (or country's) law pertains to an aspect of the planning, the other state's laws cannot be ignored. The attorney may not have to look affirmatively for laws that will benefit the client, but must consider relevant foreign law.

If the attorney accepts within the scope of the engagement to search for the best appropriate governing law, the attorney then has a duty to consider all the alternatives, For example, if an attorney offers that the law of another state might be better, the attorney may then have a duty to consider the best alternative.

Rule 5.5 of the Model Rules of Professional Conduct implicitly permits a lawyer to consider the choice of law from a foreign jurisdiction but not to continue on a regular basis to advise about the foreign law.

When advising about another state's law, the best practice is to associate with an attorney in that state in order to best serve the client. (Florida has a very onerous unauthorized practice of law rule. For example, merely mailing a deed to be filed in a deed office in Florida from an out-of-state attorney is a felony.) In an actual case, an out of state attorney created a revocable trust under Florida law and waived trust accountings (not permissible under Florida law); under Florida case law the attorney's retainer agreement is null and void.

45. Duty of Fiduciaries Regarding Consideration of Place of Administration and Governing Law

a. ***Statutory Provisions.***

Uniform Trust Code. Section 108(b) states that a trustee "is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries."

Uniform Probate Code. Section 7-305 is similar. It also adds that "[i]f the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state."

Restatement (Third) of Trusts. Comment b(2) to §76 provides that "[u]nder some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee." The factors discussed in that comment that would justify changing the place of administration of a trust "include the nature and location (and particularly changes in the location) of assets under the trustee's management, relocation of beneficiaries or significant changes in their needs and circumstances, and opportunities to obtain more favorable tax or other treatment in another state or country."

Twenty-six jurisdictions have the UTC or UPC language. The Pennsylvania statute omitted that language, for fear that it would cause trustees to have a duty to consider "all conceivable jurisdictions," which theoretically might require knowing laws of the entire world.

b. ***Case Law***. Only a handful of cases have addressed the trustee's duty to change situs. Those cases have involved reducing trust administrative costs, such as avoiding state income tax. One speaker described a situation in which a trust company pointed out that state income tax could be avoided if the trust moved to Delaware. A beneficiary inquired why the trustee did not raise this issue 10 years earlier.

c. ***Trustee and Attorney Potential Liability****.* If a trust has no contacts with the state other than the location of the trustee, and if the trustee fights being removed in order to change the trust situs to save administrative expenses, potential liability could be alleged. With respect to potential attorney liability, problematic situations could arise, such as the failure to advise a trustee-client or beneficiary-client to consider moving the trust situs. There have been no cases yet addressing attorney liability for this reason.

d. ***Appropriateness Standard****.* Requiring that an "appropriate" jurisdiction be used is overly simplified. Does that mean the *most* appropriate? Appropriate for what purpose—income tax? lowest fees? etc.

e. ***Examples of Issues That May Be Impacted.*** Miscellaneous issues that may be impacted by the place of administration and the governing law include perpetuities considerations, reducing fiduciary liability, simplifying account requirements, using directed trusts, avoiding state and local income taxes, spendthrift trust protection for third party trusts, creditor protection for self-settled trusts, virtual representation, appointment of fiduciaries, and obtaining community property treatment for residents of non-community property states. (Various probate issues that may arise under conflicts of laws issues include the forum for probate, choice of fiduciaries, standards for admitting the will to probate, disinheritance clauses, and availability of pre-mortem probate.)

46. Sources of Law Regarding Governing Law Issues

There are various general sources of law regarding governing law matters: the common law, the Restatement (Second) of the Conflict of Laws (1971), the Uniform Trust Code, the Uniform Probate Code, and the federal common law.

The Restatement (Second) of Conflict of Laws (in §§268-272, 277-279) addresses governing law regarding a trust's validity, construction and administration based upon whether the trust is testamentary or inter vivos, and based on whether the trust holds real estate or movables (personal property). Reliance on the Restatement (Second) of the

Conflict of Laws is now questionable for a variety of reasons. It is disputed by scholars but is routinely still cited by courts (presumably because they are unaware that it has been discredited).

The Uniform Trust Code has been adopted in about half the states. The Uniform Trust Code applies a uniform approach in §§403 (regarding validity) and 107 (regarding "meaning and effect"), rather than having separate rules for testamentary and inter vivos trusts or for real and personal property held in a trust.

The Uniform Probate Code has limited discussions of governing law issues based on the place of administration. *E.g.*, U.P.C. §7-305.

There is little federal common law but several U.S. Supreme Court cases have ruled that ERISA preempts state laws regarding various issues involving retirement plans that are subject to ERISA. In *Egelhoff v. Egelhoff*, 532 U.S. 141 (2001) the Supreme Court held that ERISA supersedes state laws automatically revoking beneficiary designations in favor of divorced spouses for life insurance or retirement plans governed by ERISA. The Supreme Court "doubled down" in *Hillman v. Maretta*, 133 S. Ct. 1943 659 U.S. __ (2013) by extending federal preemption to preclude state law automatic beneficiary designation revocation measures following divorce with respect to an insurance policy purchased under a program for federal employees.

47. General Categories of Conflict of Laws Issues Regarding Trust Issues

a. ***Validity of Transfer to Trust***. As an example, a New York court refused to recognize the validity of a purported transfer of German real estate to a trust because Germany, the situs of the land, does not recognize trusts. *In re Estate of Strauss*, 75 Misc. 2d 454, 347 N.Y.S. 2d 840 (Sur. Ct. 1973). Another example of this issue is whether a transfer of Florida real estate to an Alaska or Tennessee Community Property Trust is recognized if the settlor remains in Florida, which does not recognize community property.

b. ***Formal Validity of the Trust***. Section 2-506 of the Uniform Probate Code addresses the governing law to determine the validity of a will. Section 403 of the Uniform Trust Code addresses the governing law to determine if an inter vivos trust is formally valid.

c. ***Law Governing Capacity of Settlor***. States have varying rules regarding the standards of capacity of a testator or trust settlor. Query whether an instrument can contain a governing law clause designating which state's law will apply regarding capacity or undue influence issues? Prof. Schoenblum's view is that the law of a state with a more demanding burden of proof and/or a narrower conception of who has a confidential relationship with a testator or settlor can be designated.

d. ***Law Regarding Substantive Validity of the Trust***. Examples in §269 of the Restatement (Second) of the Conflict of Laws of issues regarding substantive validity of a trust are the rule against perpetuities, the rule against suspension of the power of alienation, the status of a revocable trust as a testamentary substitute, whether a restriction on marriage is enforceable, and whether a purpose is a charitable purpose. (Various specific substantive trust issues are discussed below.)

48. General Governing Law Rules Regarding Validity, Construction and Administration of Trust

a. ***Validity.*** Validity is straightforward, and includes things such as complying with required formalities for creation of the trust, whether the trust violates the rule against perpetuities, and competency or capacity of the person creating trust.

   Under the Restatement (Second) of the Conflict of Laws, validity of a will is governed by the law of the testator's domicile. Validity of trust provisions are governed by the law of the state designated in the trust instrument, provided the state has a substantial relation to the trust, unless (i) for testamentary trusts, the trust provision violates a strong public policy of the decedent's domicile, and (ii) for inter vivos trusts, the designated law violates a strong public policy of the state with which the trust has its most significant relationship. If there is no governing law designation in the instrument, the validity of a trust provision is based on (i) for testamentary trusts, the law of the state of the testator's domicile at death, except that the law of the state where the trust is administered applies if necessary to sustain the validity of the trust unless the trust provision involved violates a strong public policy of the decedent's domicile, and (ii) for inter vivos trusts, the law of the state to which the trust has its most significant relationship. The validity of a trust for real property is generally determined by the law where the real property is located.

   Under the Uniform Trust Code, the validity of an inter vivos trust can be determined under the law (i) where the settlor was domiciled, (ii) where the trustee was domiciled or had a place of business, OR (iii) where any trust property was located. The settlor presumably could designate in the trust instrument any of those states to govern the trust's validity. The validity of a testamentary trust is ordinarily determined by the law of the decedent's domicile.

b. ***Construction.*** Construction issues include things such as when heirs are determined, whether a spouse of the beneficiary is included among the beneficiary's next of kin, the effect of class gifts, the meaning of *per capita* or *per stirpes* transfers, whether a disposition is vested or contingent, the effect if a beneficiary dies without issue, the effect on spousal election rights, and the rules governing powers of appointment. Construction also involves the effect of adult adoptions, and civil unions or same-sex marriages.

   Under the Restatement, the governing provision in the instrument controls, whether the trust is testamentary or inter vivos and whether it is an interest in movables or land. If there is no governing law designation, the governing law regarding construction with respect to movables will be in accordance with the state the settlor likely would have desired to apply, and with respect to land will be based on where the land is located.

   Under the Uniform Trust Code, the "meaning and effect" of the trust is governed by the law designated in the trust unless that law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue. If no governing law is designated in the trust, the law of the jurisdiction having the most significant relationship to the matter at issue will govern "meaning and effect" of the trust.

c. ***Administration.*** Administration includes matters relating to the management of the trust, duties owed by the trustee to beneficiaries, principal-income determinations, powers of the trustee, liability of the trustee, removal of trustees, appointment of successor trustees, trustee compensation, termination or modification of trusts, creditors' rights, notice requirements, and decanting provisions.

Relatively recent statutes regarding various administration issues (such as a power to adjust or to decant) provide specifically that the provision is a law governing the administration of a trust--so that trusts that move situs to the state can take advantage of that provision. Some question whether it is really appropriate for a state to legislate what is construction vs. administration in an attempt to persuade trusts to move to that state. For example, is a decanting authority really administration or is that a construction issue? The power to adjust provisions could be viewed as raising construction rather than administration issues. Notice provisions could be viewed as more than just administrative matters.

Under the Restatement, there is a distinction for movables and immovables. For movables, administration issues are governed by the law designated in the trust instrument except for matters based on public policy grounds. As to other matters, the state designated to govern administration does not have to have any other relation to the trust. If no governing law is designated for the administration of movables, the law where the trust is administered generally controls for testamentary trusts, and for inter vivos trusts the law of the state to which administration is most substantially related controls. For immovables, administration is governed by the law where the land is located.

Under the Uniform Trust Code, the governing law as to "meaning and effect" includes administration, and the UTC provisions described in subparagraph b above regarding construction apply.

d. ***Impact of Transfer of Situs—Changes Law as to Matters of Administration.*** The law governing the validity and construction of a trust should not change as a result of changing the trust situs. However, the law governing administration of trusts generally is controlled by the law of the new situs.

Under the Restatement (§§271-72), the law governing administration will be the local law of the new jurisdiction if this is in accordance with the intention of the testator, express or implied. For inter vivos trusts, the law of the new jurisdiction governs administration provided the change in the place of administration is authorized by the terms of the trust, either express or implied. The mere authority to appoint a new trustee in a different state can constitute such implied authorization. However, if the trust terms reflect the settlor's intention that the trust is always to be administered under the local law of the original state, the law of administration would not change. See the discussion of the recent Delaware *Peierls* decision in Item 49.d below.

Under the Uniform Trust Code (§107), changing the "principal place of administration" will change the law governing the administration of the trust.

e. ***Principal Place of Administration.*** The Uniform Trust Code (§108) and Uniform Probate Code (§7-203) both refer to the "principal place of administration" rather than situs. The "principal place of administration" concept is central to many situs related issues under the UTC and UPC. The comment to §108 of the Uniform Trust Code (which addresses the designation of the principal place of administration) provides that locating a trust's principal place of administration ordinarily determines which court has jurisdiction over a trust. "It may also be important for other matters, such as payment of state income tax or determining the jurisdiction whose laws will govern the trust."

The Uniform Trust Code does not define the "principal place of administration," but the comment to §109 states that a "trust's principal place of administration ordinarily will be the place where the trustee is located."

In the famous U.S. Supreme Court case of *Hanson v. Denckla,* 357 U.S. 235, *reh'g denied* 258 U.S. 858 (1958), a Pennsylvania resident (who later moved to Florida) created a Delaware trust with a Delaware corporate fiduciary. The trust was revocable and the settlor retained the power to control distribution decisions. Investment authority was directed by a trust adviser who was also in Florida. The U.S. Supreme Court affirmed the decision of the Delaware supreme court that the trust was administered in the state of Delaware (not Florida) *where the trustee was located*.

Factors that could be relevant in determining where a trust is principally administered could include the location of the trust's assets and documents evidencing ownership of property, where trust records are maintained, the location of the trustee's office that is responsible for the administration of the trust, where the trust officers responsible for the administration of the trust are located, where trust officer meetings concerning the trust are held, where trust committee meetings and trust reviews occur, whether trust account administrative transactions occur, where trust accountings and reports are prepared and reviewed, where documents relating to the trust are executed on behalf of the trust, where trust income and contributions are received and where distributions are authorized and disbursed, where tax reports are prepared and reviewed, where tax compliance audits are preformed and reviewed, where the trust instrument is executed by the trustee, and where decisions are made concerning the timing and amounts of discretionary distributions.

If there are trust advisors of directed trusts with a corporate trustee, the advisors are typically individuals who are not regulated in any respect. Therefore, the principal place of administration would appear to be the place where the trustee is located and subject to regulatory authority.

49. Selection of Governing Law In Trust Instrument

a. ***General Limitations.*** Under the Restatement (Second) of Conflict of Laws, the idea is that a trust document may not simply choose any law whatsoever, but may apply the law of a jurisdiction that has a substantial relationship to the trust. In addition, the law selected cannot violate a strong public policy of the forum jurisdiction. (For example, is the forum state's perpetuities provision based on a strong public policy that would preclude selecting the governing law of another jurisdiction with more liberal perpetuities provisions?) The Restatement (Second) of Conflict of Laws provide the following factors in determining "substantial relationship" for inter vivos trusts of personal property: where the trust is administered, the place of business or domicile of the trustee at the time of the creation of the trust, the location of the trust assets at that time, the domicile of the settlor at that time, the domicile of the beneficiaries, or other unspecified contacts or groupings of contacts that may suffice. Restatement §270.

If the governing law of another jurisdiction is selected, plan to have as many contacts as possible with that state, including location of the trustee, trust administration, assets (for intangibles, use an LLC created under the laws of that state to hold the intangibles) and beneficiaries (for example, to select Alaska laws consider creating an Alaska trust and name that trust as the beneficiary of the trust that is designating Alaska law as the governing law).

The Uniform Trust Code is more restrictive. Section 107 restricts the choice of law to one that is not "contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue." (That same restriction applies under §270 of the Restatement (Second) of Conflicts of Laws for determining the validity of a trust—"does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6.") Therefore, a court must consider which jurisdiction in the entire world has the greatest ties to the trust. How is that determined? The Uniform Trust Code comments do not provide any standards to make that determination, but leaves that issue to each locale. As a practical matter, a judge in the forum state will use the forum state's law if the decision is close.

Whether an issue is based on a strong public policy is ambiguous. The only examples given in the Restatement (Second) of Conflict of Laws are (i) exculpation of the trustee for failure to exercise reasonable care, diligence and prudence," and (2) "unusually strict rules as to self-dealing." §271. The decision does not necessarily turn on whether the issue is addressed in the state's constitution. Legislatively prescribed issues may also be based on strong public policy particularly if there are no exceptions to the rule or any ability to draft around the issue.

