ACTEC 2015 Annual Meeting Musings

April 2015

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 2015 Annual Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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BESSEMER TRUST

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April 20, 2015

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Important Information Regarding This Summary
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INTRODUCTION

Some of my observations from the 2015 ACTEC Annual Meeting Seminars at Marco Island, Florida on March 5-8, 2015 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. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-12 are observations from a seminar by T. Randolph Harris, Beth Shapiro Kaufman, and Andrew Pharies, Hot Topics

1. LEGISLATIVE DEVELOPMENTS

The Treasury on February 2, 2015 released the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. Most of the proposals regarding the estate and gift tax are much the same as last year, but there are some big surprises.

a. **Treating Gifts and Bequests as Realization Events**. A major new proposal in the Fiscal Year 2016 Plan would raise substantial income taxes by closing the "trust loophole," to cause an immediate realization of gain upon making gifts or at death (with an elimination of the basis step-up at death under §1014). The description released in connection with the State of the Union Address refers to the basis step-up under §1014 as "perhaps the largest single loophole in the entire individual income tax code." There are various exemptions from this tax.

b. **Increased Capital Gains Rates**. In addition, the proposal would increase the top rate on capital gains and qualified dividends to 28% (including the 3.8% net investment income tax) for couples with income over about $500,000.

c. **Effect of Capital Gains Tax Reforms.** The President's proposal states that 99% of the financial impact of raising the capital gains rate and eliminating the basis step-up would be on the top 1% of taxpayers, and 80% of the impact would be on the top 0.1% of taxpayers (those with over $2 million of income).

d. **Restore 2009 Estate, Gift and GST Tax Parameters, Beginning in 2016**. The 2014 and 2015 Fiscal Year plans proposed restoring the 45% rate/$3.5 million estate and GST exemption/$1 million gift exemption effective beginning in 2018. The 2016 Fiscal Year Plan moves up the effective date to 2016 (while President Obama is still in office).

e. **New GRAT Requirements in 2016 Fiscal Year Plan.** Proposals in prior years would have added GRAT requirements including (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. The 2016 Fiscal Year Plan adds a requirement that the remainder interest in the GRAT at the time the interest is created has a minimum value equal to the *greater* of 25% of the value of the assets contributed

to the GRAT or $500,000 (but not more than the value of the assets contributed). In addition, GRATs would be prohibited "from engaging in a tax-free exchange of any asset held in the trust." (Observation: This would likely kill GRATs as a practical matter aside from unusual circumstances.)

f. **Sales to Grantor Trusts**. The 2013 Fiscal Year Plan proposed that assets in grantor trusts would be included in the grantor's gross estate. This proposal was narrowed in the 2014 Plan to include the portion of trust assets attributable to sales to grantor trusts (net of the amount of the consideration received by the person in that transaction), and was continued in the 2015 Plan. This sale to grantor trust proposal was combined with the GRAT proposal in the 2016 Fiscal Year Plan.

g. **Annual Exclusion**. As a "simplification" measure, the 2015 Fiscal Year Plan first proposed deleting the present interest requirement for annual exclusion gifts, allowing the $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 annual exclusion proposal under the 2015 Fiscal Year Plan is summarized at Item 1.c of Estate Planning: Current Developments and Hot Topics (December 2014) found here and available under Insights at www.Bessemer.com/Advisor. The 2016 Fiscal Year Plan clarifies this proposal to indicate that "[t]his new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion." In addition, the 2016 Fiscal Year Plan adds that the $50,000 limit would be "indexed for inflation after 2016."

h. **Other Matters**. Various other transfer tax proposals that have been included in prior years are also continued (including consistency of basis, GST exemption 90-year limit, §6166 lien provisions, "HEET" trusts, definition of executor, as well as the proposal to require that inherited IRAs [including Roth IRAs] and retirement plans be paid over five years [with some exceptions, primarily for surviving spouses]).

i. **Estate Tax Repeal**. Estate tax repeal talk has re-emerged. In response to the Greenbook for the 2016 Fiscal Year Plan, Representative Kevin Brady (Republican-Texas), a member of the House Ways and Means Committee, stated that the President's "reneging on the 'permanence' of the estate tax agreements" is creating a movement to have a floor vote this year on repealing the estate tax. Daily Tax Report, at 22DTR GG-3 (Feb. 3, 2015). At least seven estate tax repeal bills have been introduced (and would likely pass the House; getting 60 votes in the Senate could be more problematic). Some prognosticators theorize that the capital gains at death proposal is included as the Administration's counter to an estate tax repeal bill, and that a veto of an estate tax repeal bill would be followed by reform discussions including the proposals in the 2016 Fiscal Year Plan.

2. REGULATIONS AND TREASURY GUIDANCE PROJECTS

a. **Treasury-IRS Priority Guidance Plan for 2014-2015**. The Priority Guidance Plan (often referred to as the "Business Plan") for 2014-2015 has 10 items directly related to estate and gift tax, and three other relevant topics (material participation by trusts,

updating references throughout the regulations to §1022 regarding carryover basis, and §6166 security matters).

Another high priority is §2801 regulatory guidance, regarding tax imposed on citizens and residents who receive gifts from certain people who have expatriated. The law was passed in 2008, and the IRS has been trying to issue regulations since 2009. The IRS will not collect this tax before regulations are issued; once the regulations are issued, the IRS will collect the tax retroactively.

A number of items have been on the plan for an extended period. The longest is the §2704 project, which has been on the plan for 12 years. (And there are some indications that regulation project is moving again.)

One project is whether QTIP trusts may be used in connection with portability, despite Revenue Procedure 2001-38. "It is pretty clear that the IRS will tell us that it's ok and will not invalidate the QTIP election in that circumstance."

One project that was completed this year was the issuance of final regulations under §67 (the "2% haircut rule"), as discussed below.

b. **Items Dropped From Priority Guidance Plan**. Several items have been dropped from the Guidance Plan in recent years. The "guidance on private trust companies" project was dropped in the 2013-2014 plan. The decanting project was dropped in the 2012-2013 plan. The IRS has indicated that these projects are not dead. There are no resources to work on the private trust company project ("as opposed to those on the plan that have not come out in 12 years"). The IRS is working on the decanting project, but knows that it will not be completed in the current year.

c. **Guidance Projects Will Shrink**. The IRS Commissioner said recently that due to a restriction in resources, the guidance will plan will shrink going forward.

d. **Further Discussion**. For a more detailed discussion of some of the items on the current Guidance Plan, see Item 2 of the Heckerling Musings 2015 and Current Developments found here and available at www.Bessemer.com/Advisor.

3. Section 67 Final Regulations

Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income. Under §67(e) the same rules apply to estates and trusts, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are allowed in full. The IRS finalized the regulations on May 9, 2014, with very few changes from the proposed regulations. The final regulations apply to any taxable year of any trust or estate that begins on or after January 1, 2015. The unbundling requirement was continued from the proposed regulations with few changes. For a more detailed discussion of the §67(e) final regulations see Item 25 of the Heckerling Musings 2015 and Current Developments found here and available at www.Bessemer.com/Advisor.

Planning Tip: When representing a trust or estate, open a new billing file for "below the line" issues (such as gift tax return preparation and audits). Otherwise, the CPA will want

proof of the allocation of expenses. Will giving billing records to the CPA jeopardize privilege issues?

4. Valuation Cases

a. **Richmond v. Commissioner**. A decedent's 23.44% interest in 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 determined an overall discount of 37.4% (including a 15% discount for the corporate built-in gains tax, determined using a present value analysis of the corporate tax on appreciation at the time of death). A 20% undervaluation penalty applied; the reasonable cause exception did not apply where the estate relied on an unsigned draft report from a CPA who had no appraisal certifications. For a more detailed discussion of *Richmond*, see Item 21 of Estate Planning: Current Developments and Hot Topics (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

b. **Elkins v. Commissioner**. The Tax Court allowed a small (10%) discount for undivided interests in art, ignoring under §2703 a co-tenants agreement requiring unanimous consent to sell the art, and reasoning that a hypothetical buyer would know that family members had a strong attachment to the art and would be willing to buy out the third party at little or no discount. *Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013) (Judge Halpern). The Fifth Circuit rejected the Tax Court's assumption that a hypothetical buyer would know the family would buy any undivided interest with no (or little) discount. In light of the fact that the IRS presented NO evidence of what the discount should be if an undivided interest discount applied, the court held that the evidence from the estate controlled. The Fifth Circuit utilized expert testimony supplied at trial, which was a larger discount than claimed on the Form 706, without addressing whether the position on the Form 706 was an admission against interest. The court reversed—without remanding to the Tax Court for further consideration—and a $14 million refund was allowed. 767 F.3d 443 (5th Cir. September 15, 2014).

c. **Giustina v. Commissioner**. The court determined the value of the decedent's 41.1% interest in an FLP with timberland forestry operations. *Estate of Giustina v. Commissioner,* T.C. Memo 2011-141(Judge Morrison), *rev'd and remanded for recalculation of valuation,* 114 AFTR 2d 2014-6848 (9th Cir. December 5, 2014). The Tax Court based its valuation with a 75% weighting on the cash flow method and a 25% weighting on an asset method. The liquidation value of the timberland far exceeded the value based on cash flows. The Ninth Circuit observed that the Tax Court concluded there was a 25% likelihood of liquidation of the partnership even though the decedent could not unilaterally force liquidation, reasoning that the owner of that 41% interest could form a two-thirds voting bloc with other limited partners to do so. The Ninth Circuit said that conclusion was contrary to the evidence, and that the Tax Court was engaging in "imaginary scenarios." For a more detailed discussion of *Giustina*, see Item 24.b of the Heckerling Musings 2015 and Current Developments found here and available at www.Bessemer.com/Advisor.

d. **Adell v. Commissioner**. The estate tax value of a decedent's interest in a closely held corporation was reduced by the value of the business attributable to "personal goodwill"

of the decedent's son. The court determined that the son had key personal contacts and that his goodwill had not been transferred to the company through a covenant not to compete or an employment agreement. For a more detailed discussion of *Adell*, see Item 28.b of Estate Planning: Current Developments and Hot Topics (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

5. IRS Recognition of State Court Trust Reformation; PLR 201442042

Successful GRATs would pourover into an "incredibly defective" trust—it was a revocable trust. (The attorney likely just used the wrong form in drafting the trust.) The ruling recognized the validity of a state court reformation proceeding to correct the trust. The IRS national office reaction was that the reformation proceeding was not "gaming the system," because "nobody would do this" (*i.e.*, intentionally having GRAT assets pourover into a revocable trust). Two morals: (1) Do not underestimate what types of rulings might be secured from the national office if facts support a desired position; (2) Extraneous facts of the case are that the attorney who drafted the "incredibly defective" trust came to a large law firm through a merger. The attorney left after committing malpractice, but the large firm was left "holding the bag."

6. Division of QTIP Trust Preceding §2519 Transfer; PLR 201426016

The taxpayer proposed dividing a QTIP trust into three separate trusts and obtaining a court order terminating one of the three trusts. The IRS ruled that §2519 would apply only to the one trust that was terminated and not to other two trusts. One of the divided trusts would be converted to a unitrust, which opened the scenario of the unitrust distribution from that one trust equaling the cash flow that would have been available to the spouse from all three trusts, which in effect would have allowed the spouse to make a gift under §2519 while keeping all of the cash flow that he or she would have received in any event from the original QTIP trust. This also opens the possibility of creating minority interests for valuation purposes of the amount of the gift (from the deemed transfer of the third trust) and the amount that would be included in the spouse's gross estate under §2044 at his or her subsequent death from the other two trusts. For a more detailed discussion of PLR 201426016, see Item 12.b of the Heckerling Musings 2015 and Current Developments available here and available at www.Bessemer.com/Advisor.

7. Resurrection of "De Facto Trustee" Concept—*Securities Exchange Commission v. Wyly*

In a disgorgement proceeding following a securities law violation, the court based damages on income taxes that had been avoided by the inappropriate use of offshore trusts. The judge determined that the trusts were grantor trusts, despite the existence of independent professional trustees in the Isle of Man, on the theory that the grantors directed all trust decisions. The court noted that the Tax Court had previously rejected this theory in *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, which held that whether the independent trustee exception under §674(c) applies turns on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to

his wishes." (The Tax Court's rejection of the theory was grounded in the U.S. Supreme Court's decision in *U.S. v. Byrum,* an analogous determination that retained powers to cause gross estate inclusion under §2036(a)(2) must be "ascertainable and legally enforceable powers.") The court disagreed with that long-standing analysis, pointing to the substance over form doctrine, reasoning that the trustee always followed the grantors' directions, and observing that "tax law deals in economic realities, not legal abstractions." *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (Judge Scheindlin).

One of the panelists believes this case is not concerning regarding the resurrection of a "de facto trustee" doctrine, but it is merely a results-driven case with the judge being guided by jury fact decisions. Randy Harris summarizes: "The case will put you to sleep or it will keep you awake."

For a more detailed discussion of *Wyly*, see Item 30 of Estate Planning: Current Developments and Hot Topics (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

8. Asset Protection Issues

a. **Mississippi DAPT Statute**. Mississippi adopted a domestic asset protection statute in 2014, joining Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming as DAPT states. (In addition, Oklahoma and possibly Colorado also offer more restricted protection to settlors who are beneficiaries of irrevocable trusts.) Mississippi is not trying to attract trust business with its statute: it has not extended the rule against perpetuities; it has a state income tax; and the DAPT statute requires that the settlor keep in place a $1 million general liability policy. (Query whether that requirement prevents transfers to an irrevocable trust with the settlor as a discretionary beneficiary in Mississippi from being a completed gift?)

b. **Dahl v. Dahl**. The Utah Supreme Court addressed whether assets of a Nevada irrevocable trust could be reached in a divorce dispute between Utah spouses. Following a divorce, the ex-wife tried to reach trust assets, claiming that they were marital assets, that the trust was null and void, and that the trust was revocable. The lower court held that the trust assets could not be reached. The Utah Supreme Court reversed, finding that the trust was a revocable trust. (One line of the trust agreement said that the trust was irrevocable, but the next line said the settlor reserved the power to alter or amend the trust.) In addition, the court added in its discussion that the Nevada choice of law provision would not be given effect (with respect to the construction of the trust as being an irrevocable or revocable trust). Utah generally respects a choice of law provisions in a trust unless doing so would undermine a strong public policy of Utah. Utah has a long-established policy in favor of equitable distribution of assets in divorce cases, and respecting the Nevada choice of law provision would deny the court the ability to achieve an equitable division of the marital estate. Some commentators have mentioned this case in the context of whether a choice of law provision selecting the DAPT laws of another state will be recognized, but the reasoning of the case did not address the DAPT element of Nevada law. 2105 UT 23 (Jan. 30, 2015).