A recent case states that laws relating to the *administration* of a trust may be designated by the settlor, even if the state designated has no connection to the trust. *In re Thomas H. Gentry Revocable Trust,* 2013 WL 376083 (Hawaii Ct. App. Jan. 31, 2013) held that with regard to legal fees incurred in Hawaii litigation over trust accounting under a Hawaii trust administration, California law applied because the trust instrument directed that California law governed matters of administration. The case reasoned:

> [A] number of authorities agree that a settlor's choice of law regarding trust administration is enforceable. <u>See Restatement (Second) of Conflict of Laws</u> §272; George Gleason Bogert, George Taylor Bogert & Amy Hess, <u>The Law of Trusts and Trustees</u> § 297 (3d ed. 2011) A settlor may "freely regulate most matters of administration[,]" including which state law is to govern the administration of the trust. <u>Restatement (Second) of Conflict of Laws</u> § 272 cmt. c. The designated state does not need to have any connection with the trust itself. <u>Id.</u>; Bogert et al., <u>The Law of Trusts and Trustees</u> § 297 ("As to matters of trust administration, the settlor may designate the local law of a particular state to govern such matters even though that state has no connection with the trust.")

The case listed, as examples of matters of administration the following—approval of annual accountings, trustee's duty to inform and account to beneficiaries, management of trust, trustee powers, duties, liabilities, and right to compensation and indemnity for expenses.

b. ***Consider Multiple Governing Laws as to Different Issues***. Selecting differing governing laws for differing issues is sometimes referred to as "dépecage." That is permissible under the common law and the Restatement (Second) of Conflict of Laws (the laws designated may be required to have some contact with the trust). Under the Uniform Trust Code, there may not as much discretion permitted in selecting different governing laws for different issues because §107(1) refers to the selection of a *single* choice of law as to "meaning and effect"—which may generally encompass just construction—without discussing whether multiple laws may be selected as to other issues. (Curiously, §107(2) of the Uniform Trust Code, however, seems to leave open the possibility of applying multiple jurisdictions' laws as to different issues if no governing law is designated in the trust instrument.) Therefore, under the Uniform Trust Code, an instrument may be able to apply the governing laws of differing states as to some issues but not as to others.

The draftsman should consider whether applying multiple governing laws for various issues would be best. Do not just assume that one state's laws will be applied in their entirety. No state has a complete set of rules that is ideal.

c. ***Better Not to Designate Any Governing Law Than To Do So Blindly****.* Professor Schoenblum argues that the draftsman should not select any governing law in the trust instrument if the draftsman will not take steps to determine which state's law is best for a particular situation. There are default rules as to governing law if the instrument is silent. A general "validation bias" principle applies—if the laws of one state that is the dominant state result in a negative result as to a particular issue but the laws of another state with a "pretty good" connection to the trust yields a positive result, the laws of the state with the positive result applies. Therefore, there is the possibility of applying better state law if no law is designated in the instrument. The governing law clause "should never be treated as boilerplate, to be added reflexively."

d. ***Allow Change of Governing Law, For Example By Changing Place of Administration.*** The trust instrument should allow the trustee to change the place of administration, which generally would apply the governing law of that state. Prof. Schoenbaum thinks that is a good idea, but his only concern is giving the trustee that authority if by doing so the trustee could take steps to choose a law that limits the liability of the trustee.

Several recent Delaware supreme court cases referred to as the *Peierls* decisions (issued on October 4, 2013) clarify that Delaware law generally will govern the administration of a trust that allows a successor trustee to be appointed unconstrained by geography, once a Delaware trustee is appointed and the trust is administered in Delaware. That is not the case, however, if the governing instrument has a choice of law provision stating expressly that another jurisdiction's laws shall always govern matters of administration. A possible constraint is that the *Peierls* decisions provide that if a trust is subject to the continuing jurisdiction of a court in another state, it may be necessary to "obtain the permission of that court to terminate such accountability."

50. Rule Against Perpetuities

Texas uses a traditional rule against perpetuities, which is imbedded in its state constitution. If a Texas resident transfers assets to a trust using the law of another state with a long perpetuities period, will that be recognized? How do we know if the perpetuities provision is based on strong public policy, such that attempts to apply the law of another state will not be recognized? The Restatement of Donative Transfers says that the rule against perpetuities is a matter of strong public policy. The Restatement (Second) of the Conflict of Laws (the trust provisions of which were drafted by Austin Scott) takes the position that the rule against perpetuities is not a strong public policy, but that the elective share is.

As a peculiar example of this quandary about what constitutes a strong public policy in the context of perpetuities provisions, Nevada has a constitutional provision regarding the rule against perpetuities but has a statute allowing a 300 year perpetuities period. Thus, the state statute conflicts with the state constitution.

51. Elective Share

The elective share is uniformly recognized as a matter of strong public policy. Just opting for a governing law clause in another state will not work to avoid elective share requirements.

52. Forced Heirship

An issue can arise as to whether the forced heirship rights of a foreigner apply with respect to trust assets in the U.S. The Cayman Islands recognize that having assets in U.S. trusts will defeat forced heirship rights (as well as elective share rights) as to those assets. The New York *Renard* case refused to recognize the forced heirship rights of a son from France who challenged a will that was probated in New York. Forced heirship rights are not nearly as strong a public policy in the U.S. as elective shares; none of the states recognize forced heirship other than Louisiana.

53. Fiduciary Liability

Fiduciary liability is generally a matter of trust administration, and it is unclear whether the choice of governing law will have an impact of fiduciary liability matters. Fiduciary liability is generally a matter of tort law, and under tort conflicts of law principles, one cannot choose a favorable governing law to protect against tort liability. Whether a settlor can limit fiduciary liability by a choice of laws clause is not clear; some courts have concluded the governing law provision will govern fiduciary liability only if the clause specifically makes clear that it applies as to fiduciary liability matters. Even then, having as many contacts as possible with the selected jurisdiction would help support the enforceability of applying that jurisdiction’s laws regarding fiduciary liability.

54. SELF-SETTLED SPENDTRIFT TRUSTS

About a dozen states have domestic asset protection trust (DAPT) laws. Other states have provisions making clear that if a power of appointment is exercised to appoint assets into a trust for the benefit of the original settlor, the trust is not treated as a self-settled trust for creditor purposes (including Arizona, Ohio and Texas). Statutes in more states provide the same thing regarding inter vivos QTIP trusts, including in Arizona, Delaware, Florida, Michigan, Ohio, North Carolina, Texas, Virginia and Wyoming. Will selecting the governing law of those states by residents of other states be effective for creditor protection purposes?

Various cases have suggested that attempting to apply the DAPT or spendthrift laws of another state is fraught with uncertainty.

Two sections of the Restatement (Second) of Conflict of Laws seem relevant. One section might suggest that the settlor's designation of governing law would be respected. Section 273 states that "Whether the interest of a beneficiary of [an inter vivos] trust of movables is assignable by him and can be reached by his creditors is determined by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related." That section makes no mention of limitations or any reference to public policy. The other section, which is cited by most of the courts that have considered the application of another state's or country's self-settled trust law, is §270 which states: "An inter vivos trust of interests in movables is valid if valid (a) under the local law of the state designated by the settlor to govern the validity of the trust provided … that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6."

In *In re Huber*, 2013 WL 2154218 (Bankr. W.D. Wash., May 17, 2013), a Washington real estate developer created an Alaska asset protection trust in 2008 when he was aware of the collapsing housing market and that his prospects for repaying loans was fragile at best. The trust was found to be a fraudulent transfer voidable under both §544(b)(1) [state law fraudulent transfers] and §548(e) [transfer made within 10 years of filing petition for bankruptcy to a self-settled trust or similar device if made with actual intent to defraud creditors]. The court also reasoned that the trust was invalid under conflict of laws analysis because the trust had its most significant relationship with Washington, citing §270 of Restatement (Second) of Conflict of Laws, and Washington had strong public policy against "asset protection trusts." Implicitly, the court must have determined that Washington had the most significant relationship to the matter at hand; it stated that the contacts with Alaska were minimal and the contacts with Washington were substantial. (The court did not address §273 of the Restatement (Second) of Conflict of Laws.)

The *Huber* case cited and relied on the reasoning of *In re Portnoy*, 201 B.R. 685, 701 (Bankr. S.D.N.Y. 1996). Another similar case, though not cited or mentioned in *Huber*, is *In re Brooks*, 217 B.R. 98, 32 Bankr. Ct. Dec. (CCR) 23 (Bankr. D. Conn. 1998). Both *Portnoy* and *Brooks* involve non-U.S. self-settled trusts. Both applied the law of the forum to invalidate non-U.S. self-settled trusts, basing their reasoning on §270 of the Restatement (Second) of Conflict of Laws (without analyzing §273). (Even though the trust was "invalidated" in *Portnoy,* in that case the debtor was able to settle with the creditor for about 15 cents on the dollar.)

In contrast, the spendthrift trust laws of Hawaii were respected in a California bankruptcy proceeding for a California resident. *In re Zukerhorn*, 484 B.R. 182 (B.A.P. 9th Cir. 2012). The court emphasized that the trustee and settlor were domiciled in Hawaii at the time of the trust's creation, the assets were located in Hawaii, and the debtor, a beneficiary of the trust, was domiciled in Hawaii and remained a citizen of Hawaii for over 70 years. The Hawaiian governing law spendthrift provision was respected because this was not the case of a California resident trying to obtain the benefits of a foreign jurisdiction. (*Zukerhorn* was not a self-settled DAPT case; the court made the point that the self-settled trust analysis did not apply because the case involved the beneficial interest of the son of the settlor. This case, involving standard spendthrift trust issues, does not implicate the same public policy issues as DAPT cases.)

55. Pre-Mortem Probate

Pre-mortem probate is recognized in several states, including North Dakota, Ohio and (recently) Alaska. If a client is anticipating a possible will contest, consider using a funded revocable trust in a jurisdiction where the revocable trust is more difficult to attack than a will. For example, in Alaska and Delaware, a revocable trust can be declared valid before the death of the settlor. Alternatively, a pre-mortem probate may be possible. Probate jurisdiction is generally based on the decedent being domiciled in the state or having real property located in the state. In addition, if probate is held in a state and other interested parties appear in the proceeding, they may be bound by res judicata.

Bob Goldman points out that for some people, maybe the only thing worse than having their will contested is having to sit through the contest during their lives. Also, he says that an issue will be whether there is a "case or controversy" sufficient to give the court jurisdiction to hear the case.

56. State Trust Income Taxation

Changing the place of trust administration, location of the trustees, etc. may be a possible strategy to avoid state income taxation on the undistributed income of a non-grantor trust. However, some states have "forever tainted" rules—subjecting the trust to income taxation in the state if the settlor (or testator) was located in the state when the trust became irrevocable, even if all contacts with the state are ended (i.e., the settlor, trustee, trust assets, and trust beneficiaries are all located outside the state). The only attack on that kind of taxing system is a constitutional attack, but some older cases have upheld its constitutionality. *E.g., Chase Manhattan Bank v. Gavin*, 733 A. 2d 782 (Conn. 1999).

Three state court cases in 2013 have been successful in attacking those kinds of state taxing systems on constitutional grounds—finding that Illinois, New Jersey and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (Dec. 2013)(no Illinois connections with inter vivos trust other than that the settlor was an Illinois resident when the trust was created; "what happened historically with the trust in Illinois has no bearing on the 2006 tax year;"only $2,700 of trust income at issue but trust was by the Pritzker family, which probably has many other trusts subject to the same rules; violation of Due Process Clause); *Residuary Trust A u/w/o Fred E. Kassner, Michele Kassner, Trustee v. Director, Division of Taxation,* 2013 N.J. Tax LEXIS 1 (January 3, 2013)(mere fact that testator of testamentary trust resided in New Jersey not sufficient authority for New Jersey to tax trust on its out of state income ["source income" allocated to New Jersey from S corporation was subject to New Jersey taxation]); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011, 2013 WL 2257832 (Pa. Cmwlth May 24, 2013) (trust's "only presence in Pennsylvania was Settlor's status as a resident in 1959 when he created the Trusts and the residences of the Trusts' discretionary beneficiaries, neither of which provides the necessary substantial nexus with Pennsylvania for the Trusts to be subject on all of their income. Settlor retained no continuing control or power of appointment over the Trusts' property and the in-state beneficiaries are discretionary and have no current or future right to the Trusts' income or assets;" violation of Commerce Clause).

Interestingly, the states that have lost these cases have not revised their websites to advise affected taxpayers that their taxing system has been invalidated on constitutional grounds. A number of states (mostly in the Northeast) have these kinds of state taxing systems (based on the residence of the settlor or testator when the trust was created.

Items 57-67 are observations from a seminar by Steven B. Gorin, Charles A. Redd, and Clinton Eugene Wolf, Jr., The Ascendancy of Income Tax Planning

57. Introduction Regarding Increased Importance of Income Tax Issues

Various factors have increased the relative importance of income tax issues in estate planning, including (1) the high indexed estate, gift and GST exemptions (less than 0.14% of decedents each year will owe federal income tax), (2) portability, and (3) the higher top income tax rates and the new net investment income tax (which applies to the undistributed income of even modest trusts).

Three major planning areas for income tax considerations under this new paradigm of planning are (1) grantor trust planning (because of the high rates on the undistributed income of non-grantor trusts), (2) planning considerations to reduce the undistributed income of trusts that are subject to the top rates, and (3) achieving basis step-up at the death.

58. Grantor Trust Treatment as to Trust Beneficiary—"Beneficiary Defective Inheritor's Trust"

If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under §678. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under §678(a)(2) after the power lapses if the holder has interests or powers that would cause §§671-677 to apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust). See Ltr. Ruls. 201216034, 200949012, 200011058, 200011054 through 200011056, 199942037, & 199935046.

This is sometimes referred to as the "beneficiary defective inheritor's trust" or "BDIT." A typical design of this arrangement is for the parent of a client to make a nominal contribution to a trust (typically within the "5 or 5" amount). The trust would designed as a grantor trust to the client so that the client could enter into sales transactions with the trust to build its value. The client could be a discretionary beneficiary and the trustee (limited by a HEMS standard on distributions). The client could have a limited power of appointment over the trust, and the trust would not be subject to the client's creditors.

For a discussion of this strategy see Item 31 of the Estate Planning Current and Hot Topics (December 2013) summary here and available under Insights at www.bessemer.com/advisor. *See generally* Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013).

The IRS has expressed its displeasure with the strategy of making sales to BDITs, by adding the "sale to a BDIT" transaction on its "no-ruling" list for the first time in 2013, and by making specific reference to the "deemed owner under the grantor trust rules" in the legislative proposal about sales to grantor trusts.

59. GRANTOR TRUST TREATMENT FOR SURVIVING SPOUSE USING DECEDENT'S ESTATE EXEMPTION

There are two general ways for a surviving spouse to create a trust using the first decedent-spouse's estate exemption that is a grantor trust as to the surviving spouse (so that the spouse can enter into sales transactions with the trust without current taxation and so that the trust can grow without having to pay income taxes because they are paid by the spouse).

a. ***Portability***; Fund Trust Following First Spouse's Death. First, the decedent's will could leave assets outright to the surviving spouse and the executor could make the portability election. The spouse could subsequently make a gift, which would be deemed automatically to first utilize the DSUE amount received from the decedent, but which would be a grantor trust as to the surviving spouse. The surviving spouse could not be a beneficiary unless the trust is created under DAPT laws that prevent the spouse's creditors from being able to reach the trust assets merely because the spouse is a discretionary beneficiary. There is some degree of inherent uncertainty regarding the effectiveness of such DAPT provisions if the spouse does not reside in a DAPT state and uncertainty regarding the estate tax treatment of the trust if the spouse is a discretionary beneficiary. Therefore, this strategy is often available only to "mega estates;" otherwise the spouse will be unwilling to make a large gift to a trust of which he or she is not a discretionary beneficiary.

b. ***Supercharged Credit Shelter Trust***sm. The second approach is utilizing the Supercharged Credit Shelter Trustsm as described in Mitchell M. Gans, Jonathan G. Blattmachr, & Diana Zeydel, *Supercharged Credit Shelter Trust*sm, PROB. & PROP. 52 (June/July 2007). This is a favorite strategy of one of the panelists. It involves the creation of an inter vivos QTIP trust by a client for his or her spouse. At the donee-spouse's death, the assets would pass into a “bypass trust” for the surviving spouse’s benefit. The transfer would be treated as being made from the decedent spouse (the original donee-spouse) for estate tax purposes (so the surviving spouse could be a discretionary beneficiary and trustee), but is treated as having been created by the surviving spouse (the original donor-spouse) for purposes of the grantor trust rules pursuant to Reg. §1.671-2(e)(5)(first sentence).

60. NON-GRANTOR TRUST PLANNING ISSUES

a. ***Clayton QTIP***. Leaving assets to a QTIP trust for a surviving spouse allows a great deal of flexibility. If the QTIP election is made, the executor could also make the portability election so that the surviving spouse could use the decedent’s DSUE amount. If the QTIP election is not made, the trust terms could include the decedent’s descendants as discretionary beneficiaries, thus affording the possibility of sprinkling income among lower bracket beneficiaries (as well as obtaining the other advantages of credit shelter trusts).

   Potential problems include (1) whether Revenue Procedure 2001-38 precludes the validity of a QTIP election if is not needed to save estate taxes at the first spouse’s death, and (2) whether there are potential gift tax issues if the surviving spouse is the executor with the authority to make the QTIP election but fails to make the election (in which event the spouse would effectively relinquish the mandatory income interest that he or she would otherwise have received.) One of the panelists is concerned about both of these issues. (As to the potential gift issue, he says that could be viewed as merely being a tax election, “but that is just a label.”)

b. ***Distributions to Avoid Compressed Federal Income Tax Rate Structure Applicable to Trusts***. Trusts are subject to the highest marginal income tax bracket and to the 3.8% tax on undistributed net investment income if the trust has taxable income of only $12,150 in 2014 (this is an indexed amount). Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket ($450,000/$400,000 in 2013, $457,600/$406,750 in 2014). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the $250,000/$200,000 threshold. The total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

   Planners should consider in a planning context whether their clients want to design the trust to maximize the potential for minimizing trust income taxes by giving the trustee the discretion to consider income tax savings (or by using broad distribution standards)—however, the Kiddie Tax may eliminate the possibility of using the lower tax brackets of beneficiaries as long as they are under age 19 (or under age 24 and a full time student). In addition, in an administration context, planners (and fiduciaries) should balance achieving tax benefits against fulfilling other fiduciary duties.

   Distribution planning will turn in part on whether capital gains are included in distributable net income, so that distributions may “carry out” the capital gains to the beneficiaries rather than taxing them at the top trust brackets (as well as the 3.8%

net investment income tax). For an extended discussion of this issue, see Item 9.I of the Heckerling 2014 Musings found here and available under Insights at www.bessemer.com/advisor.

61. Trust Holding S Corporation Stock

a. ***QSST.*** Qualified Subchapter S Trusts ("QSSTs") are treated as owned by the single beneficiary of the trust who consents to treating the trust as a QSST. Using a QSST is the clearest way of creating a trust that is a grantor trust as to the beneficiary under §678. All income must be distributed annually to the single beneficiary, and no principal distributions can be made to anyone other than that beneficiary. The trust is a grantor trust as to the beneficiary regarding items of income from the S corporation. (But when the trust sells the stock, the capital gain on the sale is taxed at the trust level.)

   Disadvantages of QSSTs are that all income must be distributed annually (making the income distributions subject to "creditors, predators, in-laws and out-laws").

   For purposes of the 3.8% net investment income (NII) tax, material participation (to determine if the income from the S corporation qualifies for the active trade or business income exception) is tested at the beneficiary level. If the beneficiary is an employee of the corporation, the active business income exception will likely apply if the corporation is operating a business. Also, the beneficiary's AGI level is used to determine the amount of NII subject to the tax rather than applying the very low trust threshold of $12,150 (the threshold in 2014).

b. ***ESBT***. Electing Small Business Trusts (ESBTs) do not have to distribute all of their income and may have multiple discretionary beneficiaries. All S corporation income is taxed at the highest bracket with limited deductions. For purposes of the 3.8% NII tax, the S corporation portion of the NII is taxed at the trust level regardless of distributions. No income shifting is permissible with ESBTs.

c. ***Structure Issues***.

   QTIP vs. Credit Shelter Trust. If S corporation stock is left to a credit shelter trust, it is locked into ESBT treatment (with no income shifting possible). Using a "one lung" approach to leave all of the estate to a QTIP trust leaves more flexibility for income shifting and portability purposes.

   Single Beneficiary Trust for Children. Using separate single-beneficiary trusts for each child leaves more flexibility. Each child could be a trustee or an independent trustee could have the authority to make distributions beyond just a HEMS standard. There would be flexibility to make the QSST election (and thereafter distribute income annually) or to use the ESBT approach. If there is a "pot" trust for all children, the QSST election would not be permitted; in that situation consider splitting the trust into separate trusts for the children if the QSST election is desirable.

   Toggling Between QSST and ESBT? If distributing all of the income in some year is undesirable, the trust might be able to make the ESBT election for that year, but would not permitted to convert back to a QSST for three years.

Can Be Significant Income Splitting Advantage. As an example, if an S corporation produces $230,000 of flow-through income annually, the tax savings of using a QSST rather than an ESBT if the shareholder has modest income can be over $34,000 per year.

62. Net Investment Income 3.8% Tax

Planning considerations for the 3.8% tax on net investment income (NII) under §1411 is discussed in detail in Item 9 of the Heckerling 2014 Musings found here and available under Insights at www.bessemer.com/advisor. Several specific planning issues are highlighted below

a. ***Self-Charged Rent.*** Rental income is generally treated as NII. There is an exception for self-charged rent. For example, if a business is owned in an S corporation and the client's real estate is leased to the entity, the rental income is not NII if the person who owns the real estate also owns the business (even if the ownership is not in the same percentages). That is a good way to get around subjecting rental income to the 3.8% tax. There is also an exception if the rental operation is a trade or business and the owner is a real estate professional (for example, devoting at least 500 hours per year to the real estate rental operation).

b. ***Working Capital.*** An example in the §1411 regulations makes clear that all NII items in a business (for example interest on the business bank account) are treated as NII even if the bank account is business related.

c. ***QSST and ESBT Material Participation Testing***. For QSST normal operational income, whether there is material participation for purposes of application of the active business income exception is tested at the beneficiary level. However, when an S corporation sells the S corporation stock or sells its assets in conjunction with liquidation of the business, the QSST regulations provide that the trust, rather than the beneficiary, is taxable on the sale. The preamble to the §1411 final regulations says that material participation for purposes of the income from the stock sale or liquidation asset sale is determined at the trust level (and how a trust materially participates is subject to considerable uncertainty). ACTEC submitted comments to the IRS taking the position that shifting the material participation to the trust for the moment of the stock sale is not appropriate.

   Material participation by an ESBT is tested at the trust level (with the inherent uncertainty that entails).

d. ***Material Participation by Trust.*** What a trust must do to "materially participate" in a trade or business under §469 (and for purposes of §1411) is unclear. So far, the IRS has taken a very strict approach, requiring the trustee directly to materially participate in the business. See Item 9.g of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor. The Preamble to the final regulations under §1411 points out that "the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date." A Joint Task Force of the ACTEC Fiduciary Income Tax and Business Planning Committees will prepare substantive comments about the material participation by trusts issue for consideration by the ACTEC Washington Affairs Committee to submit to the IRS.

e. ***Character of Income as NII or Not Is Made at Trust Level and Does Not Change When Item Is Distributed to Beneficiary.*** The final regulations say that the character of an item of trust income as NII is determined at the trust level (for trusts that are not deemed to be owned by the grantor or a third party for income tax purposes under the grantor trust rules including §678), and that determination does not change when the NII item is distributed to a beneficiary. Reg. §1.1411-3(e)(3)(ii). (This position was surprising to planners.) Presumably, the reverse would be true as well— active business income that is not NII to the trust would not be NII to the beneficiaries. (The IRS has indicated informally that is the case.)

   Accordingly, even if a beneficiary is clearly materially participating in a business, a distribution of business income from the trust to the beneficiary will not qualify for the "active business income" exception if the trust did not materially participate in the business to qualify for the exception at the trust level (and how a trust materially participates is subject to great uncertainty).

63. Basis Basics

The basis of an asset is generally the purchase price, plus improvements, less depreciation.

There is an automatic step-up (or step-down) in basis at the death of the owner.

For entity assets, basis step-up applies at the death of the sole owner of an LLC or a sole proprietorship. For a partnership or multi-member LLC, a §754 election allows applying the decedent's fair market value in the interest in the entity to the "inside basis" of the entity assets attributable to the decedent's interest. See Item 66.a below.

There is no basis step-up for S corporations or C corporation assets (although some planning alternatives may effectively achieve the same result as for partnerships, as described in Item 66.b below).

The future tax savings resulting from a basis step-up of an asset may outweigh the estate tax savings of excluding the asset from the gross estate (especially if the beneficiary's estate exemption exceeds the value of assets owned by the beneficiary). If a beneficiary is merely subject to state estate tax, the 16% typical maximum state tax rate may be outweighed by the 23.8% tax on capital gains that could be avoided with a basis step-up.

Depreciable property may be depreciated (i.e., deducted) three times by the family: (1) by the original owner, (2) by the surviving spouse after the owner's death, and (3) by the children after the surviving spouse dies.

64. Basis Step-Up Planning Issues

Basis step-up planning strategies include utilizing broad distribution powers, giving a third party the authority to grant the beneficiary a general power of appointment, applying a formula general power of appointment under the terms of the trust, or employing the Delaware tax trap. These alternatives are discussed in detail in Item 7 of the Heckerling

2014 Musings found here and available under Insights at www.bessemer.com/advisor. Portability planning allows basis step-up at the surviving spouse's death. Various strategies may be used to attempt to secure a basis step-up at the first spouse's death, regardless of which spouse dies first, as discussed in Item 8 of Heckerling 2014 Musings found here and available under Insights at www.bessemer.com/advisor (including a discussion of the application of §1014(e) and the possibility of avoiding §1014(e) if the assets pass to a discretionary trust for the surviving spouse rather than outright to the surviving spouse).

65. Leveraged Transaction to Achieve Full Basis Step-Up But With Only Net Equity Estate Inclusion

Assume the client owns property worth $10 million that has been fully depreciated. Borrow $9 million using the property as collateral, and transfer the $9 million proceeds using leveraged transfer planning strategies (for example, it might be invested in a limited partnership or LLC). At the client's death, the $10 million value of the property will be included in the client's gross estate value and receive a basis step-up, but the net value in the decedent's estate, after subtracting the debt amount on Schedule K, will be only $1 million (plus any portion of the $9 million loan proceeds that have not been transferred by other transfer planning or discounting strategies).

The borrowing must be for recourse debt in order for this strategy to work. If the debt is non-recourse (i.e., if the client is not personally liable for the full amount of the debt), only the value of the property net of the non-recourse indebtedness is included as an asset of the gross estate on Schedule A of the estate tax return. *See* Instructions to Schedule A, Form 706; Reg. §20.2053-7.

66. Choice of Entity Issues Regarding Basis Concerns

a. ***Partnership.*** The §754 election allows an inside basis adjustment for the transferee partner's account pursuant to §743. That impacts the transferee's portion of gain or loss on a subsequent disposition of the partnership assets or the partner's share of basis for depreciation deductions or for property distributions. The basis adjustment is available to the surviving spouse for community property.

b. ***S Corporation.*** There is no equivalent of a §754 election for S corporations. There is a limited opportunity to replicate the partnership result if nondepreciable property is held in a separate entity and if all of the assets are sold and the S corporation liquidates in the same year as the sale of all of the assets. The capital gain on the shareholder's K-1 is offset by a capital loss when the corporation is liquidated (because the shareholder's basis in the stock that is liquidated would be the stock basis after death plus the gain on the K-1).

   If the property is depreciable and the corporation liquidates, §1239 might convert the K-1 income to ordinary income; in that case the capital loss would not offset the ordinary income.

   Getting real estate out of a corporation and into a partnership can avoid these complexities in achieving a basis step-up for the real estate at the entity owner's death.

67. Seller Financed Sale of Goodwill

A buyer that purchases a business in a seller financed transaction typically uses the cash flow from a business to pay the purchase price. There are dramatic differences in the level of taxation based on type of entity that is used.

For a C corporation, there are three levels of tax to get dollars from the business operations to the buyer and from the buyer to the seller: (1) There is a corporate level tax on business income (assume 40% federal and state); (2) there is a dividend tax on a distribution of cash from the corporation to the buyer (assume 30% federal and state tax, including the 3.8% tax); and (3) there is a capital gains tax to the seller when dollars are distributed to the seller (assume 30% federal and state tax rate). To get $70 to the seller requires **$238** of business earnings.

For an S corporation, there are two levels of taxation: (1) the individual S corporation shareholder's ordinary income tax on flow-through income (assume 46% including federal and state tax); and (2) there is a capital gains tax payable by the seller when dollars are distributed to the seller (assume 30% federal and state tax rate). To get $70 to the seller requires **$185** of business earnings.

For a partnership, there is a single taxation level if the payments are taxed under §736(a), in which event the payments are ordinary income to the seller but deductible by the partnership. (If the parties elect to treat the payments as redemption payments under §736(b), the payments are capital gain to the seller, but are nondeductible to the partnership [which in effect creates the double taxation level that applies to S corporations].) The tax rate on self employment income is about 50% (40% federal, 5% state, 3.8% self employment tax, and 1.2% for various phase outs). To get $70 to the seller requires only **$140** of business income.

Partnerships should be more popular than they are. The taxation of partnerships is complex but there are big advantages.