9. INHERITED IRAS NOT PROTECTED IN BANKRUPTCY, *CLARK V. RAMEKER*

In *Clark v. Rameker*, 573 U.S. __, 134 S. Ct. 2242 (2014), the U.S. Supreme Court, in a unanimous decision, held that assets in an IRA inherited by a non-spouse beneficiary after the death of the IRA owner are not "retirement funds" and are not protected in bankruptcy under §522(b)(3)(C). The opinion does not directly address the treatment of spousal rollover IRAs, but suggests that they would be protected.

The case does not impact (i) creditors' claims in non-bankruptcy matters or (ii) claims in bankruptcy matters for debtors who live in states with state law exemptions for inherited IRAs who elect to apply the state law exemptions rather than federal bankruptcy exemptions. The following states have broad exemptions for inherited IRAs: Alaska, Arizona, Florida, Missouri, and Texas. `

10. MATERIAL PARTICIPATION BY TRUSTS, *FRANK ARAGONA TRUST V. COMMISSIONER*

Whether a trust materially participates in a business is important for purposes of the passive loss rules of §469 and for purposes of the active business income exception to the 3.8% tax on net investment income under §1411. The IRS takes the position that it is very difficult for a trust to materially participate in a business, and a regulation project is underway for the IRS to clarify the material participation by trust issue. *Frank Aragona Trust v. Commissioner,* 142 T.C. No. 9 (2014 (Judge Morrison) addressed an irrevocable trust in which three of six co-trustees were full time employees of a wholly owned LLC that managed the trust's extensive real estate holdings. The court held that the trust did materially participate, despite the IRS argument that the individual co-trustees' activities involving the management of the trust assets were as employees and not as trustees.

For a considerably more detailed discussion of the issues regarding material participation by trusts, including the *Aragona Trust* case, See Item 9.g-h of the Estate Planning: Current Developments and Hot Topics Summary (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

11. STATE INCOME TAX "RESIDENT TRUST" CASES

Three state court cases in 2013 found 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. A fourth rejected a summary judgment motion, allowing a trust to proceed with arguing that a state statute permitting North Carolina to tax undistributed trust income if beneficiaries live in the state violates the Due Process and Commerce Clauses of the U.S. Constitution and violates §19 of the North Carolina constitution. These cases are discussed in Item 22.a of the Estate Planning: Current Developments and Hot Topics Summary (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

Practice Pointer: If a state taxes a trust based solely on the resident status of the settlor when the trust was created, the tax is likely unconstitutional. The planner must decide between filing returns each year and taking the position on the returns that the trust is not a resident in order to cause a statute of limitations to run (which puts the state taxing

authority on notice to audit the return), or not filing with the risk that the state years later could seek taxes, penalties and interest.

12. NEW YORK ESTATE, GST AND INCOME TAX CHANGES

a. **New York Estate, Gift and GST Tax Legislative Changes.** Legislation was enacted March 31, 2014 making changes to the New York estate, gift, GST tax rules and the taxation of trusts. Several adjustments were made to the New York estate tax in legislation enacted as part of the adoption of the current year budget in April 2015.

Estate Exemption. The New York estate exemption is increased as follows: 2014-2015, $2,062,500; 2015-2016, $3,125,000; 2016-2017, $4,187,500; 2017-January 1, 2019, $5,250,000; after January 1, 2019, equal to the federal estate tax exemption. The estate exemption amount is phased out for estates between 100% and 105% of the exemption amount. Estates greater than 105% of the exemption have NO exemption amount. This creates a "cliff" tax issue. (A 2015 Senate bill would have broadened the phase-out window to 110% of the exemption, but that proposal was not adopted by the Assembly.) For example, a $3.1 million estate in 2015-2016 pays no New York state estate tax, but a $3.3 million estate would pay a New York estate tax of $210,000. The tax is actually greater than the $200,000 increase in the taxable estate from $3.1 to $3.3 million. Some firms add formula clauses leaving assets to charity of so much as will not decrease amount passing to non-charitable beneficiaries. The clause would apply in this narrow window of estates.

Estate tax rate. The top rate remains at 16%.

QTIP Election. A QTIP election can be made for New York estate tax purposes even if a federal estate tax return is not required to be filed. If a federal return is filed and the QTIP election is made on the federal return, a New York QTIP election must also be made. (A 2015 Assembly bill would have allowed a separate New York QTIP election when a federal estate tax return is filed solely to elect portability, but that provision was not adopted by the Senate.)

Gifts Made Within Three Years of Death. For decedents who die as a resident of New York, gifts made after April 1, 2014 and before January 1, 2019 by the New York resident will be included in his or her estate for New York estate tax purposes if the person dies within three years of making the gift. (The 2015 legislation clarifies that gifts by New York residents of out-of-state real property or tangible personal property are excluded from the gift add-back.) Similar rules apply to non-resident decedents who made gifts of New York situs property while the person was a resident of New York. This added tax would not be deductible for federal estate tax purposes under §2057 as a state death tax because it is not a tax on assets in the federal gross estate. The 2015 legislation clarifies that the gift add-back does not apply to estates of decedents who die on or after January 1, 2019 (although future legislation before 2019 could certainly change that).

GST Tax. The New York GST tax is repealed for estates of persons dying on or after April 1, 2014.

Non-Residents. Many states calculate the amount of state estate tax payable to the state by a non-resident individual based on the percentage of the total estate that is located in

that particular state. New York previously applied that approach but now bases its state tax solely on the value of assets deemed to be New York assets (such as New York real estate). Therefore, if a non-resident individual owns a $3.1 million coop in New York and that is the only New York asset, there would no New York estate tax. The 2015 legislation provides that deductions associated with intangible personal property are expressly disallowed (in light of the fact that intangible personal property of non-residents is not subject to the New York estate tax).

b. **New York Income Taxation of Trusts*.*** The March 31, 2014 legislation also addresses trust income taxation in various respects.

Throwback Rule for Trust Distributions. Trusts established by New York residents (New York Resident Trusts) are generally subject to the New York income tax unless the trust has no New York trustees, no New York tangible property or real estate, and no New York source income. Such trusts created by New York residents that are exempt from the New York income tax are referred to as Exempt New York Resident Trusts.

Even though undistributed income from an Exempt New York Resident Trust is not subject to income tax in the year the income is received by the trust, distributions from the trust to a New York resident beneficiary after 2014 will be subject to New York income taxes with respect to certain accumulations of trust income. This "throwback" tax will not apply to income that was accumulated in the trust either (i) before 2014, or (ii) before the beneficiary first became a New York resident. There is no interest charge on the throwback tax. Capital gains are not typically considered income for these purposes (if the capital gains are not included in distributable net income).

California imposes a similar throwback tax, although it includes capital gains in the throwback calculation.

Incomplete Gift Non-Grantor Trusts. "Incomplete gift non-grantor trusts" are trusts formed in a state with no income tax (often Delaware or Nevada, in which event they are referred to as "DING" or "NING" trusts) for the benefit of the grantor and other persons. The purpose of the trust is typically to accumulate income in the trust that is not subject to state income taxation in the state where the trust is located and not included in the grantor's income for state income tax purposes. Under the new legislation, such trusts created by New York residents are deemed to be "grantor trusts" for New York income tax purposes, which results in the income being included in the New York grantor's income whether or not the income is distributed to the grantor. This provision is effective for income earned on or after January 1, 2014, but not for trusts liquidated before June 1, 2014.

Items 13-17 are observations from the Annual Joseph Trachtman Lecture by Carlyn S. McCaffrey: Transfer Tax System—Past, Present, and Perhaps the Future

13. THE PAST: HISTORY OF THE TRANSFER TAX IN THE UNITED STATES

While the present estate tax system was born in 1916, a few months before World War I, that was not the first tax on gratuitous transfers of property. The first three transfer taxes were based solely on the need for revenue. Subsequent transfer tax legislation, the

rationales for Congressional adoptions of transfer taxes, and constitutional attacks on the transfer tax are briefly summarized chronologically. For an outstanding summary of the history of the estate tax see Louis Eisenstein, *The Rise and Decline of the Estate Tax,* 11 TAX L. REV. 223 (1956) and Joint Committee on Taxation Staff, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System*, prepared for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on March 18, 2015.

a. **Stamp Act of 1797*.*** The 1791 fiscal crises due to an undeclared war with France led to the passage of the Stamp Act of 1797, which imposed something like an inheritance tax. It imposed duties on paper used in certain legal instruments including licenses to practice law and receipts for legacies and intestate shares. A 0.2% tax was imposed on transfers over $500. An exception applied for assets passing to wives, children, and grandchildren. The tax lasted 5 years and was repealed shortly after a treaty was signed with France.

b. **Civil War*.*** The Internal Revenue Act of 1862 was passed to raise revenue for the Civil War. It was a tax on the receipt of personal property intended to take effect at death, as long as the total gifts exceeded $1,000. The rate was generally 1-5%, but the rate was less than 1% for assets passing to issue, ancestors, and siblings.

   In 1864, a succession tax on real estate was adopted. This was the first gift tax. It included gratuitous transfers during lifetime and at death. An exemption applied for property passing to a widow, but not to a widower.

   Both taxes were repealed in 1870.

c. **Constitutional Challenge—Scholey v. Rew***.* The taxpayer argued that the 1864 succession tax on real property was a direct tax on real property enforceable through liens on the subject real property, and that this direct tax was unconstitutional because it was not apportioned among the states. Article I, §9, clause 4 of the U.S. Constitution, as amended by the 16th amendment, limits the ability of Congress to impose taxes by directing that "direct taxes … shall be apportioned among the several states." The Court rejected this attack, reasoning that the succession was not a direct tax, because it was not a tax on land or mere ownership of land, but on the devolution of real property. *Scholey v. Rew*, 90 U.S. 331 (1874).

d. **1898 Inheritance Tax*.*** The economic and political landscape changed dramatically between the 1870 repeal of the 1860s taxes and next inheritance tax in 1898. Global trade and the industrial revolution facilitated unprecedented growth and individual wealth. The Populist movement objected to the increasing concentration of personal wealth. Andrew Carnegie wrote a book in 1889, *The Gospel of Wealth*, saying that wealthy individuals should not leave fortunes to children: "The man who dies rich dies disgraced." He proposed a tax of least 50% on wealthy estates. (He left so much to charity following his death that his wife and children had to sell the family home.)

   The War Revenue Act of 1898 imposed an inheritance tax to help finance the Spanish American War. The tax was based both on the size of the estate and the relationships of beneficiaries. The tax applied to estates over $10,000, with rates ranging from 0.75% to 2.25% for amounts passing to lineal issue, ancestors or siblings. Higher rates (up to

15%) applied for amounts passing to various categories of more remote relatives or non-relatives. The Spanish American War ended in 1898, and the tax was repealed in 1902.

e. **Constitutional Challenge—Knowlton v. Moore**. The next constitutional challenge on a transfer tax was a challenge of the 1898 Inheritance Tax. The executors based their claims on the Constitutional requirements that direct taxes must be apportioned among the states, and that indirect taxes must be uniform throughout the United States. The executors claimed that the legacies tax was an unapportioned direct tax. They argued that *Scholey* had reasoned, among other things, that a successions tax could not in principle be distinguished from an income tax, and that the Supreme Court had held in *Pollock* (158 U.S. 601, *vacating* 157 U.S. 429 (1895)) that the income tax was a direct tax. The Supreme Court in *Knowlton* (in a very long and rambling opinion) rejected this argument, distinguishing an income tax from a tax levied on the transfer of property at death. The executors also argued that the inheritance tax not uniform because of the variation in rates, but the Supreme Court reasoned that the provision in Article I, Section 8 of the Constitution that "all duties, imports and excises shall be uniform throughout the United States" refers purely to geographic uniformity—uniformity requires that the tax must operate throughout the country but does not relate to the "inherent character of the tax as respects it operation on individuals." The tax applied to all of the states so met the uniformity requirement. *Knowlton v. Moore*, 178 U.S. 41 (1900).

e. **Revenue Act of 1916**. The first three transfer taxes were motivated pretty much purely by the need for revenue (although the 1898 tax was enacted during a period of growing resentment over dynastic wealth). During the years leading up to World War I, there was a growing movement for breaking up wealth and equalizing the distribution of wealth. President Theodore Roosevelt joined the movement in 1906, calling for a progressive tax on all fortunes, and requiring that no more than certain specified amounts could be left to any one individual. (His focus was an inheritance tax rather than an estate tax.) Six years later, the Progressive Party included an inheritance tax in its platform to equalize the way that wealth is distributed. Despite this growing support, Congress failed to pass a federal inheritance tax proposal in 1913.

   Another estate tax was not passed until the horrific war in Europe was on the horizon. The Revenue Act of 1916 provided for progressive rates ranging from 1% to 10%, beginning on estates over $50,000. As the War grew closer, the rates were increased the next year, resulting in rates ranging from 2% on the first $50,000 of taxable estate to a maximum rate of 25% on estates exceeding $10 million. There was no exemption for property passing to spouses, but the Act included some of the features of the present-day estate tax: It included property owned at death, certain lifetime transfers which were for inadequate consideration, transfers not intended to take effect until death, and transfers made in contemplation of death.

   By 1917, less than 1% of decedents had to file estate tax returns, rising to 1.3% in 1922. However, it collected only 0.55% of total government revenue.

   In 1918, there was an attempt to replace the estate tax with an inheritance tax, which failed; a compromise was reached to keep the estate tax with lower rates on estates under $1 million (but without reducing the maximum rate on large estates). Also, the tax base was expanded to include spousal dower rights, life insurance proceeds in excess of over $40,000 that were received by the estate or its executor, and property subject to

the exercise of a general power of appointment. Most importantly, the estate tax was retained rather than repealed following the conclusion of World War I, introducing a period of using estate taxation to fund day-to-day government operations, rather than just to fund war efforts.

f. **Another Constitutional Challenge—New York Trust Co. v. Eisner**. The executor of Mr. Purdy's estate paid estate tax and sued for a refund. The executor argued that the estate tax was an unconstitutional interference with the rights of states to regulate descent and distribution, and was not uniform, and was an unapportioned direct tax.

   One of the arguments was that the federal government had the power to tax legacies on the passage of property at death, but not to tax assets that were still in estates, and that an estate tax was an intrusion on estate administration processes. In response, Justice Oliver Wendell Holmes, Jr., writing for the Court, rejected this approach, viewing the estate tax as a tax "on the transmission at its beginning."

   The executor argued that a tax on the privilege of receiving is not a direct tax because it can be avoided (by refusing to accept the property), but a tax on the estate is inevitable and therefore direct. Justice Holmes responded by noting that *Knowlton v. Moore* had addressed this same argument "on the practical and historical ground that this kind of tax always has been regarded as the antithesis of a direct tax." Justice Holmes concluded this analysis with his famous quote: "Upon this point a page of history is worth a volume of logic." *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

g. **Mellon Attacks; Revenue Acts of 1924, and 1926, and 1932**. Andrew Mellon attacked the estate tax throughout his term as Secretary of the Treasury from 1921-1932, hiring lobbyists and trying to raise grass roots support. He testified before the Senate Finance Committee that the estate tax undermined the U.S. economy and predicted that the capital of the country would become worthless. He failed in his effort to repeal the tax; part of the reason was that he did not get any significant pro-repeal support in the press. Indeed two of the most popular magazines (Collier's and the Saturday Evening Post) supported the tax. Despite Mellon's attacks, the estate tax was continued in the Revenue Acts of 1924 and 1926 (though he was able to achieve a reduction in the rates and an increase in the exemption in 1926).