Items 68-75 are observations from a seminar by John Bergner, Julie Kwon, Carlyn McCaffrey and Steve Akers, Staying Alive, Staying Alive: How to Keep the GRAT Dance Going After Funding

68. Overview—Advantages of GRATs

Advantages of GRATs include (1) their safety and effectiveness in light of the fact that they are authorized by statute and regulations, (2) their flexibility (the settlor can be the trustee during the trust term, they can hold S corporation stock, etc.), (3) they are an effective wealth shifting technique (transferring combined income and appreciation in excess of the §7520 rate), (4) they can transfer wealth at no transfer tax cost (if the annuity payments are structured to almost "zero out" the value of the remainder)—so they have been called a “heads I win, tails I don’t lose” strategy, and (5) they can be structured to place a cap on the amount that is transferred at the end of the annuity term.

Disadvantages include that most (if not all) of the value will be included in the settlor’s estate if the settlor dies during the GRAT term, and that GST exemption cannot be allocated to the trust when it is created based on the very low value of the remainder interest. There has been an increase in audit transactions, examining how GRATs have been administered (and in particular when annuity payments have been made and how the distributions in satisfaction of annuity payments were valued). One panelist is now handling a case in which the annuity payments were made 6 and 4 months late, respectively, but before the GRAT was selected for audit. The IRS is taking the position that the GRAT is invalid from its creation under the reasoning of the *Atkinson* case (in which the requirements of a charitable remainder trust were totally and egregiously ignored in its administration). That case could not be settled with the examining agent and it is now being considered by Appeals.

GRATs are not “set up and forget them” transactions. The proper administration of GRATs is critical and creates opportunities to maximize the effectiveness of GRATs.

The materials include a number of comprehensive forms useful in administering GRATs.

69. Steps Immediately Following Creation of GRAT

a. ***Assign Responsibilities.*** The planner should make clear who is responsible for filing the gift and income tax returns and for making annuity payments. One panelist’s approach is to continue having responsibility with respect to ongoing annuity payments, finding that clients are willing to pay for this advice (GRAT transactions typically are large transactions). An investment advisor might assume responsibility for advising about investment issues for the GRAT, particular if the GRAT consists of a highly concentrated position.

b. ***Coordination With Estate Plan.*** If the settlor is married, the planner must take steps so that the GRAT value will qualify for the marital deduction if the settlor dies before the end of the GRAT term. In that event, any remaining annuity payments will be made to the settlor’s estate (so that the remainder value can be “zeroed out,” Reg. §§ 25.2702-2(a)(5), 25.2702-3(e) Ex. 5). The remainder interest in the GRAT should not also be made payable to the estate, or else the GRAT value at the date of death might be treated as a reversionary interest, which must be valued at zero under §2702. Planning alternatives include:

  - If the settlor dies before the end of the GRAT term, the annuity should convert to an interest that is the greater of the stated annuity amount or the income from the trust (this is particularly important if the annuity passes to a QTIP trust).
  - The settlor could be given a power of appointment over the remainder interest as to any portion of the trust that is included in the settlor’s gross estate. This gives the settlor the flexibility to decide (and later amend) whether the remainder should pass outright to the surviving spouse or to a QTIP trust in order to qualify for the marital deduction. The trust should provide whether the remainder passes outright to the surviving spouse or to a QTIP trust in default of the exercise of the power.

- The settlor should execute a codicil bequeathing the right to the remaining annuity payments to the same recipient of the remainder interest (i.e., to the spouse outright or to the QTIP trust that receives the remainder interest).

Some planners may leave the remainder interest only to surviving children (because amounts passing to the children of children who die during the trust term would be taxable terminations subject to the GST tax). If so, the client might want to revise the will to leave an offsetting amount to the children of a deceased child. (Drafting such a formula amount can be rather complex.)

c. ***Gift Tax Returns.*** The attorney should prepare (or at least review) the gift tax return reporting the transfer to the GRAT. Special issues apply for reporting GRAT transfers, which are all too often done incorrectly (see below).

d. ***Income Tax Returns.*** The GRAT is a grantor trust. The planner should make clear with the client and accountant how the grantor trust income will be reported.

e. ***Reporting Requirements for Insiders.*** The panelists typically engage securities attorneys to advise as to whether the insider must report GRAT transfers, and to review any filings, even if the in-house counsel prepares the report. (The holder of the "So-GRAT" patent apparently reviews the securities filings to determine when any stock options have been transferred to GRATs by insiders who are required to make securities disclosures. For that purpose, one panelist typically gives non-descript names to GRATs so that a mere review of the securities filing does not disclose that the transfer was to a GRAT.)

70. FILING TAX RETURNS

a. ***Income Tax—Reimbursement of Grantor's Income Tax?*** GRATs typically do not include income tax reimbursement clauses. Rev. Rul. 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1). Giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3). More important, if creditors can reach the trust, the transfer to the trust is likely an incomplete gift. *See e.g., Outwin v. Comm'r,* 76 T.C. 153 (1981) (trustee could make distributions to settlor in its absolute and uncontrolled discretion, but only with consent of settlor's spouse; gift incomplete because settlor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the creditor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); Rev. Rul. 76-103, 1976-1 C.B. 293 (gift incomplete, where trust assets were distributable to settlor in trustee's complete discretion and where donor's creditor could reach trust assets; also trust assets included in donor's estate under § 2038 because of donor's control to terminate the trust by relegating the grantor's creditors to the entire trust property).

Reimbursement clauses may be helpful in the event the GRAT assets explode in value and generate huge capital gains taxes on the sale of the trust assets. Otherwise, the settlor may be "quite grumpy." If a reimbursement clause is used, hopefully the client's state is one of the states that have amended their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. See TEX. PROPERTY CODE ANN. § 112.035(d); N.H. STAT. ANN. § 564-B:5-505(a)(2), or that the selection of such a state's laws to govern the trust will be respected. If there is not a state law denying creditors access to the trust assets merely because of the existence of the clause, some planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors.

Other planning strategies for dealing with the possibility of very large income taxes from the GRAT are for the grantor to retain a substantial portion of the equity interest that is transferred to the GRAT (so that the grantor will be experiencing some portion of the same explosion in value that generates unusually large capital gains taxes), or to cap the amount passing to family members following the end of the GRAT term (so that assets in excess of a stipulated amount will be returned to the grantor, again limiting the settlor's exposure to seemingly unlimited income tax exposure with respect to the GRAT activities).

b. ***Gift Tax***.

Special Disclosures. There are special disclosures required for GRATs under the adequate disclosure regulations, and the additional disclosures are often not included in gift tax returns. Reg. §301.6501(c)-1(e)(2). For example, the disclosure must describe how the annuity payments were valued (including actuarial factors and discount rates), and must include the identity of all related parties "holding an equity interest in any entity involved in the transaction."

Election Out of Automatic Allocation of GST Exemption. In addition, the return typically should elect out of automatic allocation of GST exemption, either when the GRAT is created or at the end of the "ETIP." (This issue is described in detail in Item 23.d of the Heckerling Musings 2014 found here and available under Insights at www.bessemer.com/advisor.) One of the advantages of opting out of automatic allocation is that this approach leaves flexibility. Once GST exemption is allocated, it is irrevocable. If the client opts out of automatic allocation, that can be changed at any later time, or the client can affirmatively allocate GST exemption to the GRAT at the end of the GRAT term.

Split Gift Election. The split gift election is typically not made for GRATs. However, the election may be made if the client has made other gifts during the year for which a split gift election is desired. If the GRAT remainder passes to a trust of which the donor's spouse is a discretionary beneficiary, uncertainties arise as to whether the split gift election is effective as to the GRAT. The split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605. The election applies only as to the ascertainable severable interest that passes for persons other than the spouse.

A reason that the parties affirmatively may want to make the split gift election from a GRAT gift is to be able to use the consenting spouse's GST exemption if there may be a desire to allocate GST exemption to the remainder trust following the end of the GRAT term. While the *amount* that can qualify for gift splitting may be limited for gift purposes, the regulations appear to provide that if any portion of the transfer qualifies for gift splitting, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. Reg. §26.2652-1(a)(4); 25.2513-1(b)(4).

71. Making Annuity Payments

a. ***Cash.*** Hopefully, the GRAT will have cash to make annuity payments. If not, the GRAT may be able to borrow from third parties or a family entity or another grantor trust (but not from the grantor, as discussed below) to have cash to make the annuity payments. If assets are distributed in kind to satisfy annuity payments, transferability and valuation problems may arise, as discussed below.

b. ***Transferability***. Transferring of some types of assets in satisfaction of annuity payments may present mechanical difficulties (*e.g.*, hedge funds, certificated stock, horses, art, private equity funds). A better alternative is to transfer those types of assets into a limited partnership or LLC and transfer an interest in the entity to the GRAT. (The entity would be structured with full liquidation rights, etc. so that discounts would not apply in valuing interests in the entity.) When annuity payments must be made, a mere one-page assignment of an interest in the entity would be sufficient to make the annuity payment.

   Using such an entity to hold the interests will require the completion of a questionnaire to make sure the entity is a qualified investor for securities law purposes.

   This can be particularly helpful with private equity funds. The client would transfer all of his or her interests (including carried interests) into the LLC so that an assignment of an interest in the entity would be a "vertical slice" transfer that would not invoke §2701. In addition, as capital calls are made, the entity could borrow funds to be able to make the capital calls.

   Another approach to simplifying the assignment process that has been used by some planners is to execute formula assignments at the time the GRAT is created, dated on the dated that each annuity payment is due. The assignments would provide that they could be revised before the payment date, but if not revised, the assignments would be effective on the respective payment dates.

c. ***Valuation Problems.*** The best practice is to obtain a new appraisal each year of the interest that is distributed in satisfaction of annuity payment amounts. (Using last year's appraisal is referred to by some planners as using a "SALLY" appraisal—"same as last year.") If the valuation is wrong there may either be a deemed contribution (if the value is too low) or a deemed commutation (if the valuation is too high). Planners argue that there should be no deemed contributions or commutations because the trust instrument requires distributing the correct amount and the instrument has provisions requiring adjustments for incorrectly valued distributions. To some degree that begs the question, though, because the IRS argues that the failure to comply with trust provisions results in treating the trust as invalid from the outset under an *Atkinson* argument.

A practical problem is that the appraiser cannot possibly secure all relevant information and prepare an analysis of the value of the hard-to-value asset on the same day that it is distributed. The forms include provisions for making an assignment based on values to be determined by an appraiser in the near future. After the appraisal is received the parties would sign a supplemental assignment agreement confirming the units transferred based on the appraised value.

Practical problems also arise for marketable assets that are easy to value. For marketable securities, if the value is based on the mean of the high and low for the day, that will not be known until the market close, and then the interest can no longer be transferred (or can be transferred only with considerable difficulty) on that day because the market is closed. A practical approach is to obtain the high and low values on one day and make the transfer the following day using those values. (In particular, if the values are obtained on the anniversary date and the units are transferred the following day, the trustee can take the position that settlor received the amount that should have been received if the transfer had been made on the anniversary date.)

d. ***Loans From Grantor Should Not Be Used to Make Annuity Payments.*** The regulations provide that a retained interest is not a qualified interest unless the trust instrument expressly prohibits the use of notes, other debt instruments, options, or similar financial arrangements that effectively delay the grantor's receipt of the annual payment necessary to satisfy the annuity amount. "Issuance of a note, … directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount." Reg. § 25.2702-3(b)(1)(i). The preamble to that regulation states that the annual annuity payment "must be made with either cash or other assets held by the trust." (T.D. 8899). If the settlor on Day 1 loans cash to the GRAT in return for a note from the GRAT, and the GRAT used that cash on Day 2 to make the annuity payment, the overall net effect is that the settlor has received a note from the trust. The preamble makes clear that the trustee of a GRAT may borrow the required funds for a GRAT payment from an unrelated third party. However, the step transaction will be applied where a series of transactions is used to achieve a result that in inconsistent with the regulations. For example, if the trustee borrows from a bank to make the annuity payment, and then borrows from the grantor to repay the bank, the payment would be treated as an indirect issuance of a note from the GRAT to the grantor in payment of the annuity payment.

A possible planning approach would be for the GRAT to distribute in-kind property to the grantor, and have the grantor exercise a substitution power to substitute a note from the GRAT for the property. The initial distribution by the GRAT would seem to satisfy the payment requirement under the regulations. The subsequent exchange would appear to be permitted under the substitution power. The IRS would likely take the position that a property distribution followed by a substitution of a note by the grantor would violate the prohibition on making annuity payments "directly or indirectly" by the issuance of a note from the GRAT.

There is no prohibition in the regulations from the GRAT issuing a note to the settlor for any purpose other than making annuity payments. If the GRAT needs liquidity during the year for some reason, can the GRAT borrow from the settlor? Presumably so if the cash is not tied "indirectly" to the trust's later annuity payment to the settlor; but any such borrowing from the grantor raises the inherent fact question as to whether such an indirect connection can be made to the annuity payment itself.

e. ***105 Day Grace Period.*** The § 2702 regulations that were issued in 1992 provided that the annuity payment could be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year (without regard to extensions). (If the trust does not file a return, but is a grantor trust and meets the requirements of Reg. § 1.671-(4)(b) so that the trust income is just reported directly on the grantor's return, the payment must be made by the date the trust's return would have been due if the trust were filing a return.) Reg. §25.2702-3(b)(i)(i). A final regulation issued on September 5, 2000, provided that only annuity payments made based on the taxable year of the trust could be paid after the close of the taxable year, but by the due date of the trust income tax return. Payments based on the anniversary date of the trust had to be paid by the anniversary date. Reg. §25.2702-3(b)(4). This final regulation was corrected to state that if the payment is being made annually based on the anniversary date of the trust, the payment must be paid no later than 105 days after the anniversary date. T.D. 8899, issued November 28, 2000. The regulations do not address whether interest should be paid on any late annuity payment that is made within the allowed grace period.

Most planners value assets that are made late (within the 105 day grace period) on the date of the actual payment. Some planners do not require that interest be made on the late payments. One panelist is concerned with not paying interest. GRAT instruments typically do not specifically authorize the annuity payments to be made late (particularly without payment of interest for the late payment), because that would seem to require that the present value of the annuity payments be calculated assuming that they would be paid late—which would reduce the present value of the annuity. If the instrument does not authorize late payments (but within the 105 day grace period), there may be a fiduciary duty to pay interest to compensate for late payment. Another panelist argues that interest should not be required, under the reasoning that (1) the instrument does not prohibit use of the 105 day grace period, (2) the instrument contains a clause stating that the trust should be interpreted in a manner so that it creates a qualified annuity interest under §2702, and (3) the regulations contemplate the possibility of making payments late within 105 days without any express requirement of paying interest on the late payment.

If payments are not made within the 105 day grace period, the payments should be made as soon as possible (to avoid an *Atkinson* argument by the IRS invalidating the trust under §2702), and a sense of fairness and consistency would seem to require that interest be paid at the same §7520 rate that was used in valuing the annuity payment right when the trust was created.