   The Revenue Act of 1924 made significant changes to the transfer tax: (1) The maximum rate was increased to 40%; (2) a gift tax was introduced using the estate tax rate schedule (which was repealed in 1926 but brought back permanently in 1932 at lower rates); (3) a state death tax credit was instituted (not to exceed 25% of the federal estate tax); and (4) the tax base was broadened to include jointly-owned property and property subject to a power retained by the decedent to alter, amend, or revoke the beneficial enjoyment of the property.

   The Revenue Act of 1926 increased the exemption from $50,000 to $100,000, lowered the estate tax rates to 1%-20% (the 20% rate applied to estates over $10 million), increased the credit for state death taxes to 80% of the federal estate tax, and repealed the gift tax.

   The Great Depression brought a drop in federal revenues, and the federal estate was increased in the Revenue Act of 1932. It imposed rates starting at 1% on the first $10,000 of taxable estates and going to 45% of estates in excess of $10 million. The

exemption was lowered back to $50,000, the credit for state inheritance taxes was repealed, the tax based was broadened again to include lifetime transfers in which the transferor retained a life estate or the power to control who benefits from the property or income from such property, and the gift tax was reinstated with rates at 75% of the estates tax rates for cumulative lifetime gifts in excess of $5,000 per year. The stated purpose of the gift tax was to prevent avoidance of the estate tax, but the primary reason was probably to raise revenue following the depression. (Presumably, if the purpose had been to prevent estate tax avoidance, the rates would have been the same as the estate tax rates.)

h. **Constitutional Challenge to Gift Tax—Bromley v. McCaughn***.* The gift tax was held to be constitutional despite arguments based on the apportionment clause, the uniformity and the due process requirements, in *Bromley v. McCaughn,* 280 U.S. 124 (1929).

i. **FDR Proposal; Populist Movement Calling for Redistribution of Wealth**. President Franklin Roosevelt faced (i) a financial crisis and (ii) a populist movement by Huey Long calling for a redistribution of wealth (he wanted to confiscate fortunes over $8 million and limit inheritances to $5 million). By 1935 these populist societies had 7.5 million members and were a significant political threat. One of FDR's ways of dealing with both of these crises was to suggest a new succession tax that would be imposed on any individual who received inheritances or gifts over a certain amount. He failed in that attempt, but did get Congress to raise the top estate tax rate to 70% in the 1935 Revenue Act.

j. **1934 and 1935 Acts**. The 1934 Act increased the estate and gift tax rates, with the highest marginal rates of 60% and 45%, respectively, applying to transfers in excess of $10 million.

   The 1935 Act reduced the exemption from $50,000 to $40,000 but increased the estate and gift tax rates again, with the highest marginal rates of 70% and 52.5%, respectively, applying to transfers in excess of $50 million. (The top rate applied to estates over $50 million; until this Act, the top rate had applied to estates over $10 million since 1917.) The 1935 Act also introduced the "optional valuation date" allowing an estate to use values one year after the date of death—intended to address estates that may have dropped significantly after the date of death, a situation faced by many estates during the Great Depression of 1929.

   In the year after passage of the 1935 Act, the revenues from the transfer tax grew to 9.71% of the total revenue, but still impacted less than 1% of decedents.

k. **1940, 1941, and 1942 Acts**. In 1940, a temporary 10% surcharge was imposed on both income and estate and gift taxes, in light of the need for additional revenue necessitated by the military build-up just prior to World War II.

   In 1941, rates were increased again, with a top rate of 77% (where it stayed until 1976).

   The 1942 Act increased the estate exemption from $40,000 to $60,000, increased the gift exemption to $30,000, and set the gift tax annual exclusion at $3,000. The $60,000 and $30,000 estate and gift exemption levels remained intact until 1976.

l. **1948 Act-Marital Deduction*.*** The 1948 Act introduced the marital deduction—intended to put couples in common law states on an equal footing with community property state couples–by providing the decedent a marital deduction for 50% of the property transferred to the other spouse (the deduction was limited to one-half of the decedent's adjusted gross estate) and, thus, effectively allowing both spouses to be taxed on one-half of the property's value. A similar deduction was allowed for inter vivos gifts to a spouse. (The 1948 marital deduction replaced a more complicated provision in the 1942 Act providing that each spouse would be taxed on the portion of jointly-owned or community property that each spouse contributed to that property's acquisition cost.)

m. **Rejection of Proposal for Transfer Tax for Wealth Redistribution in Early 1970s**. An attempt was made to dramatically increase the estate tax as a wealth distribution tool in the early 1970s. Senator George McGovern in 1972 proposed replacing the estate tax with an inheritance tax on recipients. The first $60,000 received by a recipient would be exempt, and a progressive tax would be imposed on larger inheritances, reaching a limit of 77% on an estate of $500,000 or more. His plan was widely rejected. His spokesperson attributed the widespread rejection of the McGovern plan to the "Dream Factor." Every ordinary person thinks she could leave $500,000 to her children. (This Dream Factor continues to be cited as a major reason for those who oppose the estate tax. For example, Professor Graetz cited a study concluding that 64% of California voters apparently believe they will be among the wealthiest 5%-10% of the population at death. Michael Graetz, *To Praise the Estate Tax, Not to Bury It,* 93 Yale L.J. 259, 285 (1983).)

n. **1976 Tax Reform Act*.*** Almost 30 years passed before the next significant transfer tax legislative change. Economic advances resulted in the expansion of the transfer tax. In 1948, it raised 2.14% of total revenues and applied to 2% of decedents. By 1976, the estate tax impacted 13% of all decedents. Farmers were particularly vulnerable, because their land may have limited value as a farm but a much higher value from developers.

The 1976 Act instituted the special use valuation concept under §2032A in response to this concern. The Act created a unified estate and gift tax framework, applying a single graduated rate of tax imposed on both gifts and testamentary dispositions. (Previously, the gift tax rate was lower than the estate tax rate; there is still a gift tax advantage because of the tax-exclusive base for gift taxes.) The estate and gift tax exemptions were changed to a unified credit. The unified credit effectively excluded the first $120,000 of value from estates in 1977, increasing to $175,625 in 1981. The top rate was decreased from 77% to 70% (applying to estates in excess of $5 million). A GST tax was also enacted in 1976 (later repealed and re-enacted in a different form in 1986).

o. **Professor George Cooper's "Voluntary Tax" Article**. Professor George Cooper wrote an article in 1977 in the Columbia Law Review suggesting that the estate tax was effectively a voluntary tax because of strategies that were being used by wealthy families to avoid the tax. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance,* 77 COLUMBIA L. REV. 2 (March 1977). He reviewed estate plans of some of the wealthiest families in the U.S. back to the creation of the estate tax in 1917, and noted that those strategies remained as viable options in 1977. Some of the strategies reviewed by Professor Cooper were the following: Estate freezing strategies (preferred stock recapitalizations, installment sales, family partnerships, intra-family

loans and opportunity shifting), creating family wealth (life insurance, qualified plans and annuities, and survivorship benefit plans), and disposing of already accumulated wealth (GST trusts, CLTs, CRTs, and private family foundations).

Professor Cooper's article was the opening salvo in an attack on the estate tax. The argument was that unless the tax could be reformed, there was no use keeping the tax.

p. **Economic Recovery Tax Act of 1981 (ERTA); Subsequent Acts Leading Up to 2001**. Notable changes were made in 1981. An unlimited marital deduction was permitted, with the introduction of QTIP trusts. The unified credit was to be increased from $47,000 in 1981 to $192,800 in 1987 (exemption equivalences of $175,000 to $600,000). The top rate was to be decreased from 70% to 50% (applicable to transfers over $2.5 million) over a period of time (but this full decrease to 50% was delayed in 1984 and 1987 legislation, and the Omnibus Budget Reconciliation Act of 1993, created new 53% and 55% marginal top rates). The gift tax annual exclusion was increased to $10,000, and an unlimited exclusion was allowed for a donee's tuition or medical expenses.

Changes in 1984 included delaying of the scheduled rate decreases, eliminating the exclusion for interests in qualified retirement plans, providing rules for the gift and income tax treatment of below-market rate loans, and expanding the §6166 rules for installment payment of estates to certain holding companies.

The Tax Reform Act of 1986 substantially revised the GST tax rules, including taxing direct transfers to grandchildren.

In 1990, the special valuation rules of Chapter 14 were enacted (replacing the infamous §2036(c) provision that had addressed estate freeze transactions in an overly broad manner).

Legislation in 1997 increased the unified credit in stages to $345,800 by 2006, effectively raising the exemption equivalent to $1 million. The 1997 legislation also indexed a number of thresholds and limits, including the annual gift tax exclusion and GST exemption, and ceiling on value reduction under the special use valuation. (It also provided a new exclusion for qualified conservation easements, and also added a new deduction for interests in qualified family-owned businesses, which was subsequently removed in ATRA 2012 for decedents dying after 2003.)

q. **Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)**. Leading up to 2001, the percentage of decedents having to file estate tax returns increased to over 5%, due to bracket creep with inflation. Starting in the 1990s, there was a significant movement to repeal the estate tax. President Clinton vetoed the Death Tax Elimination Act. A wide variety of groups opposed the estate tax (even though the members of many of these groups would never be subject to the tax). A counter movement of wealthy individuals argued against estate tax repeal (including Warren Buffet, George Soros, and Bill Gates, Sr.). EGTRRA was the result of a failed effort to repeal the estate tax by President George Bush. The failure to obtain 60 votes in the Senate to repeal the estate tax resulted in EGTRRA, which gradually increased the exemption equivalent amount from $1 million to $3.5 million by 2009, with a one year repeal of the estate and GST tax in 2010, accompanied by carryover basis. The credit for state death taxes was converted to a deduction (to minimize some of the federal revenue cost).

The original proposal included a one-year repeal of the gift tax as well. That was ultimately dropped; several prominent trusts and estate attorneys told of income tax abuses that would result without a gift tax. (If the gift tax repeal had not been dropped, an enormous opportunity of making tax-free transfers would have been available in 2010.)

14. Rationales for Support or Opposition to Estate Tax

Jans Beckert wrote a book, *Inherited Wealth* in 2004 that discusses the rationales of Congressmen for voting for or against the estate tax beginning with the 1916 tax. (As mentioned previously, the rational for prior estate taxes have been almost purely driven by the need for revenue.)

In 1916, 59% of the estate tax supporters based their support on the need for revenue and just 22.6% based their support on a rejection of the privileges associated with wealth or promoting greater equality. The opponents argued double taxation and that transfer taxation should be left to the states. Seventy-five percent of the opponents based their position on a states' rights position.

In the 1920s, the rationale for the estate tax was still not based on equalizing wealth or breaking up wealth. Only 14.4% of estate supporters based their support on equality issues.

By 1976, support for the estate tax was still based primarily on revenue concerns. Only 17% of the supporters of the estate tax (and opponents to reducing the tax) based their support on redistribution arguments. Of the Congressmen who supported estate tax relief, the following reasons were given: 55%-concerns for farmers and small businesses; 17.8%-bracket creep concerns; and 8.9%-preserving wealth for family members.

In 2001, only 2.8% of Congressmen cared about wealth redistribution issues—the support for the estate tax was just based on revenue concerns. There were 78% of the Congressmen who viewed protecting small businesses and farms as a priority.

15. The Present: The Present Transfer Tax System

The American Taxpayer Relief Act of 2012 (ATRA) brought a "permanent" transfer tax system with $5 million indexed gift, estate and GST exemptions and portability of the estate exemptions between spouses. In 2015, the exemptions are $5.43 million, or $10.86 million for couples with portability. The current system is permanent in that it will not change if Congress fails to act at some point in the future.

16. Major Planning Strategies Under Current Transfer Tax System

a. **Planning Strategies**. Only three of the sophisticated planning techniques discussed by Professor Cooper in his 1977 Columbia Law Review article have been eliminated (or at least modified) by legislation: preferred stock freezes (addressed in §2701), direct gifts to grandchildren (addressed in the 1986 GST tax), and qualified plans (the gross estate exclusion for qualified plans was eliminated in 1984).

There are two major categories of planning strategies: (1) Shifting future wealth accumulation (targeting the three ways of accumulating future wealth–future investment growth, accumulations from services, and investment opportunities); and (2) Removing existing value from the transfer tax base.

b. **Shifting Future Appreciation**. Some of the strategies for shifting future appreciation are as follows.

- *Gifts*. Gifts may be disadvantageous (i) if the gift property subsequently declines in value, or (ii) if the estate tax savings on future appreciation does not offset the added income tax that is payable due to a loss of basis adjustment under §1014 because the individual does not own the asset at death. For a gift of a zero basis asset, the asset would have to appreciate by 147% for the estate tax savings to start to be offset by the income tax cost of losing the basis step up. If there is debt equal to 50% of the value of the property, the assets must appreciate by 208% to reach the crossover point. Flexibility may be built into the plan to cause estate inclusion in order to avoid the income tax cost of a loss of basis step up (for example, by purchasing the asset from the grantor trust before death).
- *Installment Sales*. Sales are typically made with grantor trusts. The trust obligation can take the form of an ordinary installment note, self-canceling note (SCIN), life annuity, or annuity for a term of years approximating life expectancy. If the purchasing trust is thinly capitalized, risks may arise under §§2702 and 2036.
- *Preferred Equity Freezes*. Preferred equity freezes are still possible under §2701 but they are more complex than before the adoption of §2701.
- *GRAT*. Advantages of GRATs include the savings clause feature, and the protection of investment losses (because there is no downside to the GRAT if the asset declines in value). Disadvantages of GRATS are the mortality risk (if the grantor dies during the trust term, most of the assets will be included in the grantor's estate) and the inability to allocate GST exemption to the GRAT until after the initial GRAT term. (Sales of the GRAT remainder interest to a GST exempt trust may ameliorate the GST disadvantage.) The Administration currently proposes substantial revisions to the GRAT requirements.
- *CLAT*. A charitable lead annuity trust operates much like a GRAT, except that the present value (with an interest factor) passes to charity in the lead annuity payments.

c. **Intra-Family Services and Diversion of Opportunities**. Services are not property; a parent can perform services for the benefit of children without make a transfer for gift tax purposes. Similarly, investment opportunities can be diverted to younger generations without making a gift as long as the person is not relinquishing an existing legal right.

d. **Removing Existing Value From Transfer Tax Base**.

- *Excludable Gifts*. Annual exclusion gifts and gifts for the donee's tuition or medical expenses do not use up any of the lifetime exemption amount.