To avoid the problem of late payments, one panelist uses a nominee provision, stating that if an annuity payment is not timely made, the trustee holds assets equal to the amount of the annuity payment (the assets with the lowest income tax basis) as the settlor's agent or nominee.

f. ***Securities Law Issues With Using Insider Stock to Satisfy Annuity Payments.*** Section 16(b) of the Securities Exchange Act of 1934 permits recovery to a corporation of insider trading profits made within a 6-month period. A distribution of insider stock in satisfaction of an annuity payment might be treated as a purchase for purpose of this short swing profit rule, so that a sale of stock within the 6-month period might require disgorgement of any profit on the sale. A particular problem is that receiving insider stock in satisfaction of the annuity payment and rolling the stock into a new GRAT may be treated as a purchase and sale within six months. *See e.g., Dreiling v. Kellett*, 281 F. Supp.2d 1215, 1244 (W.D. Wash. 2003) ($247 million damage award, as a result of determining that distributions from a GRAT constituted a "sale").

Potential solutions (some of these suggestions are designed to reduce discretion to minimize appearances of distributions being treated as a purchase by the grantor): (1) reduce trustee discretion with respect to insider stock; (2) do not include a swap power over insider stock; (3) include an ordering rule so that distributions are made first from insider stock, then cash, then other assets in satisfying annuity payments in order to eliminate discretion; (4) do not include any grace period for making annuity payments. Another planning strategy may be to interpose "hurdles" between the insider stock and the grantor: (1) contribute the insider stock to an LLC and be careful to have no purchases for six months and a day; later, the grantor may decide to contribute some of the LLC interests to a GRAT; and (2) have the insider make a contribution of all annuity payments from the original GRAT to a "Gap GRAT," so the annuity payments are not distributed to the grantor but to another GRAT.

72. Exercising Substitution Powers

a. ***Situations in Which Swaps With GRAT May Be Useful.*** The GRAT instrument typically gives the settlor the power to substitute assets of equivalent power, exercisable in a non-fiduciary capacity. This is one of the ways that is used to cause the trust to be a grantor trust, but the power can provide helpful flexibility. Useful situations for exercising swap powers include (1) a substantial decline in the value of GRAT assets (so that the re-acquired asset may be transferred to another GRAT and future appreciation from that "low point" could be transferred), (2) the assets have grown dramatically (and substituting cash or a note for the volatile assets would "lock in" the GRAT's success), (3) changed liquidity needs of the settlor or of the GRAT, (4) changed client goals, and (5) to obtain a basis step-up for assets owned by the settlor at death.

An advantage of the substitution power is that the settlor can demand the return of the asset in the GRAT rather than merely approaching the trustee about negotiating to re-purchase the interest in case the trustee is willing to sell. The settlor has the absolute right to re-acquire a trust asset, and the only issue is what "equivalent value" must be paid to the trust.

An alternative approach for dealing with the "burned out" GRAT situation, suggested by Ed Manigault, is to have the grantor contribute the annuity from an underwater GRAT to a new GRAT (or "Gap GRAT"). Presumably, the annuity would be valued at approximately the remaining value in the GRAT. Any subsequent appreciation would inure to the benefit of the new GRAT.

b. ***Substitution for Note From Grantor?*** Some planners are reluctant for settlors to exercise substitution powers by giving a note to the trust in return for assets from the GRAT, for feat that the IRS might make an argument that would somehow implicate the prohibition on using notes ***from*** the GRAT to satisfy annuity payments. It should not, because the note is from the settlor ***to*** the GRAT, not a note ***from*** the GRAT to the settlor. Even so, to avoid the potential of such an argument, some planners advise against exercising substitution powers by a note from the settlor, which could result in an ugly audit, even if the IRS is wrong. (If that is a concern, one alternative would be for the settlor to pay the note in cash before the annuity payment is made, so that the GRAT could make the annuity payment in cash rather than with the settlor's own note.)

What interest rate should be used on the note from the settlor? Using a market rate would maximize the potential wealth shift at the end of the GRAT term. The conservative approach is to use the AFR on the note, to avoid an argument that the settlor gave an asset to the GRAT worth more than the asset received, thus constituting a prohibited additional contribution to the GRAT.

The materials include an agreement documenting the exercise of a substitution by cash, with a provision for adjustments (with interest) if it is ever finally determined for transfer tax purposes that the amounts exchanged are not equal.

c. ***Securities Law Issues; Section 16(b) Short Swing Profit Rule.*** Section 16(b) of the Securities Exchange Act of 1934 permits recovery to a corporation of insider trading profits made within a 6-month period. Under the § 16(b) "short-swing profits" rule, profits must be disgorged if any sales and purchases occur within six months of each other. A 1997 SEC No-Action Letter held that the creation of a GRAT and subsequent return of stock to the grantor in satisfaction of annuity payments will "effect only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities." Accordingly, such a transaction would be ignored for § 16(b) purposes under that No-Action Letter. *Peter J. Kight*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,403 (October 16, 1997). However, cases have held that the substitution of insider stock and an unauthorized transfer from a GRAT of insider stock for the benefit of insiders constituted purchases for purposes of § 16(b). *E.g.*, *Morales v. Quintiles Transnational Corp.*, 25 F. Supp. 2d 369 (S.D.N.Y. 1998)(exercise of substitution power to reacquire stock from GRAT constitutes a "purchase" for § 16(b) purposes, thus creating a six-month period during which any profits from subsequent sales of such stock would have to be disgorged to the corporation).

The mere existence of the insider-client having a substitution power does not cause a problem; it is the *exercise* of the power that may constitute a "purchase" for purposes of § 16(b).

73. TRUST EXPENSES; DEEMED ADDITIONAL CONTRIBUTIONS

When the GRAT is created, the planner should give thought to what expenses the GRAT will incur during the GRAT term. The GRAT should pay its own expenses; if the settlor pays them, the payments may be deemed to be a prohibited additional contribution to the GRAT.

Examples include trustee fees, accountant fees, attorney fees, appraiser fees, capital calls, investment manager expenses, maintenance expenses, etc.

As to appraiser expenses, the arguments could be made that the settlor should pay the expense so that the settlor can know that he or she is receiving the proper amount if annuity payments are made in kind. On the other hand, the trustee has an obligation to distribute a proper amount in satisfaction of required annuity payments. Perhaps both should bear part of the expense. If an appraisal is obtained by the settlor (or other family members) for other purposes close to the valuation date, perhaps that appraisal could be used, without the necessity of the trust obtaining (and paying for) its own appraisal.

One panelist creates separate billing files for the client and the GRAT, and allocates attorneys fees between the two files.

One approach if the trust does not have sufficient cash to pay the expenses is to borrow from a third person. The GRAT might also borrow needed liquid funds from the settlor, but this may raise an inherent factual question later as to whether the GRAT's note is indirectly treated as an annuity payment, which would violate the prohibition on using notes from the GRAT to make annuity payments.

74. Grantor With Shortened Life Expectancy

a. ***Purchase of Remainder Interest by Settlor.*** If a GRAT is really successful 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 end of the term of the GRAT, all assets in the GRAT will likely be included in the estate. But under this approach, the remainder beneficiary trust would have the dollars paid for the remainder interest that are 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 might be treated as a gift.

Revenue Ruling 98-8 treated a similar sale of the remainder interest from a QTIP trust as being the equivalent of a commutation. The IRS gave so many reasons in that ruling that it was apparent that the IRS was struggling with a reason that worked. The main rationale in the ruling was §2519, which obviously would not apply outside the context of a QTIP trust. The IRS could similarly assert that the purchase of the GRAT's remainder interest is a prohibited commutation, but it is hard to understand how a commutation can occur without action by the trustee.

To avoid that possible argument, if possible 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.

One attorney has reported doing this in a transaction in which 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.

Various planning steps to leave open the possibility of using such a strategy are helpful. (1) The remainder should pass to a separate trust. (2) The remainder trust should be a grantor trust. (3) The GRAT should not have a spendthrift clause. (4) If the settlor retains the power to designate who receives the remainder in case the settlor dies before the end of the GRAT term, the remainder may have diminished value; give someone the authority to remove that power from the settlor. (5) A power to amend the trust to assure that the trust qualifies as a GRAT and to maximize planning flexibilities should be included in the GRAT. (6) If the remainder interest is purchased, it should be valued using the same §7520 rate as when the GRAT was created for consistency purposes.

b. ***Sale of GRAT Assets to Grantor in Return for Private Annuity***. If the GRAT sells its assets to the grantor in return for a private annuity for the grantor's life, and if the grantor dies during the term of the GRAT, the GRAT would have no assets because the private annuity would expire. This same approach could be done with a self canceling installment note rather than an annuity.

The viability of this approach is unclear. The trustee could potentially have fiduciary concerns if the grantor dies during the term and the GRAT ends up with no value. In addition, there could be "economic substance" concerns if there is a pre-arrangement to do this with set values that would pass to the GRAT if the settlor survives the term and that would have nothing in the trust if the settlor does not survive.

75. Termination of GRAT

a. ***Documenting Final Transfers.*** The materials include a form for an agreement documenting the final transfers made from the GRAT to the settlor in payment of the final annuity amount and to the remainder beneficiaries. Having such a document may be helpful in explaining, in case the question ever arises, how the trust with substantial assets was funded.

b. ***GST Issues***. If the settlor's child has died during the GRAT term and if some of the GRAT asset pass to the deceased child's children at the end of the GRAT term, a taxable termination would occur and a GST tax would be payable—unless GST exemption could be allocated to that transfer.

There is considerable uncertainty as to how GST exemption can be allocated at the end of the GRAT term if the goal is to make the allocation to some but not all trusts that receive the GRAT assets at the end of the GRAT term. (For example some of the assets might pass to the grantor's children outright and the balance might pass to long-term trusts. There would be no need to allocate any exemption to the portion passing outright to the grantor's children.) One possible alternative might be to sever the GRAT before the end of the trust term, but it is not clear how that would be done (before the GRAT has split into separate trusts). A retroactive allocation in connection a qualified severance may be possible for the situation in which a child has died unexpectedly "out of order."

Item 8 on the Treasury Priority Guidance Plan for 2013-14 deals with this issue: "Regulations under §2642 regarding the allocation of GST exemption to a pour-over trust at the end of an ETIP." (That item was first added in the 2012-2013 Plan.) The AICPA had sent multiple letters to the Treasury requesting a guidance project on this issue. The letters point to situations in which the grantor would want to allocate GST exemption either affirmatively or by automatic allocation to some but not all trusts that would receive the GRAT assets at the term of the ETIP. Ron Aucutt quotes the correspondence from the AICPA, giving some glimpse on what issues the IRS might consider in this project in his ACTEC Capital Commentary. Aucutt, ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated (Aug. 12, 2013). The letter includes an example scenario in which one trust for descendants and one trust just for children is created at the end of the GRAT term. The letter asks for guidance as to whether GST exemption could be allocated just to the trust for descendants.

If GST exemption can be allocated in the desired manner, the settlor has until the due date for filing gift tax returns for the year in which the ETIP ends. Therefore, the grantor would have until April 15 of the following calendar year (and until October 15 if the income tax return is extended).

c. ***Continuing Grantor Trust.*** The remainder interest should pass to a trust that is also a continuing grantor trust. Further leveraged transactions may be possible with that trust, such as sales to the trust for installment notes. The value in the grantor trust following the end of the GRAT term can serve as the "seed" money for further sale transactions.

Another possible (but more aggressive) alternative is having the trust enter into a subsequent joint purchase GRAT transaction, in which the grantor trust pays for the remainder interest in the new GRAT (a transaction that Jonathan Blattmachr refers to as a "SPLAT," or split purchase annuity trust). Under the joint purchase approach, the value paid by the grantor for the qualified annuity interest would be excluded from the gross estate, assuming the payment equaled the actuarial value of the retained annuity interest, regardless of whether the grantor survived the term of the annuity interest. (Indeed, an annuity for the grantor's life could be used.) For a discussion of this alternative, see Item 28.l of the Hot Topics and Current Developments (December 2013) article found here and available under Insights at www.bessemer.com/advisor.

Items 76-84 are observations from a seminar by Karen A. Fahrner, Michael Rosen (U.S. Department of the Treasury, Office of Terrorist Financing and Financial Crimes) and John A Terrill, II, Bureaucracy, Red Tape, and Delay: Who's To Blame and Why? The Role of Banks and Lawyers in the War on Terrorism and Combating Money Laundering

76. Regulation of Banks and Financial Institutions

a. ***Account Opening Process Is Slower and More Complicated Than in 1990s***. In the 1990s, opening accounts at banks and financial institutions was easy and quick. Beginning in the early to mid 2000s, the process is becoming more involved, with significantly more customer intake requirements.

b. ***Overview of Regulation of Financial Institutions***. There are about 3,900 national banks and about 2,000 state banks. Various agencies provide oversight of financial institutions, including:

- the Federal Reserve System (the "Fed" was created in 1913 to create a central banking system in response to the need for short term credit for banks in times of widespread withdrawals);
- the Office of the Comptroller of the Currency (the "OCC" governs national banks [institutions that have "national" or "National Association" in their name]; it was created in 1863; it examines banks for compliance measures, approves new charters and structural changes; enforcement procedures include revoking charters, issuing cease and desist orders, assessing penalties, and removing officers);
- the Federal Deposit Insurance Corporation (the "FDIC" was created in 1933 in response to many bank failures; it provides insurance, now insuring deposits up to $250,000 per depositor; insurance proposals had been made from the 1800s and this was enacted in response to large numbers of bank failures leading up to and after the 1929 market crash [bank failures averaged 600 per year in the 9 years before 1929, there were 4,000 failures per year in the early 1930s; there have only been 517 bank failures since October 2000, including 157 failures in 2010 and 51 failures in 2012]);
- the National Credit Union Administration (which regulates, charters and supervises federal credit unions; manages the National Credit Union Share Insurance Fund); and
- the Consumer Financial Protection Bureau (created by the Dodd-Frank Act of 2010; consumers can file complaints and banks respond to the consumer and the Bureau).

c. ***Money Laundering Control Act of 1986***. This act criminalized money laundering. 18 U.S.C. §§1956-1957 (2009).

d. ***Bank Secrecy Act and Patriot Act***. The "Currency and Foreign Transactions Reporting Act of 1970" (known as the "Bank Secrecy Act") was amended by the Patriot Act in 2001, codified at 31 U.S.C. §§5311-5332. It requires customer due diligence requirements and reporting of suspicious activities (discussed in more detail below). The Bank Secrecy Act is implemented by the Federal Financial Institutions Examination Council ("FFIEC").

e. ***State Banking Regulations***. State banks are governed by state regulations. There is also federal oversight for institutions covered by FDIC insurance or that borrow funds from the Fed (and are members of the Federal Reserve System).

f. ***Examination Manual***. The FFEIC Bank Secrecy Act/Anti-Money Laundering InfoBase include a 300 page examination manual for examiners. It is the collaborative effort of various agencies that provide oversight of financial institutions (including the Fed, FDIC, OCC, National Credit Union, and the Consumer Financial Protection Bureau.

g. ***OFAC***. The Office of Foreign Assets Control ("OFAC") is an office of the U.S. Treasury Department. It has been in existence since the early 1800s; sanctions were imposed by

OFAC against Great Britain in the War of 1812. If a person is on the OFAC list for violating laws, doing business with that person, including receiving money from the person or providing legal services, is illegal, with strong sanctions. Under Economic Sanctions Enforcement Guidelines, issued in 2009, sanctions can be up to $250,000 per violation. This applies to all U.S. persons. Some large law firms run an OFAC list check for all new clients; many small firms do not (but in this area, "ignorance is not bliss.") There are procedures to obtain approval by an agency of the Treasury Department to provide legal services in particular situations.