- *Valuation Discounts*. Valuation discounts of 35-40% are common. Contributing marketable securities to entities may result in discounted values. If the individual still owns the entity at death, there may need to be non-tax purposes for creating the entity in order to avoid §2036 arguments that the assets should be included in the estate (without a discount) rather than the interest in the entity.
- *QPRT*. A QPRT results in a transfer that is reduced by the present value of the donor's right to use the residence for a period of years. It results in a shift of future appreciation as well.
- *Grantor Trust*. The "burn" feature of the grantor paying income taxes attributable to the income of a grantor trust removes substantial value from the grantor's transfer tax base over time.
- *Private Annuities; CLAT*. Life-based private annuities or CLATs may reduce the estate if the client does not survive to his or her actuarial life expectancy.
- *Paying Gift Tax*. If the grantor lives at least three years after making the gift requiring a gift tax payment, the gift tax paid is removed from the transfer tax base.

e. **Dynasty Trusts**. Dynasty trusts remove the trust assets from the tax base of the client's children and grandchildren. (The Administration's proposal is to require that the GST exemption terminate after 90 years. However, 90 years is probably enough time to pass the assets to great grandchildren without a transfer tax by the children or grandchildren; for most taxpayers, that will be sufficient.)

17. THE FUTURE: FUTURE REFORM POSSIBILITIES

a. **Repeal Efforts.** While the present transfer tax system is "permanent" in the sense that nothing will change without Congressional action, there are significant discussions of possible changes. The Administration proposes returning to the 2009 transfer tax parameters in 2016 ($3.5 million estate and GST exemption, $1 million gift exemption, 45% rate, with portability), and making dramatic changes to GRATs and sales to grantor trust strategies. There are calls for repeal of the estate tax from the other end of the political spectrum (including H.R. 1105, Death Tax Repeal Act, introduced by Rep. Kevin Brady being considered by the House Ways and Means Committee), but President Obama would likely veto a repeal of the estate tax. Some Democrats in the House prefer to provide additional estate tax relief for farmers and business owners.

b. **Rationales for Transfer Tax System**. Rationales for a transfer tax system are (i) raising revenue, (ii) facilitating a progressive tax system, (iii) as a back-up to the income tax, and (iv) breaking up concentrations of wealth.

- **Raising Revenue**. The federal transfer tax does not raise substantial revenue relative to the total federal government revenue. Even under the Administration's proposals, the tax would just raise 1.2% of total revenues. Is this an appropriate way to raise revenue in light of the complexity of administering the tax? Estimates are that a 1% increase in average income tax rates would offset the current estate tax, and that a

1.2% increase in the average rate would offset even transfer tax revenue under the Administration's proposals.

- **Facilitating Progressivity**. The transfer tax does not support progressivity on a consistent basis. The tax is not imposed until someone dies. Alternatively, the income tax rates could be made more progressive; a counter to that proposal is whether an income tax increase on wealthy individuals would "lock in assets." Some argue that an estate tax encourages consumption. There is little empirical evidence for either position.
- **Income Tax Backup**. If there is no estate tax, the argument against realizing capital gains at death would be weaker. If there is a perception that income taxes would be avoided by transfers to low bracket taxpayers, there could be a system of taxing the proceeds of sales by a donee within a fixed number of years after a gift. (A similar provision was in §644 at one time.)
- **Breaking Up Wealth**. A concern is that wealthy individuals could exert undue political influence. If that is a concern, a better approach is to attack the actual perceived problem of using money for political purposes. Breaking up wealth is often cited as a goal of the estate tax, but it has never been an important role in Congressional decisions regarding the transfer tax. At the far upper ends of the economic spectrum, there is already substantial mobility. In 2002, which was 20 years after the first Forbes 400 was published, only 58 of the original 400 were still on the list. Very few wealthy families have retained their wealth since the introduction of the estate tax in 1916. One of those few is the family of Henry Phipps, the founder of Bessemer Trust (and the family members remain the owners of Bessemer Trust).

c. **Possible Reform Approach**. Principal objections to the estate tax are that it (i) stifles economic growth by minimizing the incentive for savings and by removing assets from the private sector, and (ii) imposes a hardship on farmers and business owners.

A possible reform approach that addresses these perceived objections of the current system is to give owners the option of deferring assets from the estate tax if the assets are placed in a "capital preservation trust" that could consist of investment and business assets (but not personal use assets). (A similar proposal was discussed at the 2015 Heckerling Institute by David Clay Johnston.)

Items 18-25 are observations from a symposium by Natalie B. Choate, Robert K. Kirkland, and Steven E. Trytten, The Often Ignored If Not Forgotten Nest Egg: Practical Strategies for Estate Planning for Retirement Plans and IRAs

18. Why Retirement Benefits Are So Unique

Retirement benefits offer several unique challenges and opportunities. Their unique features include: (1) inherent future income tax liability; (2) asset protection vehicle; (3) the mere completion of the beneficiary designation form greatly impacts the timing and income tax effects of distributions; (4) a myriad of tax complications with many potential non-

sensical results; (5) the beneficiary's interest is exempt from creditors' claims in some states; and (6) unique charitable planning opportunities.

19. Overview of General Rules Regarding Distribution Requirements

a. **Required Withdrawals at Retirement**. At retirement, a uniform life table is used, which uses the joint life expectancy of the participant and someone 19 years younger. (One exception: if the individual is married to someone more than 10 years younger, the individual can withdraw even more slowly.) The withdrawal rates are very low. For individuals in their 70s, about 3 to 4% per year must be withdrawn. In their 80s, 5 to 6% per year must be withdrawn. Therefore, if there is growth in the assets greater than those rates, the assets will actually continue to grow in value despite the withdrawals, and the value of the account when the individual is 80 years old may be substantially higher than when the distributions began.

   April 1 after the individual reaches age 70½ is the "required beginning date." (This is deferred until retirement for a plan with an employer with whom the participant is still employed.) Penalties will apply if minimum required distributions do not begin by that date.

b. **Required Withdrawals by Beneficiaries Following Death of Account Owner**. A "stretch IRA" is generally desirable — to take withdrawals over the life expectancy of the beneficiary. Life expectancy is about to ages 83-85. So the objective is to withdraw over that time frame — so by about age 85, the account will be depleted by the beneficiary.

   There are federal rules stipulating when assets must be withdrawn after the account owner's death. (However, the particular plan can override these rules and require that the account be withdrawn earlier.)

   Determination Date. Withdrawals can be made more slowly if the beneficiaries are all human beings. The beneficiaries are tested for this purpose on September 30 after the year of the date of death. (Natalie Choate refers to this as the "BFD"—Beneficiary Finalization Date.) Ways of altering the beneficiaries of the account by the following September 30 are disclaimers, withdrawals, and the creation of separate accounts.

   If all beneficiaries of the account are human beings (so that there are "Designated Beneficiaries" of the plan), payments can be made over the life expectancy of the oldest beneficiary — whether or not the account owner died before the required beginning date. A spouse of the account owner can rollover the account into his or her own IRA (spousal rollovers have special advantages discussed below). In addition, a decedent's account from a company plan or IRA may be rolled over to an "inherited IRA" payable over the life expectancy of a non-spouse beneficiary (or it may be withdrawn at any time).

c. **No Designated Beneficiary**. The following rules apply if a beneficiary on the "determination date" is not a human being. If death occurred before the required beginning date, the withdrawal must be made within five years (i.e., by December 31 of the year that contains the fifth anniversary of the participant's death) and no stretch-out is available. If the account owner died after the required beginning date, the account

may continue to be withdrawn over the life expectancy of someone who was the decedent's age in the year of death.

20. PLANNING FOR SPOUSES

a. **Leaving Assets to a Trust Will "Kill" the IRA.** Leaving retirement benefits to a trust for the spouse (whether it is a "standard" QTIP trust or a credit shelter trust) will guarantee that the tru*st* will cease to exist by the time the spouse reaches or would have reached her late 80s. The benefits will have to be paid out over the spouse's life expectancy (and if the spouse is not the oldest beneficiary, the shorter life expectancy of the oldest beneficiary would be used). At age 70, the single life expectAncy is 17 years, so the benefits would be entirely distributed by age 87.

An exception that permits a somewhat slower withdrawal is if a QTIP trust with special provisions is used. If the spouse has the right to receive the entire amount of retirement benefits payable to the trust or whatever amounts are distributed from the retirement plan to the trust during her lifetime, the spouse is then treated as the sole beneficiary of the trust and qualifies for the special rules of being able to delay the required commencement date to when the spouse is age 70½ and to recalculate life expectancy each year. *See* Reg. §1.401(a)(9)-5, Q&A 7(c)(3). But the spouse is not able to use the uniform life table (which uses the joint life expectancy of the spouse and someone 10 years younger). That approach is not realistic, however, if the owner's goal is to preserve principal of the trust for younger generations. Some of the distributions from the retirement plan will be treated as principal under state law, and the owner may wish to preserve the principal portion of the payments for the remainder beneficiaries. A further disadvantage of using a trust to accumulate principal for remainder beneficiaries is that the retirement account distributions will be taxable income, even if they are principal for trust accounting purposes, and the trust will pay income tax at the maximum rates with the compressed brackets applicable to trusts.

Natalie Choate recites a "Blattmachr and Zaritsky mantra": "'That the client wanted to do it this way' is not an excuse."

b. **Outright to Spouse and Spousal Rollover.** A spousal rollover gets a trifecta of advantages.

- The spouse can delay taking distributions until he or she reaches age 70½. Otherwise, the distributions must begin by December 31 of the later of the year in which the owner died or the year in which the decedent would have reached age 70½ had he or she lived.
- When the spouse reaches age 70½, distributions are made using the life expectancy under the uniform life table (based on the joint life expectancy of the person and someone 10 years younger; at age 70 this is 27.4 years) rather than the single life table (which is 17 years at age 70). Accordingly, the benefits will not be exhausted until age 97. (The Uniform Life Table is available in IRS Publication 590.)
- At the surviving spouse's subsequent death, the spouse can name a beneficiary, who can then elect to have the benefits paid out over his or her life expectancy (using the single life table) under the rules for inherited IRAs.

- Example: Assume there is a $1 million retirement benefit, which will have a 6% return, with the minimum required distribution (MRD) amount being withdrawn each year. (i) If the benefit is paid to a trust for the spouse, the entire account will have been paid out by age 87. (ii) If the benefit is paid outright to a spouse, who rolls over the account into a spousal rollover IRA, the account will be worth over $1 million at age 87.

c. **Assets Left in Account With Surviving Spouse as Sole Beneficiary**. Rather than having the spouse make a spousal rollover or treating the deceased spouse's account as his or her own, the spouse may elect to leave the assets in the account and remain as the sole beneficiary. In that event, the spouse can recalculate life expectancies annually and can delay distributions until age 70½.

d. **Roth IRAs*.*** Making the surviving spouse the beneficiary, rather than a trust for the spouse, is even more important for Roth IRAs. If left to a trust, the Roth IRA account will have to be paid over the spouse's life expectancy; if left outright to the spouse who rolls over the account to her own Roth IRA, the spouse would never have to withdraw anything from the account for her lifetime.

e. **Estate as Beneficiary With Surviving Spouse as Sole Beneficiary and Sole Executor.** A large number of private letter rulings have allowed spousal rollovers if the owner names the estate as the beneficiary but the surviving spouse is the sole beneficiary and sole executor of the estate. The Employee Benefits Committee of ACTEC has on four occasions asked the IRS to issue a published ruling regarding this issue. The Committee will be persistent and keep asking. "We're like Bruce Stone in high school trying to get a prom date. We will keep asking."

21. Strategies to Provide for Children

a. **Practical Reality*.*** The planner's general goal with retirement accounts is to limit withdrawals, so that the retirement account can continue to grow tax-deferred, improving the odds that it can provide support for the rest of the person's lifetime. Withdrawals are subject to income tax at ordinary rates. Despite this goal, an AXA study concludes that 87% of children receiving an IRA upon their parents' deaths liquidate the IRA within one year of death. Natalie Choate reports that despite all of her work in this field, she only has a handful of stretch IRAs for children in her office that are still in the IRA and that have not been withdrawn.

b. **Deferral Is Valuable*.*** Tax-deferred compounding over a long deferral period is valuable. Case studies illustrate substantial increased after-tax economic value to beneficiaries. For qualified plans (or IRAs), deferring withdrawals over a child's life doubles the after-tax receipts, and deferring over the lives of grandchildren increases the after-tax benefits seven-fold. For Roth IRAs, the results are more dramatic. The after-tax benefits are four times as much by deferring over children's lives and the after-tax benefits are 13-22 times as much by deferring withdrawals over the lives of grandchildren.

c. **Starting Point-Client's Intent*.*** The starting point is to ascertain the client's intent aside from the tax consequences.

d. **MRD Rules for Trusts.**

(1) *General Rule*. The general rule is that a trust has no life expectancy, so the minimum required distribution rule generally is that benefits payable to a trust must be paid out within five years. If there is no "Designated Beneficiary" of a retirement plan account, the entire account must be paid within 5 years and a plan has a Designated Beneficiary if only individuals are potential beneficiaries of the plan.

(2) *See-Through Trusts–General Effect and Requirements*. See-through trusts are analyzed as if the individual beneficiaries of the trust were actually listed on the beneficiary designation, and the individual beneficiary with the shortest life expectancy controls. If sub-trusts are used, the life expectancy of each beneficiary can be used for his or her sub-account if the separate account rules are followed.

The requirements to satisfy as a see-through trust are (i) the trust is valid under state law, (ii) the trust is irrevocable or becomes irrevocable at the participant's death, (iii) the beneficiaries are identifiable (this is important so that the oldest beneficiary can be identified to calculate the relevant life expectancy over which payments are made), (iv) all trust beneficiaries are individuals, and (v) certain documentation (including, among other things, a list of all of the beneficiaries [including contingent and remainder beneficiaries]) must be provided to the plan administrator by October 31 of the year of death. The October 31 date is very important and should be included on all post-mortem planning checklists; if the beneficiary is a trust and the October 31 date is not met, the benefits will have to be paid out over five years and the trust cannot be a see-through trust.

(3) *See-Through Trusts–Which Beneficiaries Count?* For separate accounts, only the beneficiaries of each separate account are counted with respect to that separate account. Otherwise, generally all potential beneficiaries and all potential appointees under a power of appointment are included. The only potential beneficiaries who can be excluded are "mere potential successors." Potential successors after a beneficiary's death are not included *IF* the preceding beneficiary was entitled to all income and principal of the trust (or at least all of the distributions the trustee receives from the retirement plan). Typically, this is a very narrow exception, and remainder beneficiaries of most trusts are counted as potential beneficiaries. Powers of appointment must be limited so that the only permissible appointees are individuals who are no older than the oldest beneficiary.

(4) *See-Through Trusts–Conduit Trusts and Accumulation Trusts*. There are two types of see-through trusts, the "conduit trust" the "accumulation trust." The conduit trust (that term is never used in the regulations, but this type of trust has come to be referred to as conduit trust) is the simplest and most popular. For a conduit trust, all money distributed from the account to the trust is distributed to beneficiary (or beneficiaries). No money accumulates in the trust. For an accumulation trust, there can be accumulations. There is considerably more complexity for an accumulation trust in determining all of the beneficiaries who must be considered to determine the oldest beneficiary over whose life expectancy payments will be made from retirement plan.

For a conduit trust, the beneficiary who is entitled to receive all of the plan distributions is considered the sole see-through trust beneficiary (even if there are non-individual

remainder beneficiaries). Distributions can be made to a custodian or to a legal guardian of the beneficiary. Other potential beneficiaries, remainder beneficiaries, and possible appointees under a power of appointment are irrelevant for determining the life expectancy over which minimum required distributions must be made and for purposes of determining that all beneficiaries are individuals. Reg. §1.401(a)(9)-5, A-7(c)(3), Ex.2. For example, charities can be remainder beneficiaries. (If the surviving spouse is the primary beneficiary of a conduit trust, the beginning date may be deferred until the spouse reaches age 70½, and the spouse's life expectancy is recalculated annually.) After the primary beneficiary dies, any remaining plan benefits could continue to be paid over the original beneficiary's life expectancy (regardless of the age of the remainder beneficiaries and regardless of whether there are multiple remainder beneficiaries or if a charity is a remainder beneficiary.

For an accumulation trust (such as a bypass trust that gives the trustee discretion to make distributions to the spouse or children), all of the potential beneficiaries must be considered, and plan benefits must be paid out at least as rapidly as over the life expectancy of the oldest beneficiary.

(5) *See-Through Trusts–"Manage the Dots."* Imagine a diagram with each potential beneficiary (other than "mere potential successors") as a dot. The planner will want to "manage the dots" to limit the number of potential beneficiaries. There are four basic ways, using a conduit trust or three ways with accumulation trusts.

- Conduit trusts. The primary beneficiary who must receive all plan distributions is considered the sole beneficiary of the trust.
- Outright to Next Level of Beneficiaries. When the trust terminates, the asset must pass outright to the successor beneficiary, with no contingencies and no age limits (but UTMA accounts may be allowed). For example, if the plan participant has 3 children and the middle child has special needs, an accumulation trust could be created for the middle special needs child, and when he dies the assets would pass outright to the other two children. In that case, there would be three "dots" and the oldest child's life expectancy would be used for MRD purposes.
- Age restriction. The trust would provide that anyone born before a specified date would be deemed to have predeceased for purposes of retirement plan assets in the trust, so that nothing could ever pass to individuals older that the oldest primary beneficiary that is the measuring life for MRD distributions. These are difficult to draft, particularly if there are different age restrictions for differing sub-trusts. What if all of the "dots" predecease and the trust escheats to the state? That is just a theoretical concern; no IRS rulings have mentioned that as a concern. With this approach the planner must take care that a power of appointment could not be exercised to include a non-individual beneficiary.
- Last One Standing. The trust can include a class of beneficiaries, but if there is ever only one descendant living, the trust terminates and is distributed to that person. With this approach the planner must take care that a power of appointments could not be exercised to include a non-individual beneficiary or to add members to the designated class.

22. Charitable Planning With Retirement Benefits

a. **Classic Answer**: **Leave Retirement Benefits to Charity and Other Assets to Family**. For clients with charitable goals, classic advice is to leave the retirement plan benefits to the charity (who is not taxed on the benefits as an exempt organization) and to leave other assets to family members. However, one panelist tried to confirm that advice with financial projections, and the case studies tended to show that the benefits of tax-free compounding over a long period with a stretch IRA often produced better results for the family than leaving the retirement plan benefits to charity. This is particularly true if some of the charitable contributions of non-plan assets could be made during life when they would generate an income tax deduction as well.

b. **Alternative Strategies for Including Charity as Beneficiary of Retirement Plan Benefits.**

(1) *All of Particular Plan to Charity*. The easiest approach is to leave all of a particular retirement plan account to charity and leave other assets to family. This rarely is practical, however. The client will have in mind to leave a certain dollar amount or fractional share of the estate to charity.

(2) *Specific Dollar Amount*. Include an attachment to the beneficiary designation with a clear designation of the amount of the plan passing to charity. Get the provider to approve the attachment; do not wait until the participant's death to test whether the plan administrator will accept the beneficiary designation. The charity should be cashed out before the "BFD" (*i.e.*, Beneficiary Finalization Date) of September 30 of the year following the year of death. Generally, if there are multiple beneficiaries of a plan (not in separate accounts), no beneficiary can use a life expectancy payout unless all beneficiaries are individuals. Reg. §1.401(a)(9)-4, A-3. Only beneficiaries who are potential beneficiaries on the BFD are counted for this purpose and to determine the measuring life. A pecuniary gift may not qualify as a "separate account."

(3) *Specific Percentage*. Similarly, use an attachment to the beneficiary designation making the percentage beneficiary designations clear. The cautions described above for the specific dollar amount apply for percentage designations as well.

(4) *Concerns With Making Plan Benefits Payable to Trust With the Pecuniary or Percentage Amounts Designated in the Trust*. Complications may arise if the split to the charity is described in a trust. The issue will be whether the portion of the trust passing for family members can qualify for stretch-out treatment with the charity as a beneficiary of the trust. There have been some favorable rulings for such situations in which the charity is the residual beneficiary of the trust. Providing pecuniary distributions to charity via a trust is especially suspect.

If the client does want to use a trust arrangement for both the charity and family, the client needs to weigh the possible loss of stretch-out treatment for distributions made to family members against the advantage of being able to leave otherwise taxable retirement plan benefits to charity. If the participant wants the trust approach, the planner must be careful to draft the trust in a manner so that the trust can get an income tax charitable deduction for amounts left to charity (to offset the income realized when the plan benefits are distributed to the trust). The income tax charitable deduction will be available to the trust only for income distributed to charity pursuant to

the governing documents. Merely allowing the trustee in its discretion to distribute retirement benefits to charity will not qualify for the income tax charitable deduction. The trust could specify that the charitable amounts will be funded to the extent possible with retirement plan benefits or with trust income. However, saying that the charity will be funded first out of income in respect of a decedent will not work because allocations of a "class" of income is respected only if the allocation has substantial economic effect (*i.e.*, impacts how much the beneficiary may receive.)

(5) *Disclaimer Oriented Approach.* A beneficiary designation could build in flexibility with disclaimer provisions. For example, the beneficiary designation might list a child as primary beneficiary, with a provision that any disclaimed portion passes to charity, and that if the primary beneficiary fails to survive the assets would pass to his issue. The primary beneficiary then has the flexibility of deciding, if he survives the participant, whether to disclaim and have the disclaimed assets pass to charity. In that case, generally do not name a private foundation on which the beneficiary is a board member as the recipient charity or the disclaimer will not be a qualified disclaimer.

(6) *Charitable Remainder Trust.* Although not mentioned in the retirement plan regulations, another possible favorable trust beneficiary is a charitable remainder trust. For example, this can be helpful if there is a desire to leave retirement benefits to benefit children from a prior marriage. Use a two-generation CRT, especially if there is an older surviving spouse. At the account owner's death, the retirement account is paid in a lump sum to CRT, which is an exempt entity so does not have to pay income tax on the receipt of the benefits. There is a 5% annual payout to the surviving spouse for his or her remaining lifetime, and thereafter 5% is paid to the children until the last surviving child dies, and then the remaining assets pass to charity. This allows a very long stretch-out.

The charitable remainder trust can be especially helpful when the account owner holds large retirement accounts and wants to assure that a certain portion of the retirement benefits will be available for children. If the spouse is named as the beneficiary of the retirement benefits, there is no such assurance. The answer may be to use a charitable remainder trust. The spouse gets 5% per year for the rest of his or her lifetime, but at death the children receive 5% payouts for the balance of their lifetimes. "It's like a credit shelter semi-QTIP trust for retirement accounts."

The charitable remainder trust functions like a wonderful credit shelter trust for retirement benefits or other IRD assets (such as employee stock options, nonqualified plan benefits, etc.). You only have to pay out 5% per year over the spouse's lifetime and not have to liquidate the entire retirement account.

To use this type of plan with a charitable remainder trust, the spouse must be over age 70 and the second generation individuals must all be over age 40 in order to meet the minimum 10% charitable deduction for assets passing to a charitable remainder trust. Therefore, it must look like the charitable remainder trust will not last for more than about 50 years after going through the math.

23. MULTI-GENERATIONAL PLANNING WITH RETIREMENT BENEFITS

a. **Non-Exempt Dynasty Trust.** If the long-term trust for multi-generations is not GST exempt, the conduit trust is a nice option if the client is willing for all plan distributions to be distributed to the primary beneficiaries. With a conduit trust, someone could have the power to grant a general power of appointment to a primary beneficiary (if desired to reduce the income tax payable following the beneficiary's death (*i.e.*, if the beneficiary has excess estate exemption amount)). With an accumulation trust, the Last One Standing or Age Restricted approaches could be used (but there could be no ability to grant a power to appoint to creditors). By definition, the "outright to next level" could not be used because the client wants a long-term trust for multi-generations.

b. **Exempt Dynasty Trust.** The conduit trust is not a good approach with an exempt trust, because it would force large distributions to the child-level beneficiaries. The Last One Standing or Age Restriction approaches would be best.

c. **Flexible Dynasty Trust.** The client may wish to create a long term trust and leave open the possibility of allocating GST exemption to the trust. If the trust becomes partially exempt, a separate non-exempt trust could be created under the GST severance rules. Any exempt trusts so created would need to have Last One Standing or Age Restricted provisions to use a stretch-out of plans benefits. The goal would be to fund retirement benefits into exempt trusts for grandchildren and to fund other assets to trusts for children (so that the life expectancies for grandchildren could be used as the measuring lives for the MRD rules). Drafting the beneficiary designation would be tricky—how to fund the retirement plan benefits to the exempt grandchildren's trusts without going over the GST exemption amount.

   One possible alternative is to leave retirement benefits to trusts for grandchildren and pay the GST tax if the plan benefits exceed the available GST exemption. Some financial studies show that approach can be an attractive simple solution.

24. PROPOSAL FOR FIVE-YEAR PAYOUT FOR RETIREMENT PLANS

There have been several bills introduced or proposed in Congress, and the Greenbook has proposed for several years, that qualified retirement plans would have to be paid out in five years, with a few exceptions (the main one being for surviving spouses). The proposal would apply to plans for which the participant reaches the required beginning date or dies after the date of enactment. Some commentators favor such a plan on the policy basis that the huge income tax advantage is allowed for "retirement" assets, not for multi-generational transfer planning. Natalie Choate strongly opposes the proposal on policy grounds. (1) It is incorrect to say the benefits provided for retirement plans are intended only for retirement because the rules have always allowed death benefits. (2) It is not a significant revenue raiser because very few beneficiaries actually leave assets long-term in stretch IRAs. (3) The plan does not simplify matters because the proposal has seven exceptions, and if enacted we would have two different systems in place for about the next 80 years. Natalie would prefer a plan allowing a straight 21 year life expectancy for beneficiaries other than spouses.

25. Roth IRA Planning Observations

a. **At Retirement, Isolate After-Tax Money in Retirement Plan**. Upon retirement, if the participant has contributed after-tax money to the employer's retirement plan, instruct the plan administrator to transfer the pre-tax portion of the account to a traditional IRA (to continue the deferral of that income) and to transfer the after-tax portion of the account to a Roth IRA. There is no income recognition on the creation of this Roth IRA (because income tax has already been paid on this portion). (Natalie Choate describes tax-free Roth conversions "as the closest thing we have to pornography in the estate planning field.") The IRS just recently approved this type of split. Notice 2014-54.

b. **Nearing Age 70½, Contribute IRA to Employer Plan If Not Retiring**. An individual approaching age 70½ may rollover his traditional IRAs (not Roth IRAs or inherited IRAs) into the employer's retirement benefit plan to avoid having to take required distributions until following the employee's retirement (as long as the individual does not own more than 5% of the employer). Rev. Rul. 2014-9. If the traditional IRA has both pre-tax and after-tax money, the pre-tax portion could be rolled over into the employer plan (to defer the required beginning date until retirement), and the remaining after-tax portion could be converted into a Roth IRA tax-free.

c. **Roth Conversion Can Be Powerful Transfer Planning Strategy.** An individual who has a substantial IRA and who wants to maximize transfer planning to heirs may consider converting the IRA to a Roth IRA (even as a death bed strategy). The income tax paid on the conversion will be deductible for estate tax purposes.

d. **Concern With Post-Retirement Cash Flow**. An individual who is concerned with having sufficient cash flow during retirement might consider converting a portion of the retirement plan benefit to a Roth IRA. This will not require as much of an upfront income tax payment compared to converting the entire account to a Roth IRA. The Roth portion will not require minimum distributions, so the individual can save more in the plan for cash flow in later years.

e. **Roth Conversions by Big Charitable Givers**. An individual who makes large charitable contributions may bump up against the 50% of AGI limitation on income tax deductions. If the individual converts a large IRA to a Roth IRA, the additional large bump in income may permit a much larger deductible contribution in that year. Wait until late in the year before making the large charitable gift in case the individual decides to recharacterize the conversion due to a drop in investment values during the year.

f. **Recharacterization Flexibility***.* Recharacterization provides tremendous flexibility in light of anticipated additional market volatility over the near term. If the stock market plummets after a Roth conversion, the individual can "undo" the conversion by notifying the plan administrator to transfer the Roth IRA to a traditional IRA by the due date for the tax return (including extensions). The amount can later be converted again to a Roth IRA at the lower stock market values, but only after a certain required waiting time. To maximize this flexibility, when converting to a Roth IRA, segregate the different investment sectors into separate Roth IRAs, allowing the individual to recharacterize the just those IRAs holding sectors that have gone down in value significantly.

Items 26-32 are observations from a symposium by Charles D. Fox, IV, Amy K. Kanyuk, and Professor Mary E. Radford , "Ethical Considerations in Acting as an Executor or Trustee: Do You Really Want to Do This?". The panel addressed the ethical rules in a variety of case studies. The summary below summarizes the general principles applied in the case studies.

26. Significance: The Stakes Are High

Ethical issues arise regarding attorneys serving as executor or trustee or representing an executor or trustee, particularly with respect to five different issues: competence; conflicts of interest; communication, privilege, and confidentiality; compensation; and gifts. The stakes can be high if ethical rules are not followed. About 40,000 complaints are lodged against lawyers each year. While relatively few lawyers are sanctioned, the mere complaint can have negative consequences on the lawyer's reputation and career, with a high financial and emotional cost. Other risks include possible removal from representation of a client, loss of attorney-client privilege, and the denial of compensation.

27. Sources of Governing Ethical Principles

Sources of guiding ethical principles include (1) the Model Rules of Professional Conduct and Commentaries, (2) the ACTEC Commentaries on the Model Rules of Professional Responsibility, and (3) the Restatement (Third) of Law Governing Lawyers (2000). Various cases and state ethics opinions also provide guidelines.