77. Customer Due Diligence

The Customer Identification Program ("CIP") is imposed under §3.6 of the Patriot Act. It generally requires that institutions form a reasonable belief that they know the true identity of customers. Institutions must adopt formal account opening procedures—which may vary from institution to institution, and may vary based on various factors such as the type of account and whether the account is opened in person or online. The required information includes the name, date of birth, address, and tax ID number. The information must be verified under practicable risk-based procedures (this can be done after the account is opened). This includes minimally accepted documentation (such as a current government issued ID) and non-documentary procedures (such as checks with referral sources, Lexis searches, credit bureau searches or Google searches). Each element does not have to be verified, but enough must be verified to let the institution "form a reasonable belief that it knows the true identity of the customer" (quoting the FFIEC Examination Manual).

78. Reporting Requirements for Certain Types of Transactions

a. ***Suspicious Activity Reports***. Financial institutions are required to file suspicious activity reports with the Financial Crimes Enforcement Network ("FinCEN") for transactions that may be legal but that are suspicious. Identifying these activities involves objective and subjective factors. Objective factors include the results of the customer identification program and whether the person is on the OFAC list. Subjective factors entail knowing that a transaction is not "normal," which involves knowing the client to know what is normal in the context of that person and the particular transaction at issue.

b. ***Currency Transaction Reporting***. Banks must file a Currency Transaction Report for each cash transaction over $10,000. There are exceptions, but some businesses are ineligible for these exceptions, including the practice of law, accounting and medicine.

79. Proposal by FinCEN to Require Verification of Beneficial Owners of Accounts

FinCEN (an office of the U.S. Treasury Department) issued a proposal on March 5, 2012 that imposes "piercing the veil" requirements, to know who is really controlling and benefitting from entities. These requirements go far beyond the customer due diligence requirements of the Patriot Act and Bank Secrecy Act, and include identifying and verifying beneficial owners of entities. The customer due diligence requirements of the Patriot Act impose risk-based approaches, but this FinCEN proposal would enact strenuous investigation requirements regardless of the risk assessment. Beneficial ownership information is not required only for private banking customers. The customer due diligence requirements would be extended to the beneficial owners of all customers, defined as "an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account." The American Bankers Association has complained that this proposal has greatly expanded customer due diligence requirements far beyond the Patriot and Bank Secrecy Acts without national debate of balancing the advantages with the additional expenses necessitated by the rigorous investigative requirements.

80. Overview of FATF

The Financial Action Task Force ("FATF") was established in 1989 to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. FATF has developed a series of Recommendations that are the international standard for combating of money laundering and the financing of terrorism and proliferation of weapons of mass destruction. First issued in 1990, the FATF Recommendations were most recently revised in 2012. See http://www.fatf-gafi.org/.

81. U.S. Treasury Role

Michael Rosen, with the Treasury Department, is the policy advisor for anti-money laundering and countering the financing of terrorism. He also participates in the Office of Terrorist Financing Financial Crimes. A major goal of that office is to increase transparency in the financial system and determine appropriate action against national security risks with sanctions, implemented in part by OFAC, which is an office of the U.S. Treasury. Mr. Rosen's role involves coordination of the Treasury's guidance with the private banking sector as well as with law enforcement and the intelligence community.

82. Interaction of Treasury With ACTEC

The U.S. Treasury has had a strong relationship with ACTEC, going back to 2000, in determining how the transparency concepts play out in real life. Duncan Osborne and Jack Terrill have been very helpful to the Treasury in this effort.

83. Transparency Focus

A major focus of Treasury is the appropriate transparency that should be required of the ownership of financial assets. The concept is that pursuing corrupt leaders and pursuing their financing requires knowing who is in the financial sector. The goal is to determine if Treasury has the information that it needs to apply sanctions appropriately and to give law enforcement the information that it needs.

Laws currently focus of registration showing legal ownership but not beneficial ownership of assets. The concern is that illicit actors get into the financial sector (*i.e.*, are able to open accounts in the U.S.) by opening accounts in the name of entities. Banks are not now required to look behind the entity to determine who owns interests in the entity (but see the FinCEN proposal discussed in Item 79).

a. ***G-8 Transparency Initiative***. The "G-8" is comprised of the largest economies in the world, other than China. The U.K., in particular, is focused on the transparency of entities. It has adopted core principles seeking transparency of the ownership and control of companies and trusts. This is consistent with FATF Recommendations. The transparency focus is clear in the U.S. as well; the White House has specifically mentioned "beneficial ownership" in its discussions of the efforts against terrorist financing and money laundering.

b. ***U.S. National Action Plan***. The participants in the G-8 Initiative have committed to publish their respective national action plans. The U.S. Action Plan includes the following:
   - Advocate for comprehensive legislation requiring identification of the beneficial ownership information at the time a company is formed, and identifying key parameters of such legislation;
   - Clarify and strengthen customer identification requirements for financial institutions;
   - Risk assessment project, working with the Department of Justice, Treasury, and Department of Homeland Security to assess risks to various types of owners and participants in the financial sector; and
   - International cooperation, sharing information among countries about the ownership of legal entities.

c. ***Trust Transparency***. One of the principles of the G-8 Initiative specifically addresses trusts. In Europe, many countries do not deal with or recognize trusts. A commonly held belief in many foreign countries is that trusts are just used for tax evasion and other illicit purposes. The U.S. response is to ask for examples of abuses involving trusts. There are few examples. Most of the reported cases of abusive transactions using entities involve using U.S shell corporations, not trusts. Studies have shown that trusts are used infrequently for illicit purposes. The U.S. approach has been to focus on being able to provide law enforcement access to needed information about trust ownership. Other countries want information about trust ownership to be available to the public, not just law enforcement.

   FATF also is pushing for trust transparency. Recommendation 25 requires information be made available about express trusts, including information regarding the settlor, trustee and beneficiaries so that it can be accessed by "competent authorities." A new Interpretive Note to FATF Recommendation 25 observes that civil law countries generally do not recognize trusts, do not understand how they operate, and believe they present a significant risk of money laundering. It emphasizes that trustees should be required to maintain current information about the identity of the settlor, protector (if any), beneficiaries, and any other persons exercising control. Furthermore, the trustee should be required to disclose that information to banks and to other authorities.

84. Current Issues Affecting Attorneys

The role of "Gatekeepers," including attorneys, has the attention of the G-8, FATF, the Administration, and Congress. The "Transnational Organized Crime Strategy" report has a chapter about "Facilitators/Attorneys Involved in Money Laundering." Senator Levin has been vocal in pushing for attorneys to be subject to the same anti-money laundering requirements that apply to banks. Senator Levin has introduced legislation (for example, S. 1465) in the last three sessions of Congress that would require states to adopt disclosure requirements for the beneficial ownership of entities, and that would extend anti-money laundering obligations to attorneys who form companies. That position is widely opposed, including by the U.S. Chamber of Commerce.

FATF Recommendation 22 addresses expectations for gatekeepers (called "designated non-financial businesses and professions"), including attorneys, accountants, real estate agents and dealers in precious metals. The Recommendation imposes on attorneys some of the obligations imposed on banks, including record keeping, due diligence, and filing suspicious activity reports. This Recommendation regarding attorneys is why the Treasury is engaged with ACTEC and the American Bar Association regarding FATF.

These obligations are already imposed on attorneys in the U.K. They have had the obligation to file suspicious activity reports (without any notice to their clients) for some years. That is totally repulsive to the concept of attorney-client confidences in the U.S.

Items 85-94 are observations from a seminar by Scott D. Brown, John T. Rogers and Suzanne Brown Walsh, Cyber Risks: Are You, Your Firm, and Your Clients Cyber-Safe?

85. Under Attack

Digital assets are under siege; be aware of the possibility of an attack and be prepared for how to react if a breach occurs.

86. Beware of Email Links, Such as LinkedIn Requests

Instead of clicking on email links, open a browser and type in the address of the target website. LinkedIn Requests may sometimes be spam that opens access to the computer. Instead of clicking on the link to accept the invitation, go to the LinkedIn website directly and link with name of the person who was on the invitation.

87. State Supported Attacks

If there are suspicions that an attack on the computer system is from a "state supported attack" (such as by Chinese hackers), do not antagonize them. That may invite more rigorous attacks.

88. NSA Spying

How should we react to NSA spying in our practices and personal lives? We know that this occurs, but the percentage likelihood of any particular individual being spied on is infinitesimally small. There is no reason to panic.

89. Protective Measures

a. ***Be Prepared***. Know what to do if there is an attack on the office computer system. State legislation often provides that notice must be given if there is an invasion of personal information. Federal law requires protection of personal medical information under HIPAA. If a "disclosable event" occurs, notice must be given of the data security breach. The California Attorney General recently pursued someone who did not react quickly enough to a data security breach.

b. ***Home Networks Should Have a Password***. Use a password for home networks. Otherwise, someone driving by may be able to get access to the home network and home computer.

c. ***Double Authentication***. Particularly for sensitive information, use a provider that employs a double authentication method. For example, a password and answers to questions may be used. Or some business networks use a password and RSA token approach. Some major websites that offer double authentication protection are Google/Gmail, Facebook, Apple/iTunes/iCloud, Twitter, and Microsoft.

90. Electronic Communication Policy

Every firm should have an electronic communication policy. Everything done on the company's network is the company's property.

91. Client Consent

Consider sending a notice to clients about how the firm communicates with clients, including cell phones and email. Have the client consent to those forms of communication, realizing that the possibility of a breach of security is always present.

92. Ethics Issues

a. ***Rule 1.1-Competence***. The attorney msut act competently. A recent revision of the Comments to Rule 1.1 includes that the attorney "should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology."

b. ***Rule 1.6-Confidentiality***. Rule 1.6(c) is new. It provides that a lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client. The comments state that the attorney must act competently to safeguard information against unauthorized access. However, the unauthorized access to, or the inadvertent or unauthorized disclosure of, information does not constitute a violation if the lawyer has made reasonable efforts to prevent the access or disclosure. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to forgo security measures that would otherwise be required by this Rule.

c. ***Rule 5.1 and 5.3-Supervisory Responsibilities.*** Rule 5.1 address the responsibilities of a partner or supervisory lawyer and Rule 5.6 address the responsibilities regarding nonlawyer assistance.

Be careful in disposing of copiers, because they have memory of thousands of items that have been copied. The Department of Health and Human Services has sued a medical provider for a release of personal health information on a copier.

93. Firm WiFi for Guests

There should be a separate guest network, separate from the network on which firm data is stored. A password should be required, and the password should be changed periodically.

94. Access to Digital Assets by Fiduciaries

Google is the only major digital company that allows the designation of someone to have post-mortem access to digital data, through its "Inactive Account Manager." Facebook absolutely refuses access to digital content by fiduciaries.

There is a Uniform Laws project, developing the "Fiduciary Access to Digital Assets Act."

The goal is to have a completed project by the end of 2014 ready for promulgation by state legislatures.

Providers are fighting access to digital data by fiduciaries. After long debates, they have generally conceded that the Uniform Act will allow access; in return the Act will provide immunity to providers who provide access to fiduciaries. The key to the Uniform Act is Section 8 regarding "fiduciary access and authority." The default rule under the Act is that fiduciaries will have access to digital assets, but account owners will be able to opt out. (For example, an individual may not want her family to find out after her death about her secret life.)

Items 95-101 are observations from a seminar by Roselyn L. Friedman, Professor Susan N. Gary, and Michael D. Simon, Beyond Kumbaya: What Trust and Estate Lawyers Need to Know about Mediation

95. General Background Information About Mediation

a. ***State to State Variance***. There is tremendous variance among the states that have statutory provisions regarding mediation. Some states have comprehensive statutory schemes, and some states have mandatory mediation requirements.

b. ***Similarities and Distinctions from Litigation***. Some forms of ADR are similar to litigation, such as arbitration. While there are rules to simplify the process in arbitration, it proceeds much like litigation, with an arbitrator who decides who wins and who loses. Mediation, on the other hand, is designed to reach a negotiated settlement.

c. ***Emotions***. The mediator must deal with the emotions of the parties. Each party can tell his or her story, and the mediator acknowledges their emotions.

d. ***Reality Check***. Mediation provides a reality check to the parties. There are risks in litigation. Do the parties want to spend hundreds of thousands of dollars and take years of their lives litigating with family members?

e. ***Creative Problem Solving Process***. Mediation is a creative problem solving process. For example, a key part of a solution may be an apology from one or more of the parties. The best advocates in mediation are creative problem solvers, not necessarily the best litigators. The goal is to arrive at a solution, and not to pronounce a winner or loser.

96. Choosing a Mediator

Select a mediator with subject matter expertise in the subject under dispute. There is no national credentialing process for mediators. Some states provide mediator certifications. Former judges sometimes serve as mediators. Some judges approach the mediation as a settlement conference. That can work in some situations, if that is what the parties want, but that approach does not necessarily "peel back the onion" to ascertain the underlying issues between the parties to seek creative solutions. A good mediator must be able to develop rapport with the parties but also be tenacious when necessary.

97. Types of Mediation

a. ***Facilitative Mediation***. The goal is to reach a negotiated settlement, not to find a winner or loser, but to come up with a better solution than litigation. The mediator controls the process but does not determine the outcome.

b. ***Evaluative Mediation***. An expert is used to assess the case. This approach is often not appropriate when family relationships are involved, but can sometimes be appropriate for trust and estate cases. For example if there are complex business/family issues involved in a business conflict situation, the valuation of the business (or different aspects of the business) may be the key to coming up with solution.

c. ***Transformative Mediation***. The focus is not on a current settlement, but achieving a successful long term relationship (for example, running a business successfully long term, sharing a vacation home, etc.).

98. Attorneys for the Parties in Mediation

In some situations, mediation may be used to work out conflict situations even before the parties have attorneys representing them. Typically each of the parties will have attorneys in the mediation; sometimes one attorney may represent multiple parties (for example, the family attorney trying to work out a mutually agreeable arrangement for the family, in which event a joint representation letter should clearly define the scope of the engagement). In Florida, the mediator can meet with the parties alone, separate from the attorneys, to ascertain what the parties really want.

99. Mediation/ In Terrorem Provision

Some trust instruments may include a mediation/ in terrorem provision, stating that a beneficiary must participate in good faith mediation with respect to any dispute or else forfeit any interest in the trust. One speaker does not recommend that approach; it turns the mediator into an evaluative mediator—evaluating whether each party is engaging in good faith. If this kind of mediation/in terrorem approach is used, just require that the beneficiary participate in mediation rather than requiring good faith participation.

100. Practical Mediation Tips

Have a plan going into mediation. An excellent checklist for preparing a mediation representation plan is in Harold I. Abramson, MEDIATION REPRESENTATION: ADVOCATING AS A PROBLEM-SOLVER, ch. V, *Preparing Your Case for Mediation,* at 346-370 (Wolters Kluwer Law & Business 3d ed. 2013).

The "who, what, when, where" strategies for mediation are summarized below.

Who. Be careful to clarify who is the client. Know the mediator and his or her approach. Who has connection with potential claims but are not parties to the mediation?