28. Conflicts

The attorney should clearly define who is the client and the scope of the representation. There are various reasons that lawyers may be tempted to leave the relationship ambiguous, including not precluding feature representation, minimizing fees, avoiding the introduction of adversity, and avoiding awkward situations. Model Rule 1.7, comment 27 addresses conflict issues that may arise in estate planning and estate administration. It points out that a conflict of interest may arise in representing several family members, and that the lawyer should make clear his or her relationships to the parties involved. This should be done early in the representation, and also throughout the representation as additional issues arise.

Joint representation issues may arise in representing fiduciaries in a variety of possible situations including representing multiple fiduciaries, multiple beneficiaries, both the fiduciary and some or all beneficiaries regarding the administration of the trust or the sale of a particular asset or the division of assets or in a nonjudicial settlement agreement or judicial modification or decanting.

a. **Model Rules**. Model Rule 1.7(a) covers when a lawyer may represent multiple parties. It provides:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibility to another client, a former client, or a third person or by a personal interest of the lawyer.

This rule creates the presumption that the lawyer cannot provide common representation, but the presumption can be overcome and the lawyers can represent multiple clients in certain situations:

(b) Notwithstanding the existence of the concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law;

(3) The representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) Each affected client gives informed consent, confirmed in writing.

In summary, representing multiple parties in matters involving the administration of a trust or estate requires addressing (1) whether there is a concurrent conflict of interest, (2) if so, whether representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, and (3) whether the lawyer can provide competent or diligent representation to each affected client *and* each affected client gives informed written consent.

To obtain informed written consent, the lawyer must describe the risks of multiple representations and the possible effect on the lawyer's independent judgment.

b. **ACTEC Commentaries**. The ACTEC Commentaries state that with respect to the administration of an estate of trust, a lawyer may never represent opposing parties in litigation, is precluded from representing both parties in a manner in which their interest directly conflicts to a substantial degree, but may represent multiple parties if potential conflicts are not substantial and their common interests predominate. The lawyer must monitor this potential adversity as the representation progresses. The lawyer should communicate the advantages and disadvantages of dual representation to co-fiduciaries.

c. **Joint Representation of Co-Fiduciaries**. Joint representation of co-fiduciaries generally does not present a conflict of interest. The lawyer should discuss the advantages (such as expense and time savings) and disadvantages of joint representation to co-fiduciaries, and should explain that the lawyer may not keep confidences between fiduciaries or favor one over the other.

d. **Duties to Beneficiaries If the Lawyer Only Represents a Fiduciary**. The majority view is that a lawyer has a duty only to the fiduciary and not to the beneficiaries. *See* ABA Legal Ethics Opinion 380 (May 9, 1994). The Restatement (Third) Governing Lawyers, however, provides that a lawyer may owe a duty to beneficiaries if the lawyer knows that the fiduciary is violating its own duty and does not stop the fiduciary from doing so. Restatement §51(4). This duty would arise "only when the lawyer knows that appropriate action by the lawyer is necessary to prevent or mitigate a breach of the client's fiduciary duty." Restatement §51 comment h.

The ACTEC Commentaries provide that the lawyer owes "few, if any," duties to beneficiaries, but refers to duties of the lawyer that may be both "restrictive" in nature, and affirmative in requiring steps to protect the beneficiary's interests.

e. **Joint Representation of Both Fiduciary and Beneficiary (Different Parties)**. The ACTEC Commentaries provide that conflicts in representing both a fiduciary and beneficiary are "waivable." For example, an executor may give informed consent, confirmed in writing, to permit the lawyer to represent both the executor and a child who is a beneficiary of the estate. The lawyer would also need informed consent from the child that is confirmed in writing. This is consistent with Model Rule 1.7, but not all states require written consent.

f. **Representation of Same Person as Fiduciary and Beneficiary**. The ACTEC Commentaries describe advisable procedures for the lawyer who represents the same person as fiduciary and beneficiary, with possible interests that are adverse to other beneficiaries. Advise the fiduciary of the lawyer's duties to all beneficiaries. Advise the beneficiaries of the representation of the fiduciary/beneficiary. Advise the other beneficiaries that they may at their own expense retain separate counsel. Keep separate records regarding representation of the fiduciary and of his or her interest as beneficiary. Charge fees separately for services as fiduciary and as beneficiary. If a conflict develops that materially impairs the lawyer's representation, the lawyer should withdraw from representing in one or both capacities.

g. **Lawyer Designating Itself as Fiduciary or Lawyer for Fiduciary**. ABA Formal Ethics Opinion 02-426 (May 31, 2002) provides that a lawyer may serve as fiduciary if obligations under Model Rules 1.4(b) and 1.7(b) are satisfied. Model Rule 1.4(b) states "a lawyer shall explain a matter to the extent and reasonably necessary to permit the client to make informed decisions regarding the representation." The lawyer should discuss options available to the client in selecting a fiduciary. A lawyer may disclose his or her own ability to serve as fiduciary, but cannot allow the potential self-interest to interfere with the exercise of independent professional judgment. Model Rule 1.7(b) provides that even if a concurrent conflict of interest exists, a lawyer may represent a client if various requirements are met including that the lawyer reasonably believes the lawyer will be able to provide competent and diligent representation to each affected client, and each affected client gives informed consent.

   The ACTEC Commentary takes a similar position:

   > Accordingly, a lawyer should be free to prepare a document that appoints the lawyer to a fiduciary office so long as the client is properly informed, the appointment does not violate the conflict of interest rules of MRPC 1.7, and the appointment is not the product of undue influence or improper solicitation by the lawyer.

   The ACTEC Commentary also states that the lawyer should advise the client that including such a direction in the will is neither necessary nor customary. The lawyer should advise whether a direction in the instrument to hire the lawyer is binding on the fiduciary under governing law (it usually is not binding).

   Preparing instruments to name the attorney as a fiduciary is common in certain places (such as Boston and Philadelphia) but is not customary in most of the country. As discussed below, written informed consent should be obtained. (As an example, New Hampshire does not allow after-the-fact consent.) Including a provision authorizing the removal and replacement of the attorney as trustee helps avoid an appearance of impropriety.

29. Communications

A lawyer for a fiduciary may frequently interact with beneficiaries; the lawyer should be careful to clarify who he or she represents. Model Rule 4.3. Failure to do so raises the risk that any actions or agreements taken by the beneficiary will not be binding on the beneficiary.

30. Confidentiality

Model Rule 1.6(a) is the general rule that a lawyer shall not reveal confidences. Model Rule 1.6(b) provides various exceptions, including situations in which the lawyer reasonably believes that disclosure is necessary to prevent reasonably certain death or substantial bodily harm, or to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.

a. **Fiduciary Exception to the Duty of Confidentiality and the Attorney Client Privilege**. A minority of jurisdictions have adopted an exception to the duty of confidentiality and attorney-client privilege commonly known as the "fiduciary exception," under which a beneficiary may be able to discover communications between the attorney and fiduciary. Rationales for this exception include that beneficiaries are derivative or secondary clients of the lawyer and that the trust has paid the cost of the lawyer's fee for the advice. The Uniform Trust Code left open whether such a fiduciary exception exists. A case that adopted the minority position is *Riggs National Bank of Washington D.C. v. Zimmer*, 355 A.2d 709 (Del. Ch. 1976). If the trustee hires the attorney only because of threatened litigation, all of the conversations are privileged. An 11th Circuit case recently affirmed this.

b. ***Testamentary Exception to Duty of Confidentiality and the Attorney-Client Privilege***. Communications between a lawyer and client before the client's death may be discoverable if disclosure after the client's death would help further the client's testamentary intent. The Restatement (Third) of Law Governing Lawyers recognizes this exception even if the personal representative refuses to waive the privilege. §81 comment b. The ACTEC Commentaries take a more limited approach; disclosure is appropriate if the client's personal representative consents or if the decedent "had expressly or impliedly authorized disclosure." Disclosure is "impliedly" authorized if it "would promote their client's estate plan, forestall litigation, preserve assets, and further family understanding of the decedent's intention. Disclosure should ordinarily be limited to information that the lawyer would be required to reveal as a witness."

c. **Duty to Report to IRS and Government Authorities**. The duty of confidentiality may restrict a lawyer from reporting mistakes or misstatements that a fiduciary-client makes to the IRS. Such a disclosure was held to violate the ethical duty of confidentiality in *In re Disciplinary Proceeding Against Botimer*, 214 P.3d 133 (Washington 2009). \

31. COMPENSATION

The Model Rules of Professional Conduct §1.5(a) adopts a reasonableness test for attorney compensation. This is representative of a trend away from fees based on a single factor or calculation, such as a percentage of the probate or trust assets. The ACTEC Commentaries state that courts have prohibited, seriously limited, or scrutinized the use of fees based on the percentage of the value of the estate.

32. GIFTS TO LAWYERS BY CLIENTS

Under Model Rule 1.8(c) and Comment 6 to §1.8, a lawyer may not *solicit* substantial gifts from clients (or *prepare documents* consummating such gifts) but lawyers might *accept* gifts from clients subject to general rules under which fiduciaries are presumed to have defrauded their clients in such circumstances. The Restatement, on the other hand, does not prohibit solicitation (although a Comment mentions it) but deals only with document preparation and acceptance of gifts. It prohibits accepting a gift from a client, including a testamentary gift, unless the lawyer is a relative or natural object of the client's generosity, the value conferred is insubstantial, or the client before making the gift received independent advice or was encouraged and given a reasonable opportunity to seek such advice.

Items33-41 are observations of a seminar by Louis S. Harrison and Stephanie Loomis-Price, Avoiding the IRS on your Valuation Journey: The Art of Crafting Defensible Appraisals

33. THE FINANCIALS

The three relevant documents comprising a company's fundamental financial information are the income statement, the balance sheet, and the cash flow statement. Information from these documents will be essential to the valuation process.

a. **Income Statement.** The income statement is the statement of earnings accrued on an accounting basis. This is not cash flow, but the profits of the company based on accounting principles. It reflects accounting profit or loss, showing all revenue and expenses as well as the effects of basic accounting principles such as depreciation and amortization. Accounting income does not accurately reflect cash flow (for example, cash receivables may not be collected).

b. **Balance Sheet**. The balance sheet generally reflects the financial net worth of the assets of a company at a particular time. It lists the assets of the company, some of which may be listed at their book values and some of which may be listed at their fair market values. Book value is the accounting value of the assets—for example, the book value of real estate is typically the purchase price less prior depreciation. A balance sheet may list an item of goodwill but that is not an asset available to the company upon liquidation.

c. **Cash Flow Statement**. The income statement and balance sheet use the accrual basis of accounting to better reflect revenue sources and expenses, but this may be far different than actual cash flow. The cash flow statement reflects the actual cash generated for

the business, the cash used for financing or reinvestment in capital projects, and the cash available for distribution to partners/shareholders. For a company that is producing cash flow for distributions, this statement will be very important in determining the company's value.

34. FUNDAMENTAL VALUATION APPROACHES

a. **Daunting Universe of Approaches**. There is a broad host of valuation approaches that have been cited by appraisers and the courts, such as market method, market comparison approach, guideline public company method, multiple of book value, discounted present value, dividend earnings, capitalized distributions, capitalized earnings, EBIT, EBITDA, earnings approach, asset approach, liquidation method, cost approach, multiple of free cash flow, weighted average cost of capital approach (or WACC), etc. These methods boil down to three fundamental approaches: 1) Asset approach; 2) Multiple of EBITDA; and 3) Discounting of future cash flow.

   The asset approach is used for valuing asset holding companies that do not produce significant cash flow. The last two approaches are used for valuing operating companies. There is no consistency as to which of the last two methods is preferred for particular circumstances. For example, the *Wall* case (T.C. Memo 2001-75)(Judge Beghe) said that the EBITDA approach must be used because of the inability to estimate future income, but the *Deputy* case (T.C. Memo 2003-176)(Judge Gerber) several years later said the exact opposite–that the discounted present value of cash flows approach should be used for valuing similar companies. Logically, it might seem that the EBITDA and discounting future cash flow approaches would yield similar results, but that is not always the case.

b. **Asset Approach; Liquidation Value**. The liquidation value of the underlying assets of the company is determined. The method is appropriate for a holding company that owns passive assets, such as a limited partnership that owns marketable securities. This approach is straightforward. Make sure that the approach of the regulations in determining the values of marketable securities is used (the average of the high and low of the day). Appraisal reports are sometimes confusing in listing extraneous information, such as the dividend yield on stocks owned by the entity. (That is not important because the price of the security reflects its dividend payment history and projections.) Similarly, EBITDA and cash flow are meaningless. Make sure that the appraisal is consistent and as straightforward a possible.

c. **EBITDA; Market Approach**. A company's "EBITDA" is its **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization. This amount can be substantially more than just the earnings. The EBITDA approach is sometimes called the market approach because it applies a multiple to the company's EBIDTA based on comparable public companies, with appropriate adjustments. The term "market approach" is also appropriate because operating companies are typically bought and sold in the private equity real world on a multiple of EBITDA basis.

   The key to this approach is to determine the appropriate multiple that is multiplied times the EBITDA. The multiple is often based on the multiple for publicly traded companies with relevant adjustments for risk factors. The attorney can add significant

input to the valuation process by communicating about the specific company operations to determine relevant comparables and about factors that enter into determining an appropriate multiple factor. The last step is to make adjustments based on other relevant factors such as adding retained cash (that is not needed for necessary capital improvements or working capital to produce the earnings), by subtracting outstanding debt, and by applying minority and marketability discounts to determine the value of the particular interest in the company that is being valued.

d. **Discounted Cash Flow***.* The discounted cash flow approach is also sometimes referred to as the free cash flow or income approach. This is based not on the "income" but on actual cash flow and cash profit. Future cash flows are estimated and the future cash flow stream is discounted to present value using an appropriate discount factor. Key factors with this approach are (i) determining what starting point for the "cash flow" is appropriate (*e.g.*, starting with the last year's cash flow, a 3-year average, or a weighted average, etc.), (ii) determining anticipated increases in cash flow in future years (are there pressures on the business that create concerns about cash flows in the future), (iii) determining the appropriate discount rate, and (iv) making appropriate adjustments based on other relevant facts such as adding retained cash not needed for capital improvements or working capital, subtracting outstanding debt, and applying minority and marketability discounts to determine the value of the particular interest in the company that is being valued.

e. **Determining Multiple or Discount Rate**. The *multiple* applies to the EBITDA (or market approach) method, and the *discount rate* applies to the discounted cash flow approach.

(1) *Attorney Can Add Value*. The attorney can add significant value to the planning process by providing information about inherent risk issues that can lower the multiple of increase the discount rate, which can have a significant depressant effect on the ultimate value. The attorney's goal is to be able to justify lower multiples or higher discount rates by demonstrating that the company is much riskier compared to competitors in the industry.

(2) *Measure of Risk.* The multiple or discount rate depends in large part on risks inherent in the company being appraised. Information about risk issues that the attorney can provide may have a substantial impact on the valuation. The riskier the company, the lower the multiple will be or the higher the discount rate will be.

(3) *Mathematical Relationship Between Multiple and Discount Rate*. The multiple and discount rate are inverses of each other (*i.e.*, each is 1 divided by the other). If the multiple is 20 (*i.e.*, the company would sell at 20 times earnings), the discount rate is 1/20, or 5% (meaning that an investor would require a 5% return on its investment in the company's cash flow). A multiple of 5 is equal to a discount rate of 1/5, or 20%.

(4) *General Rules of Thumb*. A multiple of 5 (or discount rate of 20%) reflects a company with uncertain cash flows and substantial risk. A multiple of 10 (or discount rate of 10%) reflects a fairly high valuation—the cash flow is not particularly risky and the company is not too risky.

(5) *Determining Multiple.* The multiple is often based on comparables with similar publicly traded companies. The price to earnings ratio for publicly traded stocks is often 15-20. But that is of earnings, not EBITDA. If the interest, taxes, depreciation and

amortization of the publicly traded company is added its earnings, the ratio will typically drop to about 8-15 rather than 15-20. Additional risk factors will typically drop the multiple for a "comparable" closely held company lower than for the publicly traded company. Factors that could justify a lower multiple include unstable management, a key employee that would be difficult to replace, inherent risks of the company's specific industry, poor location (all the competitors are moving to Mexico or competitors are in a state without a minimum wage, etc.), limited vendors for essential raw materials, limited customer base, the company too small to attract capital needed for growth, the company has inherent particular risks (*e.g.*, a tanker running aground in a Exxon/Valdez incident, etc.), or the company is too large to be nimble and react to changing circumstances. The report should logically explain why the multiple should be higher or lower.

(6) *Determining Discount Rate.* The discount rate is typically determined under a "build up" method to reflect the appropriate risk level. Start with the discount on a risk-free long term rate (such as the interest on a 20-year Treasury note)–about 2%. Add to that an appropriate premium to for the added risk of investing in large cap stock in the U.S. stock market–about 7-8%. Add to that a small stock premium if the company being valued is a closely held company–about 3-4%. That often gets the discount rate to about 13-14%. Add to that idiosyncratic risks associated with the particular company (the same types of risk factors discussed in the preceding paragraph regarding determining a multiple.) The discount rate may end up at 19-21%. For an example of how appraisers analyze these various elements of the overall discount rate, see *Estate of Deputy v. Commissioner*, T.C. Memo 2003-176. Appraisals should make clear how the discount rate is determined; confirm that the analysis makes sense and is consistent with the capital structure of the company within its industry.

f. **Make Adjustments.** From the analysis above, make further adjustments from items reflected on the company's balance sheet. The value should be increased by excess cash that is not needed for capital expenditures or working capital, and should be reduced by outstanding debt. Do not make adjustments for "property plant and equipment" (presumably that asset is needed to produce the earnings or cash flow) and do not add anything for "goodwill." (The goodwill of a company is its value as an operating company and that has already been included in the valuation.)

In addition, apply appropriate minority or marketability discounts with respect to the particular interest in the company that is being valued.

35. Opportunities For Attorneys to Add Value to Valuation Process

Follow a "LHF" approach—focus on the low hanging fruit.

a. **Anchoring**. Provide input to establish a value as low as possible in good faith. If a particular value is proposed on a rational basis that provides a good negotiating position on audit. "Anchoring" is a behavioral finance term. Once a number is proposed, no matter how absurd it is future negotiations will pivot off that number. If the discussion starts with a high number, the ultimate result will likely be higher than if the discussion starts with a low number. Construct the anchor carefully.

Consider that the IRS examining agent may use the anchoring process as well, perhaps based on the report of an IRS valuation engineer. To the extent possible, discuss valuation issues with the examining agent before the agent decides to take the step of bringing in an IRS engineer. In *Adell v. Commissioner*, the IRS engineer report used a value of $92 million, but the IRS reduced is valuation position at trial (using a third party appraiser) to $26 million.

b. **Cash Flow**. For the discounted cash flow approach, the attorney may be able to support reasons why a lower cash flow is appropriate. For example, if the cash flow has increased 20% per year over the last three years, using the last year's cash flow may not be appropriate if there are reasons supporting the increasing cash flows that may not apply in the future. An average of the prior three years or even a weighted average may be appropriate.

c. **Multiple or Discount Rate**. The attorney may be able to point out particular inherent risks in the company being valued to support a lower multiple or higher discount rate.

d. **Minority or Marketability Discounts**. Similarly, the attorney may be able to point out factors that would support a larger minority or marketability discount for valuing the particular interest in the company that is being valued.

36. Reviewing Appraisals

a. **Overall Goal***.* When faced with reviewing a long complicated appraisal, keep in mind that the overall goal of the attorney is the opportunity to have the report best tell the taxpayer's story. The attorney can help assist in making sure that the report reflects the owner's cautiousness or pessimism about the company's future (and entrepreneurs are traditionally always scared about what might go wrong). The attorney wants to make sure that the appraiser (and examiner and court) takes those concerns into consideration. The attorney's role is the ability to influence the telling of that story. View the technical details of an appraisal with an eye to the overriding goal of telling the story.

b. **Review Draft Report***.* Always review the draft report in detail. If the attorney first receives a signed "final" report, the attorney should immediately call the appraiser and tell the appraiser that the report is not final and that the attorney will be reviewing it closely. Stephanie Loomis-Price reads the appraisal about five times—looking for different things each time.

c. **Provide Comments; Do Not Superimpose Attorney's Opinion.** After reviewing the report, the attorney should call the appraiser to give his or her comments. Explain that the comments are not edits, but merely comments for the appraiser to consider. The goal is to make sure that the report is as accurate, logical, and understandable as possible. (Stephanie once asked Judge Halpern if that process was concerning to him and he said no as long as the attorney is merely offering comments for the appraiser's consideration.) The worst case scenario is that a judge views the appraisal report as merely being the attorney's opinion of value and throws out the appraisal totally, leaving the taxpayer with no valuation evidence. Do not risk that.

Do not send edits to the appraiser. The goal is to dialogue with the appraiser about comments to make the report more professional, accurate and understandable.

d. **Make Comments to Improve Understandability and Readability of the Report.** IRS examiners and judges are not valuation experts. They may need assistance with understanding even fundamental concepts. A major goal of the reviewer is to make sure the report is readable and understandable. One attorney asks her legal assistant to read the report and highlight anything the assistant does not understand.

e. **Disclose Anticipated Events to Appraiser.** Disclose plans to make significant distributions or to engage in sales discussions, etc. in the foreseeable future. Reasonably anticipated events should be disclosed as facts for the appraiser to take into consideration. The fact may have a relatively small impact on the value, but if not disclosed, the appraisal's credibility may be impacted and the judge may disregard the appraisal in its entirety, leaving the taxpayer with no valuation evidence.

f. **Review for Grammar and Typos**. The judge's reaction may be "If your appraiser can't spell the client's name, how can I trust anything the appraiser says?" Some judges do not care about typos but some are very sensitive to that.

g. **Check References That Are Quoted or Cited.** In the *McCord* case, the attorneys had to explain to the judge why a quote in the appraisal report was not in the cited reference material. Highlight everything that is a quote or citation to a reference, and check it.

h. **Appraisal Accurately Reflects Governing Documents**. The appraisal report should accurately summarize the salient provisions of the governing documents for the company being valued. For example, the draft of one report stated that unanimous approval of all owners was required to liquidate the entity, but in fact any owner had the unilateral right to force the termination of the entity. Pointing out that mistake to the appraiser resulted in a dramatically altered report. Read the governing documents to make sure the appraiser understands the terms in the agreement.

i. **Check the Math**. Check the math for all calculations, and all numbers cited. For example, if the report refers to 99 comparables, count them to make sure there are indeed 99 of them.

j. **Review Logic of Valuation Theory***.* Make sure the logic of the report makes sense. For example, the report may list several reasons why a downward adjustment should be made and various reasons why an upward adjustment should be made, but conclude there should be an upward adjustment without explaining why the upward adjustment factors outweigh the downward adjustment factors.

k. **Olfactory Test**. In *McCord*¸ Judge Foley referred to the olfaction of the tax planning. The Fifth Circuit referred to this as a smell test or "gut" feelings:

> … Judge Foley's use of "olfaction" is an obvious, collegially correct synonym for the less-elegant vernacular term, "smell test," commonly used to identify a decision made *not* on the basis of relevant facts and applicable law, but on the decision maker's "gut" feelings or intuition.

If the appraisal report does not "feel right" to the reviewer, it will not make sense to the IRS examiner or judge either. "Use your nose in reviewing appraisals."

l. **Review Factual Details; Buy-Sell Agreement**. Review the important facts in the report, such as the company's distribution policy (and if there is a policy is it being followed), terms of the partnership agreement, assets of the entity (Stephanie reviewed a draft report that omitted a 400,000 acre ranch!!), etc.

In particular, confirm whether or not the appraiser considered any buy-sell agreement provisions and whether that consideration is appropriate. One attorney told of reading a report and finding a footnote near the end of the lengthy report saying that the attorney had instructed the appraiser to ignore Chapter 14 when the attorney had not done so. There is a difference of opinion as to whether the attorney or the appraiser should be responsible for determining whether Chapter 14 applies, but at least the attorney needs to know whether the appraiser has taken the buy-sell agreement value into consideration.

m. **Share Draft Report With Client**. The client may be able to spot inaccuracies, or point out why particular comments in the report are not correct. (The owner is likely extremely familiar with the industry. For example, the owner may be able to point out why particular comparables are not appropriate and why other comparable companies are much more relevant.)

One panelist told of sharing a draft appraisal with the client whose CD/jewel case company was being valued. The client was outraged that the appraiser had used a PVC pipe company as the comparable (both dealt with plastics). The client spent thirty minutes explaining why the company was more similar to Exxon than a PVC pipe company. The attorney shared those comments with the appraiser, who agreed and changed the comparable. The panelist had great fun at trial cross examining the IRS appraiser–who happened to use the PVC pipe company as the comparable.

n. **Carefully Identify Specifically What Is Being Valued.** As an example, make clear whether a limited partnership interest or an assignee interest is being valued.

o. **Consider Tiered Discounts.** Judge Swift (who is not perceived as a "pro-taxpayer" oriented judge) allowed a multi-tiered discount in *Astleford v. Commissioner* , T.C. Memo 2008-128. Footnote 5 lists various circumstances in which multi-tiered discounts are appropriate, and most situations can be fit within one of those circumstances.

p. **Cite Correct Valuation Regulation.** Cite the correct valuation regulation, depending on whether the case is a gift tax or estate tax case. There are no substantive differences, but the report's credibility may be questioned if the IRS can suggest that the taxpayer's appraiser does not even know whether the "section 20 or section 25" regulation applies. Reg. §§20.2031-1(b)(estate tax); 25.2512-1(gift tax).

37. Engage Client in Appraisal Process

Engaging the client in the valuation process is critical. The client will have a better understand of the appraisal process. Involving the client increases the credibility and integrity of the appraisal. If the IRS examiner uses an IRS engineer, the engineer typically often does not interview the owners or management.

Manage client expectations regarding the anticipated value and timing of the appraisal report. Tell the client that the planner does not know what value the appraiser will conclude, but that the attorney will review the report and make sure that factors the client is expressing are reflected in the report.

38. Tax Adjusting S Corporation Income

The Tax Court rejects adjusting the income earned by S corporations to reflect that the income is pre-tax income subject to payment of income taxes by the owners, arguing that the there are other offsetting benefits to S corporation taxation. A corporation may have $650,000 of income after paying the corporate income tax, and the S corporation may have $1.0 million of income, but the Tax Court does not allow "tax-affecting" to adjust the S corporation income. This can result in an enormous difference in the valuation.

Even though many planners think the Tax Court's approach is not correct, using the word "tax affecting" in the appraisal report will draw the immediate scrutiny of the IRS examining agent. If an adjustment is made in some manner, call it anything other than "tax affecting." Indeed, if the EBITDA approach, is used, the taxes may be subtracted in some manner in that analysis, and there is a good possibility the issue will not be raised by the IRS examining agent.

39. Responding to IRS Information Requests

The approach of some planners is to "flood the IRS with paper" in response to information requests. Stephanie's approach is to ask the IRS to send the request in writing, to read it very closely, and respond to the request narrowly to provide precisely what the IRS requested. If the IRS request is unclear, her response will point out any apparent ambiguity in the request and rephrase what she thinks is being requested and respond to that request. (Very rarely does the IRS supplement the request.)

40. Separate Trial Appraiser

Some attorneys routinely use a separate appraiser for trial, especially if deficiencies are observed in the appraisal attached to the tax return. One rationale for getting a new appraisal is that trials can occur years (or more than a decade) after the transaction date. Valuation theories can change substantially during that period. The second appraisal can show reasons why the valuation in the original report should be adjusted, or can support the valuation in the original report despite valuation theory changes.

The *Adell v. Commissioner* case interestingly refused to shift the burden of proof to the IRS under §7491(a), reasoning that the estate did not present "credible evidence" regarding the valuation issue—because of the inconsistent positions in the various estate valuation reports. T.C. Memo 2014-155.

41. Appraisal Reports-The Bottom Line

In summary, appraisal reports are all about "the story." The attorney's role is to assure that the appraisal is presented in the most professional form possible, reflecting consideration of the taxpayer's story about the company and its inherent risks.

Items 42-51 are observations from a seminar by David A. Baker and Mickey Davis, Tax Considerations in Fiduciary Litigation

42. Consider Net After-Tax Effect of Court Actions/Settlements

A recurring problem with settlements is that some attorneys are not focused on or qualified to consider the after-tax effects of the settlement. For example, when a party later receives a K-1 showing substantial income taxed to that party, the settlement may blow up. The attorney should explain to the client that the other side may not have considered particular tax issues. The settlement can be signed now, but the risk is that the parties will be back in court a year later. The client must decide what is more important—to get a settlement wrapped up today or to get some real certainty.

43. Tax Issues That Frequently Arise in Defending Fiduciaries

a. **Late Filing Penalties**. Fiduciaries have a non-delegable duty to file tax returns timely, including income, gift, and estate tax returns. Relying on bad tax advice is not an excuse to avoid late filing penalties.

b. **Fiduciary Liability for Federal Taxes**. A fiduciary has personal liability for federal taxes if the fiduciary pays or distributes property to any person for any reason, including the payment of debts and claims, before the tax due is fully satisfied. 31 U.S.C. §3713(b); Reg. § 20.2002-1. There are certain exceptions, including the payment of administration expenses allowed by the court of competent jurisdiction. One panelist expressed concern as to whether filing a request for discharge of personal liability after nine months (using Form 4810) would cut off personal liability with respect to distributions to beneficiaries. §2204; Reg. §20.2204-1. The §2204 relief from personal liability provision generally relieves a fiduciary from personal liabilities created under the Internal Revenue Code, but not under 31 U.S.C. §3713(b).

c. **Only Reasonable Fiduciary and Attorneys' Fees Can Be Deducted**. Only reasonable fees that are necessary for the estate administration may be deducted. The IRS focuses on fees for services that are not directly related to administration of an estate or trust but that are buried in a fee invoice that is subsequently approved by a state court or paid without objection by beneficiaries. Estate tax audits increasingly include a request for detailed time records to document the proper deductibility of fees charged as administration expenses. The IRS position is that the billing information is not privileged. *E.g. Triplett v. United States*, 77-2 USTC ¶9732 (10th Cir. 1977).