What. What does each party want to accomplish? When the parties leave the mediation, what specific documentation is the goal? Is the goal a full settlement agreement or a "deal point" agreement. All salient points must be included for the deal point settlement agreement to stand up in court. (Major problem areas with the enforceability of settlement agreements are whether all necessary parties sign the agreement, if a material term is omitted, or if there are conflicts allowing some party to complain later that he or she was not represented by counsel.) Have a plan before going into mediation—have an understanding of what the other party wants, and consider possible creative solutions beforehand. Otherwise, the mediation may quickly turn toward the other party's proposed solution with discussions about tweaking that solution approach.

When. One approach is to mediate early before the parties are ferociously mad at each other. If the mediation is too early, however, before discovery and before the parties know the facts, the parties may not have enough facts to evaluate the risks and strengths of their positions to have a basis for a negotiated settlement. In post-mortem litigation, having the mediation significantly before the estate tax return is filed may be helpful if a possible solution is to allow one or more parties to have input into positions that will be taken on the estate tax return.

Where. What city will be used if the parties are in multiple locations? Specific location possibilities include an office suite or hotel. Make sure that there are enough rooms for each party to have breakout discussions. Make sure food is available. (The mediation may last long into the night.) Can the parties access their vehicles after hours? Is the area safe at night if the parties leave late at night?

101. Ethics Issues

The attorney's agreement to a settlement without the client being present and without giving the attorney specific settlement authority is risky.

The attorney cannot commit extortion—threatening to turn the opposing party into the police if a settlement is not reached. (This is not an ethical issue; it is a criminal issue.) The attorney can make clear, however, that if further investigation shows that the opponent has stolen from the trust, the party will pursue all remedies, including dealing with the theft.)

The attorney cannot bully a client into a settlement. For example, the attorney cannot threaten to withdraw from representation on the eve of trial just because the attorney is unhappy with the client exercising his or her rights.

Rule 1.1 competence is always essential. The attorney should prepare for the mediation. Study the file before the mediation, and be prepared to address specific substantive issues that may arise. Associate with attorneys expert in substantive areas that the attorney is not competent to address.

An attorney cannot talk directly with an opposing party who is represented by counsel without the consent of the counsel. Similarly, the attorney cannot use his or her client as a mouthpiece to communicate with the other party. However, there is nothing wrong with encouraging the parties to talk with each other to work out their differences.

Items 102-109 are observations from a seminar by Turney P. Berry, Martin Hall, and Margaret E.W. Sager, Dr. Barnes Takes a Mulligan: Maximizing the Chances That Your Donor's Charitable Wishes are Followed

102. Overview; Follow-up to Barnes Foundation Litigation

This seminar is a follow-up to the discussion of the Barnes Foundation litigation at the 2013 Summer Meeting. Extended prominent litigation in Philadelphia modified the unworkable terms of the Barnes Foundation, resulting in moving Dr. Barnes huge art collection to a new museum in downtown Philadelphia. The Barnes litigation is discussed in detail in Items 74-75 of the ACTEC 2013 Summer Meeting Musings (available here here and at www.Bessemer.com/advisor). The seminar addresses strategies in a planning mode to provide flexibility for accommodating changing circumstances when a donor places restrictions on charitable gifts or creates a charitable foundation. Strategies that can help in carrying out the donor's intent for charitable gifts are addressed from the donor's perspective.

103. Core Objectives vs. Detailed Hopes and Precatory Goals

1. Focus on whether the donor has a core objective, which may be rather general, and a list of more detailed hopes and precatory goals. There are two general types of donor restrictions, (i) use and management restrictions, and (ii) temporal restrictions.

Use Restrictions. As an example, a donor may wish to restrict the use of a donation to funding performances of The Nutcracker on the first and second weekends of December in a particular theater in Tucson, Arizona. Many issues may arise in the future that would make that unrealistic.

Management Restrictions. In the Barnes litigation, various management restrictions led to the Foundation's financial failure, such as strict restrictions on investments to particular bonds and limitations on being able to charge for public admittance to view the art collection.

Temporal Restrictions. Focus on whether the donor really wants the charitable fund to last forever. Two concerns with very long-term funds are (i) the longer the fund lasts, the higher the probability that it will eventually be used for purposes other than the donor's original purpose, and (ii) making focused significant current distributions may give the fund more impact than dribbling out the funds for a long period of time. Julius Rosenwalt, who restricted that the Sears Roebuck family foundation would only continue for 25 years after his death, was adamant about the dangers of perpetual foundations and actively promoted non-perpetual structures. He convinced Andrew Carnegie and John D. Rockefeller to change the terms of endowment grants they had already made so that the endowments could be spent if needed. He wrote: "Trustees and officers of perpetual organizations often become more concerned to conserve the funds in their care than the wringing from the funds the greatest possible usefulness." In recent times, philanthropists such as George Soros, Ted Turner, Bill Gates, and Warren Buffet have received recognition for their non-perpetual charitable foundation structures.

Address with donors their short term goals and long term goals. For very long term funds, broaden the purpose or build in substantial flexibility. (For example, what if a fund is established to cure cancer and cancer is cured in 25 years?)

Summary. Work with the donor to distinguish what is really the core purpose of the donor vs. what is precatory.

104. Enforcement Mechanisms

The strongest mechanism is to provide that the charity will forfeit the fund to a "pourover entity" if the funds are not used for the stated purposes. If that enforcement approach is used, the restrictions on the use of the funds must be very specific—to know whether the funds are being used for those objective purposes. However, as the restrictions become more detailed and complicated, the more likely it is that the program eventually will become unworkable.

Enforcement of forfeiture provisions may be difficult. The pourover charity and the original charitable donee may "strike a deal" to permit the funds to be used for different purposes. The attorney general may have little political incentive to enforce restrictions imposed by dead donors. (Prof. Sitkoff reminds us that AG stands for "aspiring governor.")

The donor eventually must recognize that enforcement mechanisms may impose a barrier to using funds for unwarranted purposes, but there is no absolute assurance that the funds will continue to used for the stated purposes over time.

Standing. Private enforcement of charitable restrictions depends on who has standing to enforce the restrictions. Cases are difficult to reconcile as to who should have standing to enforce charitable restrictions. Possibilities include (i) the intended beneficiaries of the fund, (ii) directors or trustees of the fund, (iii) persons who can nominate board members or trustees, (iv) former board members or trustees (especially if the nonconforming actions occurred during their tenure on the board), (v) special interest groups (such as "Friends of…" organizations, typically these groups do not have standing but sometimes they do); and (vi) judicial surrogates (if no one is opposing a request to change the use of donated funds, the judge may appoint an amicus curiae or a master to investigate and inform the judge on an independent basis). (If the judge in the Barnes litigation did not think he was seeing a balanced presentation of the advantages and disadvantages of proposed changes in the use of the foundation funds, why did he not appoint a master to investigate the issue independently of the parties before the court?) Another possibility is the donor, or persons designated by the donor, may have standing to enforce charitable restrictions, as discussed immediately below.

105. Donor Standing

The traditional view has been that the donor must have some continued interest in the fund (such as the ability to select a successor charitable entity or the power to modify or release the restrictions) in order to have standing to enforce restrictions. The trend of modern cases, however, is to recognize an explicit agreement between the donor and charity giving the donor standing to enforce restrictions. Cases are pretty clear that such an agreement will not endanger the availability of a charitable deduction as long as the donor cannot ultimately divert the funds from being used for charitable purposes.

Planning Pointer: Merely giving the donor certain retained powers to enforce restrictions may not be sufficient unless the agreement also explicitly gives the donor standing to enforce the restrictions.

Some Charities Refuse to Grant Donor Standing to Sue the Charity. One of the speakers represents a very large charitable organization that absolutely refuses in donor agreements to grant donors the right to sue the charity to enforce charitable agreements.

Deceased Donor. If the donor has standing to enforce restrictions, will the donor's estate or family have standing to enforce the restrictions after the donor's death? *In Smithers v. St. Luke's-Roosevelt Hospital Center*, the appellate court held that the special administrator of the deceased donor had the rights that the donor had held to approve actions taken by a hospital to fulfill the terms of a donor agreement to build a center for alcoholics in a particular building in New York. 281 A.D. 127, 723 N.Y.S.2d 426 (2001), *order issued by* 2001 WL 331965, 2001 N.Y. Slip Op. 02954 (2001). The case eventually settled, and $8 million of the original $10 million gift was returned to the estate when the hospital did not comply with the restrictions. Alternatively, the agreement with the charity might specifically give the donor's estate or family members or a designated third party (who could designate its successor) standing following the donor's death. An alternative is to name an LLC populated by family members as being the successor to have standing following the donor's death or incapacity.

General Recognition of Donor Standing. Various authorities recognize the standing of donors to enforce charitable restrictions. *See* Uniform Trust Code §4.05 ("The settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust"); UPMIFA (gives the donor the power to consent if a charity wishes to release or modify a restriction without court approval). A Pennsylvania statute clearly affords the donor standing to enforce charitable restrictions.

106. Contract Law Argument

The donor makes a gift to charity for a restricted purpose. Is that a contract that the donor can enforce under a breach of contract theory if the restrictions are not followed? Probably not, but commercial litigators don't know that and make the contractual law argument anyway. A growing trend is to make the breach of contract argument, partly just in hopes of getting the issue before a sympathetic jury. In *Brooks v. Integris,* the jury returned to Garth Brooks $500,000 that he gave to a hospital purportedly to build a women's center named for his mother, and awarded him another $500,000 as punitive damages. The breach of contract argument is becoming more appealing, and generally should be pleaded as a cause of action in lawsuits over charitable restrictions.

107. Sample Charitable Agreement

A Sample Charitable Gift Agreement in the materials contains the following paragraphs regarding the ability to modify the purposes of the gift fund and standing issues:

4. The Charity may, in its discretion, modify and amend the purposes of the Fund if (a) the purposes of the Fund have been accomplished or have become impracticable or impossible to achieve economically, [or (b) the Charity determines that Withdrawals from the Fund may be better deployed to meet other needs of the Charity and its then current mission.] [Notwithstanding the foregoing, the Charity may take action in accordance with the provisions of this paragraph only with the advance written consent of the Donor, or if the Donor is incapacitated or not then living, the Donor's spouse, or if the Donor's spouse is not then living or is incapacitated, a majority of the Donor's then living descendants with each line of descendants, determined per stirpes beginning with the Donor's children, having one vote.] [Notwithstanding the foregoing, the Charity may not take action in accordance with the provisions of this paragraph without the advance written consent of __________.] Further, no modification or amendment of the Fund or this Agreement will be effective it if would result in the Fund being treated as other than a component fund of the Charity or that would affect the status of the Charity as an organization described in section 170(b)(1)(A) of the Internal Revenue Code of 1986, as amended (the "Code").

4A. One or more of those who must consent to the Charity taking action in the previous paragraph may at any time and from time to time bring an action in ________ Court to enforce the provisions of this Agreement and the Charity agrees and acknowledges that they have legal standing and have an interest that will allow such action. The Charity agrees not to contest the bringing of such action on grounds other than that the Charity has complied with the terms of this Agreement and to oppose any person or party who asserts a contrary position.]

108. Private Party Arbitration

The donor and charity may agree to private arbitration regarding charitable restrictions. The agreement might provide that if the arbitrator determines that the charity violated the restrictions, the donor would have the choice of remedies among various listed alternatives. A private party arbitration provision may be a suitable alternative if a charity refuses to grant donor standing to enforce restrictions in the donation agreement.

109. Intermediary Disbursing Organization

Instead of relying on the ability to sue the charity after it has failed to use funds for the designated purposes, the funds might first be left to an intermediary organization that would disburse funds to the charity that is the ultimate recipient for the designated purposes. That works fine if the intermediary organization is just making grants to an established charity. (It is rather cumbersome if the donor is creating a foundation to provide the intended services, and has to create a second foundation to oversee the activities of the first foundation.) That provides some protection, but it may just shift the issue—the intermediary organization may "go rogue" as well as the organization intended to satisfy the charitable goals. Furthermore, if the donation lists very specific purposes and if disputes arise over whether those purposes are being served, the provision just shifts the litigation. The organization that is supposed to receive the funds will sue the intermediary foundation for refusing to release the funds because it believes the funds are not being used properly.

Item 110-112 are observations from a seminar by Deborah Green, Deborah Tedford, and Margaret Murphy, The Affordable Care Act and Social Security: Where Do They Fit In Estate Planning?

110. Basics of Affordable Care Act

a. **Guaranteed Availability of Coverage.** Guaranteed coverage applies effective January 1, 2014. Insurance companies must accept all applicants. Ratings differences are permitted based on individual or family coverage; approved rating areas (within a state); age (limited to no more than a 3:1 variation); and tobacco use (limited to no more than a 1.5 to 1 variation). Plans are guaranteed renewable and cannot be rescinded by insurance companies. Individuals cannot be denied coverage based on pre-existing conditions. Discrimination based on health status is generally not allowed (but premiums can be reduced to some extent to encourage healthy behavior).

b. **"Qualified Health Plan;" Levels of Coverage.** To ensure standardized choices for all, the Act establishes the concept of "qualified health plans" meeting basic requirements, and levels of coverage. The general idea is that the plan be equivalent to typical employer plans. As an example, one requirement is that the plan cannot have any deductibles for preventive care.

The insurance may be purchased though an established exchange or from an insurance company. The exchanges are purely voluntary.

The insurance may be purchased online, through a broker or directly from an insurance company, and the cost must be the same regardless how it is purchased.

The levels of coverage refer not to the quality of the plan but to the level of coverage or reimbursement the plan provides relative to the full actuarial value of the benefits provided under the plan. The various "metal" levels of coverage provide the following percentages of the full actuarial value of benefits: Bronze-60%, Silver-70%, Gold-80%, Platinum-90% (but Platinum plans are very rare). In addition, "catastrophic plans" are available if the individual is under age 30 or meets certain low income levels.

c. **Subsidies.** Subsidies of out-of-pocket costs and of premiums are permitted for low-income individuals. These subsidies vary based on the individual's income. For example, an individual who has income up to 200% of the poverty level is entitled to a two-thirds reduction in out-of-pocket expenses. The subsidies are paid directly to the insurance company.

   Subsidies of premiums are available for certain low-income individuals, but no subsidies are available for individuals who are below the poverty level—they only qualify for Medicaid and not premium subsidies for regular insurance.

d. **Individual Mandate—Penalty Tax**. In an effort to achieve a broad insurance pool, individuals are required to obtain insurance. The penalty tax in 2014 for those who do not timely obtain coverage is the greater of $95 or 1% of modified AGI. This increases in 2015 to the greater of $325 or 2% of modified AGI and increases in 2016 to the greater of $695 or 2.5% of modified AGI. The penalties for children under age 18 are one-half the adult penalty, and the maximum penalty per family is capped at 300% of the minimum penalty (i.e., 3 x $695 in 2016, or $2,085). There are limited exemptions from the penalty tax (conscientious objectors and if the premium exceeds 8% of annual income).

e. **Coordination With Medicare.** Medicare is available for persons at age 65 (and in some instances at earlier ages). An individual at age 65 may either keep the insurance or may qualify for Medicare, but it is illegal for an insurance company to sell an individual "Marketplace Plan" to someone with Medicare Part A or Part B. The coordination of qualified health plans with Medicare does not work well for individuals who elect to keep their qualified health plans instead of Medicare. If the individual switches to a Medicare policy, the individual must notify the insurance company (14 days notice required) that the individual will be going on Medicare. Any subsidies will be halted.

111. Medicare Basics

Medicare has four parts. *Part A* pays for hospitals for "in-patient" services. Part A costs the individual nothing (if the individual or the individual's spouse paid FICA taxes at least 10 years) and it does not impact the amount of other benefits available to the individual.

Generally, there is no need to sign up for Part A as long as a worker has qualifying health plan coverage. In order to receive payments under Part A, the individual must be formally "admitted" to the hospital, and not just held for observation. After three days, the patient qualifies for Part A benefits. In contrast, if the patient is not formally admitted but merely held for observation, Part A payments are not made and the patient is liable for the hospitalization costs. Apparently, there is a growing trend of hospitals not formally admitting patients if there is not a clear diagnosis of the patient's medical problem.

Part B pays for doctors (generally for "out-patient" services), funded by general tax revenues. The monthly premium depends on the individual's income level. For example, if the individual files a joint return and has income of $170,000 or less, the monthly premium in 2013 is $104.90; for income above $428,000, the monthly premium is $335.70.

Part C is called Medicare Advantage. An individual can elect to join a Medicare Advantage Plan in his locality. It operates like an HMO-the provider agrees to pay all healthcare costs. The Medicare Advantage Plan pays all Part A, B, and D coverage. Because these plans operate like HMOs, they may not provide coverage, or only temporary coverage, if the insured leaves the plan area.

Part D is a prescription drug plan. If not covered by other medical insurance, persons reaching age 65 should enroll in a Part D drug plan, which is heavily subsidized by the government so that the individual is not paying market rates. Individuals must choose among plans, to match their particular drug needs. The national base beneficiary monthly premium for Part D is $31.17 in 2013, but prices vary significantly among plans, and the premium increases for higher income individuals. Part D plans have four stages of payment (2013 figures). (i) Initial deductible of $325. (ii) Plan pays 75% of prescriptions up to $2,970. (iii) More limited coverage from $2,970 up to $4,750 – the coverage gap or "doughnut hole." In 2013, in the coverage gap the enrollee pays 47.5% of the cost of brand name drugs and 79% of the cost of generic drugs. This is gradually reduced until 2020, when payments will not exceed 25% for any drug in the gap. (iv) Plan pays 95% of all costs above $4,750.

Penalty for Late Enrollment in Part B and Part D. If the individual is not covered under a group health plan for the individual or the individual's spouse, there is a late enrollment penalty for not enrolling in Part B upon reaching age 65. The penalty is 10% more for each full 12-month period, and this penalty will apply for the remainder of the individual's lifetime. Beware that receiving COBRA benefits following employment is not treated as group health coverage for purposes of this exception from the time requirement for timely enrollment in Part B. An individual could get stuck with a permanent penalty if the individual does not enroll in Part B and D until after the COBRA group coverage ends.

There is also a penalty for Part D premiums for the drug prescription plan after the initial enrollment period if there is a period of 63 or more days in a row when the individual does not have Part D or other creditable prescription drug coverage. The penalty is an additional 1% of the base beneficiary premium for each month the person was eligible for Part D and not covered by a creditable drug prescription plan, and lasts as long as the person has Part D drug coverage.

***Key Pointer*: This penalty is huge and lasts for life. It is extremely important to enroll timely for Part B and Part D. For Part B, this is at age 65 if the person is not covered by a**

group health plan, or within an 8-month "special enrollment period" after the individual is no longer covered by a group health plan.

Supplemental Medicare Policies; Medigap. These are commonly referred to as "Medigap" policies. Part A pays only a limited number of days, and Part B has a 20% co-pay. There are eight different kinds of supplemental plans, labeled A-J. Every A plan is identical, every B plan is identical, etc. Shop around plans, because the same benefits are available regardless of the provider. Generally, buy the cheapest plan in the class that is needed.

112. Social Security Basics

a. ***Social Security Administration Website; Personal Earnings Record of Workers.*** The Social Security Administration website has recently been changed to www.socialsecurity.gov. (It was previously [and can still be accessed at] www.ssa.gov. Some have joked that it was changed because the Social Security Administration realized that was "ass backwards.")

   Personal Earnings Record statements previously were mailed to participants in the Social Security system. (For convenience, this summary refers to participants in the system with earnings records as "workers." The more official Social Security lingo is to refer to a participant as a "number holder" or "NH." At least "worker" seems a little more personal than "NH.") The Personal Earnings Record statements are now only available online at the website (saving an estimated $70 million per year). Individual statements are available at www.socialsecurity.gov/mystatement. An worker's top 35 years are used to determine the retirement benefits. The website includes "Estimated Benefits" together with the Earnings Record.

b. ***Full Retirement Age.*** The full retirement age is 65 for those born in 1937 or earlier, increasing from age 65 to 66 for those born in 1938-1942, age 66 for those born in 1943-1954, and increasing from age 66 to age 67 for those born in 1955-1959, and age 67 for those born in 1960 and later.

c. ***Collecting Early.*** Retirement benefits can be started as early as age 62, but a permanent reduction in benefits will apply. For example, the percentage of benefits for a worker collecting early whose full retirement age is 66 is as follows: 62-75%, 63-80%, 64-87%, 65-93%, 66-100%.

   The breakeven age for a single person waiting until age 66 (versus age 62) and taking full benefits is age 78. The chance of a 62 year old male living beyond age 78 is 78% and for a 62 year old female the chance is 85%. Waiting till age 66 is a no brainer for most people, unless they cannot obtain work or have serious health issues AND are single.

d. ***Deferring Starting Benefits Beyond Full Retirement Age.*** If benefits do not begin before or at the full retirement age, the annual benefits will permanently be increased, as follows: 66-100%, 67-108%, 67-116%, 69-124%, 70 (or later, but there is no reason to defer to a later age)-132%. These are called "delayed retirement credits."

At age 70, the maximum benefit is reached. If a worker defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about $40,000 per year.

e. ***Deciding When to Apply for Benefits****.* Factors in the decision of when to begin receiving benefits include the person's health status and life expectancy (e.g, if the person will die at age 64, it would be better to begin receiving benefits at age 62), the need for income, whether the worker plans to work, and the needs of survivors.

The COLA adjustments are made based on the initial base level of payments, so the COLA adjustments magnify the impact of the reduction for early payments. Taking early payments also impacts the level of survivor benefits following the worker's death. Another advantage of delaying payments is that the benefits are based on the 35 top years; dropping out 4 years or more from the late 1970s (when the earnings limit was *much* smaller) and adding the 4 most recent years of earnings results in a higher benefit level.

The vast majority of people choose to begin receiving Social Security benefits at age 66.

Foregoing the early payment option at age 62 dramatically impacts the level of benefits that will be paid for the rest of the worker's life. For example, benefits beginning at age 62 will be about $1,850/month vs. $3,255 per month if the benefits do not begin until age 70. As discussed in paragraph c above, waiting until age 66 is a no brainer for most people, unless they cannot obtain work (and are desperate for cash flow for basic support) or have serious health issues AND are single.

In making the decision to delay receiving benefits from age 66 to age 70, observe that it takes about 12½ years to recover the four lost years of benefits--14 years taking into account the time value of money. Therefore, the decision to defer benefits means that the worker thinks he or she will live to age 82.5 (or age 84 taking into account the time value of money). Another factor to consider is that if the worker is likely to continue working until age 70, the individual will have a higher base for computing benefits as his or her 35 highest years, this increasing the "principal insurance amount" even before the "delayed retirement credits" are applied.

The decision of when to apply for benefits also involves other issues, discussed below, such as spousal benefits. Commercial resources that can assist in maximizing Social Security benefits include reasonably priced software from MaximizeMySocialSecurity.com and Social SecurityChoices.com and the "AARP Social Security Calculator" available for free at http://www.aarp.org/work/social-security/social-security-benefits-calculator/.

Deborah Tedford points out that counter-intuitively, some studies show it is more important for those with fewer savings to delay Social Security than those with substantial assets (and other income). As average Americans age, their savings tend to diminish, and the higher monthly benefits become increasingly important.

f. ***Changing One's Mind***. There is a procedure to change the election to receive benefits by filing a "Request for Withdrawal of Application." This can be filed if the recipient has not received more than 12 checks. (The reason for limiting the number of checks is to prevent someone from electing to receive benefits at age 62, then at age 70 changing the election to receive benefits at age 70—by paying back the principal amount of payments received in the meantime, but not the income earned on those payments.)

g. ***Retirement Benefit Amounts**.* For someone who has an earnings record reaching the earnings limit for 35 years, the retirement benefits are currently about $2,400-2,500/month if the benefits begin at the full retirement age. COLA adjustments apply and the amount may change in future years.

   Stated differently, at age 66, a worker can receive benefits without retiring. Benefits are based on the highest 35 years of earned income (up to a maximum amount each year) in years the worker participated in the Social Security program. If a worker has always earned the maximum for 35 years, Social Security benefits will be about $30,000 per year at age 66. If both spouses have worked and reached those maximum levels for 35 years, they would get about $60,000 per year.

h. ***Impact of Continuing to Work After Receiving Benefits**.* If the worker begins receiving benefits before the full retirement age, the person can earn up to $15,480/year in 2014 ($15,120/year in 2013) without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $2 earned above that limit.

   In the year when the full retirement age is reached, the person can earn up to $41,400/year (in 2014; $40,080/year in 2013) without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $3 earned above that limit. Only earnings before the month the worker reaches full retirement age are counted for this purpose.

   Starting with the month the worker reaches full retirement age, there is no reduction for earnings. (This was mandated by the Senior Citizens Freedom to Work Act of 2000.)

   These same earnings limits apply to a spouse or child who works and receives benefits on the worker's record.

i. ***Spousal Benefits**.* The worker's spouse is entitled to spousal benefits after the worker "files" to receive benefits if the spouse is at least age 62, even if the spouse does not have a work record. (If the spouse is entitled to benefits based on his or her own work record, the spouse can receive benefits based on his or her own work record or 50% of the worker's benefits, whichever is higher.) The spouse does not receive any benefits until after the worker files to begin receiving benefits (or "files and suspends" after reaching the full retirement age, as discussed below). When the spouse reaches the full retirement age, the spousal benefits are 50% of the "primary insurance amount" (the amount of retirement benefits if they were to begin at the full retirement age) of the worker. If the spouse begins receiving spousal benefits before the spouse reaches his or her full retirement age, the spousal benefits are reduced.

j. ***"File and Suspend" Strategy**.* The worker may "open his file" at his or her full retirement age, but then suspend the collection of benefits (so that when the worker's actual benefits begin they will be increased by the "delayed retirement credits;" as discussed above, the increase is 8% for each year past the full retirement age, up to age 70). This permits the spouse to receive the spousal benefits (50% of the worker's "primary insurance amount" at full retirement) even though the worker is not yet receiving benefits. (The Social Security lingo is that the spouse can claim spousal benefits on the worker's "opened but suspended record.") The spouse must be at least age 62 to receive spousal benefits, but benefits will be reduced if they are elected before the spouse reaches his or her full retirement age. For example, the higher earning spouse may file for benefits at the full retirement age but suspend payments so that the lower earning spouse can receive spousal benefits. The file and suspend strategy is not available prior to the worker's full retirement age. When the spouse elects to begin receiving spousal benefits, the spouse does not have to begin payments on his or her own worker account. For example, the spouse might elect to begin receiving full spousal benefits upon reaching age 66 but not begin taking payments on his or her own account until age 70 to receive the maximum delayed retirement credits (the 32% bonus).

Deborah Tedford offers the following as an optimal approach that is often used by two-income spouses. Assuming husband turns 66. He files for benefits which would entitle him to receive $30,000 per year, but he "suspends" receiving benefits (to take advantage of the 8% per year increase in benefits if receipt is deferred). When wife turns age 66, she can claim under her own work benefits or the spousal benefit. She elects to claim the spousal benefit, or 50% of what husband was eligible to receive at age 66 (i.e., about $15,000). At age 70, husband and wife each claim their own benefits ($40,000 for each of them). Wife gave up four years of benefits, but she only gave up $15,000, not $30,000 per year. With this approach, wife only needs to survive 8-9 years after reaching age 66 to come out ahead by deferring the receipt of her own benefits to age 70.

k. ***Survivor Benefits****.* Following the worker's death, survivor's benefits may be available to the deceased worker's spouse (and child if the child is not married and under age 18, increased to 19 if the child is still in high school). If the worker had not started collecting benefits, the widow or widower benefit is 100% of the worker's "primary insurance amount" when the widow or widower reaches his or her full retirement age. If the worker was receiving benefits at the time of his or her death, the widow or widower benefit will be equal to those actual benefit amounts, assuming the widow or widower has reached his or her full retirement age.

The widow or widower can receive reduced survivor benefits beginning as early as age 60. (If the collection begins at age 60, the benefits will be reduced by up to 28.5%.)

The widow or widower will lose the survivor benefits if he or she remarries before age 60 unless the subsequent remarriage ends. Remarriage after age 60 does not impact the entitlement to survivor benefits.

l. ***Divorced Spouses****.* Prior divorced spouses are also entitled to spousal benefits. Requirements are that the person was married to the worker for at least 10 years, the divorced spouse has not remarried, both are at least age 62, and they have been divorced at least 2 years. Payments made to a divorced spouse will not impact the amount of benefits payable to the worker or the worker's current spouse (or other divorced spouses of the worker who qualify for divorced spousal benefits).

A prior divorced spouse of a deceased worker is entitled to survivor benefits if the individual was married to the deceased ex-spouse for at least 10 years, if the individual is unmarried or married after age 60, and if the individual is at least age 60.

The spousal benefits and survivor benefits for divorced individuals do not appear on the "Earnings Record" and "Estimated Benefits" statement, and many divorced individuals are not aware of these benefits.

m. ***Taxation of Retirement Benefits**.* A portion of Social Security benefits may be subject to federal income taxes. The portion is based on the worker's "combined income" level, and whether the person files individually, files a joint return, or files married filing separately. The "combined income" is adjusted gross income + nontaxable interest (so investing in tax-free bonds does not help for this purpose) + ½ of Social Security benefits.

For persons filing a joint return, if the combined income of the worker and spouse is between $32,000 and $44,000, income tax is paid on up to 50% of the benefits, and if the combined income is more than $44,000, up to 85% of the retirement benefits are taxable. If some of the benefits are subject to income taxes, the worker can choose to make quarterly estimated payments or to have federal income taxes withheld from the benefits.

If a person will not begin taking distributions from IRAs or qualified plans before reaching age 70 ½ (when the required minimum distributions must commence), that may be a factor in deciding to start receiving Social Security benefits at age 66 if the worker would not have sufficient "combined income" between ages 66-70 to have to pay income tax on 85% of the benefits. (But if a worker has income at that low of a level, it is likely that the worker will have to begin taking distributions from IRAs to have sufficient income for basic support needs.)