44. Impact of State Court Judgments and Settlements on Federal Tax Issues

a. **Court Judgments—Bosch**. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) addresses the respect that federal courts must give to state court proceedings in tax cases. The issue in *Bosch* was whether a transfer in trust for a spouse, giving her an income interest for life and a general power of appointment, qualified for the estate tax marital deduction. Prior to the decedent's death, the wife had executed an instrument attempting to convert the general power of appointment to a non-general power. The trustee brought a construction suit requesting whether the wife's release of the general power of appointment was effective under state law. The trial court ruled that the release was a nullity. The Tax Court and Second Circuit Court of Appeals allowed the marital deduction. The Supreme Court reviewed the legislative history to the marital deduction, and observed that the Senate Report directed that "proper regard" be given to state court construction of wills. Because the Senate stated "proper regard" rather than "final effect," the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

   Bosch is poorly understood and is under argued by taxpayers and over argued by the IRS. While the IRS is not bound by a state court decision unless it is a determination of the highest court of the state, the IRS is required to give "due regard" to the state court decision. The IRS examiner is inclined to take the position that the lower court order is meaningless. That is incorrect; the examiner should give the state court decision due regard but typically starts from scratch as if the court order did not exist.

b. **Settlements—Ahmanson**. The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). There is a four-part test to determine if the results of a settlement will govern the tax consequences. (1) The case arose from a bona fide dispute. (2) The amount received by the parties should be something that is premised on a bona fide claim under state law. (3) The recipient does not receive more property than could be covered if the person received a full recovery following a trial. (4) Amounts received must be of a character and nature of what the person was entitled to under state property rights. (For example, if a residual beneficiary settles for a fixed sum of money, it cannot take a position that it received a specific bequest that does not carry out DNI.)

   If the IRS concludes that there is not a bona fide controversy, it can either treat the exchange of property as a gift or as a sale for full consideration.

   Effectively, the IRS seems to be taking the position that there is a "settlement tax." The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. Some examiners seem to believe that if the parties even thought about transfer tax consequences, the settlement is meaningless for tax purposes. Many situations are obviously not collusive but extremely adversarial. The courts and National Office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

c. **Obtaining Ruling by Highest State Court**. In a reformation action in Indiana, the parties reformed a will based on mistake of law in order to salvage a marital deduction. The drafting attorney was sued for malpractice for the potential added estate tax. The

Indiana Supreme Court observed that if it ratified the local court reformation, the tax problem would vanish, and it so ruled. However, in another Kansas case when parties attempted to get the Kansas Supreme Court to affirm a lower court decision in a reformation proceeding, the Kansas Supreme Court decided that the local court was wrong, thus yielding a bad tax result and a loss of the lower court judgment.

Massachusetts has a process for taking issues to the Massachusetts Supreme Court in order to resolve tax effects.

d. **Revenue Ruling 73-142**. At the 2012 Heckerling Institute on Estate Planning, Jonathan Blattmachr described how pre-transaction construction actions can avoid the *Bosch* analysis. In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73 – 142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.* Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power.* In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142.

45. Substantive Tax Considerations Arising From Settlements

a. **Inheritances Not Taxable**. Gross income does not include the value of property acquired by gift, devise, or inheritance. §102(a). However, distributions of estate or trust income will "carry out" the income to the beneficiaries up to the amount of the DNI of the estate or trust unless an exception applies. Issues can arise as to whether settlement proceeds represent a non-taxable bequest or whether at least a portion of the proceeds represents the receipt of a distribution carrying out trust income to the recipient.

b. **Bequest of Income Does Result in Taxable Income**. If a bequest or inheritance is the right to receive income, the amounts are taxable as income to the beneficiary. §102(b).

For example, a bequest to a spouse designed to qualify for the marital deduction may be an income interest for life. If an amount is paid to the spouse in settlement of his or her right to income for life, the settlement is treated as an acceleration of the income interest, and results in taxable income.

An example of this principle is *Getty v. Commissioner*, 913 F.2d 1486 (9th Cir. 1990). The testator's son sought to impose a constructive trust to enforce the testator's promise to remedy unequal treatment of the children during his lifetime. The son sought to impose a constructive trust on assets in an amount equal to the income received by the other children, which claim was settled for $10 million. The IRS argued that the claim was for income from property. The court determined that the settlement amount was based on a claim for inheritance equal to the *amount* of income the other children received, not of income itself. Therefore, the settlement amount was not taxable income to the beneficiary.

c. **Bequest for Services Rendered is Taxable Income**. A bequest made to compensate for services rendered to the decedent is not excluded from income. IRS Publication 525 states that cash or other property received "as a bequest for services you performed while the decedent was alive" is taxable compensation.

d. **Deductions of Payments by Estates**.

(1) *Taxable Income vs. Estate Tax Deduction Tension*. Claims against an estate for which the decedent paid full consideration are deductible as debts. §2053. For example, amounts received for a claim based on past services will be deductible to the estate under §2053, but the payment will be taxable income to the recipient. On the other hand, a claim based on the right to receive an inheritance or bequest will be income tax free to the beneficiary but will not be deductible to the estate as a debt.

(2) *Timing of Estate Tax Debt Deduction*. The IRS has issued final regulations, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amount for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved and paid. Reg. §20.2053-1(d)(5).

(3) *Payments Related to Divorce Transactions*. In a divorce proceeding, one spouse may agree to take less for her support rights in return for a promise by the other spouse to leave additional assets to the children, which may constitute a gift to the children. *See* Rev. Rul. 79-363; Rev. Rul. 77-314 (Situation 2); Reg. §§25.2702-1(c)(7) & 25.2702-4(d)(Ex.5). If the payment is not made before the other spouse dies, it is a claim backed by consideration that can be deducted by the other spouse's estate under §2053. Rev. Rul. 71-67. (For an excellent detailed discussion of this issue, see Carlyn McCaffrey, *Divorce and Taxes–Selected Issues*, ACTEC 2007 SUMMER MEETING.) The adequacy of consideration is determined at the time of the divorce. In administering estates, the attorney should review any divorce decrees. There may agreements to make bequests that would be deductible claims.

(4) *Claim Deductions on Original Return*. If deductible claims are not deducted on the original estate tax return, deducting them later may be difficult, or at least cumbersome.

(There is no such thing as an amended Form 706; they are filed on occasion, but represent an administrative processing nightmare for the IRS, possibly ending up with two different examining agents for the estate.)

e. **Basis Adjustments**. A basis adjustment is permitted under §1014, but not for income in respect of the decedent items.

   If a trust is not funded, a subsequent suit to correct the funding may be based on varying theories. One theory is that the individual kept the property outright and owes a debt to the intended beneficiaries. In that case, all of the assets would be in the decedent's gross estate and a basis adjustment would be permitted. Another theory is that a constructive trust should be imposed on the individual's assets. Under that theory, the assets would be excluded from the gross estate and would not receive a basis adjustment. For a summary of a discussion of this issue by Mickey Davis at the 2014 Heckerling Institute, see Item 27 of the Heckerling Musings 2014 and Current Developments summary found here and available under Insights at www.bessemer.com/advisor.

f. **Gift Effects**. Transfers in compromise and settlement of a trust or estate dispute typically will be treated as transfers for full and adequate consideration that do not result in gifts. The IRS has issued a number of favorable private letter rulings finding no gift tax exposure in a variety of settlement contexts. *E.g.*, PLR 201342001, 201104001, 200845028, 200825007, 200638020, and 200209008. Planners often worry about the gift issue in settlement discussions, but "this is one of the scariest things that almost never happens."

46. Marital Deduction Issues

Marital deduction regulations state that if any interest is assigned to a surviving spouse as a result of a controversy, the interest will be treated as having passed from the decedent to the surviving spouse only if the settlement is a bona fide recognition of enforceable rights of the surviving spouse. Such a bona fide recognition is presumed if the assignment is "pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest." Reg. §20.2056(c)-(2)(d)(2). Accordingly, amounts passing to surviving spouses pursuant to court proceedings are presumed deductible without worrying about the *Bosch* analysis; amounts passing pursuant to settlements are not entitled to the same presumption.

If the *form* of the bequest does not qualify for the marital deduction, as a general rule reformation proceedings will not be permitted to transmute the bequest into a deductible interest. (This is in contrast to the charitable deduction area, where the statute specifically authorizes reformation proceedings to reform the *nature* of bequests to qualify for the charitable deduction.)

47. Charitable Deduction Issues

a. **Exempt Status**. To qualify for a charitable deduction under §2055, property must pass from the decedent to the charity, and the charity must qualify as a §501(c)(3) organization as of the date of death. The charitable deduction may be claimed for a

bequest to any entity that is to be created under the decedent's documents. In this situation, the estate will need to form the organization and apply for exempt status before the filing date of the estate tax return. If that deadline is not met, the exempt status will not relate back to the date of death, and no estate tax charitable deduction is allowed.

b. **"Voluntary" Charitable Payments**. If a party agrees to make a payment to charity to settle an unrelated dispute in which the charity has no claim for receiving assets, no estate tax charitable deduction is allowed. The property does not pass from the decedent. Even if the charity is a beneficiary of the will but the settlement amount exceeds what the charity was entitled to receive, the excess will not qualify for an estate tax charitable deduction.

c. ***Cy Pres****.* "*Cy pres*" literally means "as near." If a charitable bequest cannot be satisfied (for example if the charity no longer exists) a state court cy pres proceeding may determine the general charitable intent and declare an amount that would pass to the next best charitable target. Such amounts qualify for the estate tax charitable deduction under §2055.

48. Construction and Reformation Proceedings

A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction, because the interpretation relates back to the date of death (assuming the four-part analysis of settlement agreements can be satisfied).

A reformation modifies a document, and the IRS position is that the reformation applies prospectively only. It may not result in an action resulting in assets passing to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction.

An ambiguity may be located to be able to use a construction rather than a reformation proceeding, in light of the more favorable tax treatment resulting from construction actions. "Constructions rock. The longer we practice, the more we realize that anything can be ambiguous."

49. Decanting

A variety of tax uncertainties result from decanting transactions. For a discussion of the tax issues that arise in decanting transactions, see Carlyn McCaffrey & Amy Heller, *Fixing Estate Planning Documents*, 48th Annual Heckerling Inst. on Est. Pl. ¶1507.5 (2014); Melissa Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 Est. Plan. & Community Prop. L.J. 35 (Fall 2013).;

a. **No Ruling Position***.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (the annual "no ruling" revenue procedure) added "decanting" rulings to the list of topics under Section 5, dealing with areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise. That no ruling position has been continued in subsequent years.

b. **Notice 2011-10 and Further IRS Guidance**. Notice 2011-101 requested comments on various issues regarding decanting, and the IRS received a number of comments. The Priority Guidance Plan for 2012-2013 dropped the decanting project, and it has not been added to the lists for 2013-104 or 2014-2015. IRS officials say that they are still working on the project (but the continued elimination from the Priority Guidance Plan suggests that further guidance might not be coming for some extended time, if ever).

c. **Gift Tax**. The IRS raised the question in Notice 2011-101 whether a beneficiary's acquiescence to a decanting has gift tax consequences. The trustee, however, is merely exercising a power that has applied to the trust from the outset or that applies under state law. How can the beneficiaries be deemed to have made a gift even if the decanting extends the time before they receive assets?

   Most state decanting statutes require notice to the beneficiaries. If beneficiaries are aware of a proposed decanting transaction and do not object and thereby lose an interest they might otherwise have in the trust, is the failure to object a gift?

   A way to avoid gift implications for an acquiescing beneficiary is to give the beneficiary a testamentary limited power to appointment to appoint the assets among a class of beneficiaries. Reg. §25.2511-2. If the settlors or trustees are concerned about how the beneficiary might exercise a power of appointment, they could provide in the decanted trust could provide that the power can be exercised only with the consent of a non-adverse party (including the consent of the court). That would still cause the gift to be incomplete.

   An important Revenue Ruling also provides some relief. A beneficiary who is denied a right by the fiduciary through the exercise of a power does not make a gift as long as the beneficiary still has the power under local law to cause the trustee to reverse the decision. Revenue Ruling 84-105 involved a situation in which the trustee overfunded the credit shelter trust by valuing properties too low, and therefore underfunded the marital deduction trust. As long as the surviving spouse has the power to reverse it there is no gift. The Ruling concluded that the gift was not made when the credit shelter trust was initially funded in 1979, but when the surviving spouse did not object or attempt to appeal the probate court order approving the funding when the order became final some years later. If the beneficiary is also the fiduciary exercising the power, that situation is different. In that case, make sure that the beneficiary has a retained special power of appointment to make any gift an incomplete gift.

d. **Estate Tax**. If a beneficiary can participate in a decanting decision that may result in distributions to the beneficiary not being limited by an ascertainable standard, there could be potential §2041 concerns. Many states have enacted legislation that would prohibit this result as a general matter. Furthermore, many of the decanting statutes include a statement that the power to decant is to be construed as a non-general power of appointment, and prohibit a beneficiary-trustee from participating in a decanting action. Some statutes contain an exception to the prohibition on a beneficiary's participation in the power to decant if distributions are limited by an ascertainable standard.

e. **GST Tax**. Who is the transferor of the new trust? Does the GST exempt status of the prior trust carry over to the new trust?

f. **GST Impact on Decanting of Grandfathered Trusts**. The IRS was unhappy when the New York decanting statute referred to extending grandfathered GST trusts in the legislative history of the purpose of the decanting law. The IRS made changes to the final GST regulations governing grandfathered trusts (i.e., irrevocable trusts created before September 26, 1985 that are not subject to the GST tax). The regulations provide that a *beneficiary* can exercise a special power extending the trust as long as it does not violate the rule against perpetuities without destroying the grandfathering protection. However, if a trust is extended under a *trustee's* power to decant, the first safe harbor of the grandfather trust modification regulations (discussed in Item 50.a below), which covers distributions from an exempt trust to a new trust, would apply only if the decanting power was in the instrument at the time it was created or the power to decant was present in the governing law at the time the trust was created. *See* Reg. §26.2601-1(b)(4)(i)(A)(ii) ("at the time the exempt trust became irrevocable, state law authorized …"). Because there were no state decanting statutes in 1985 or before, that second leg would be present only if the common law of the state recognized decanting in 1985 or before. Florida is the only state where that clearly is the case, with the *Phipps* case dating to back to 1940. Under the rationale of the *Phipps* case, a decanting power may have existed in all states, but there can be no certainty about that. If the first safe harbor does not apply, but state law has since been changed to recognize decanting distributions to a new trust, the fourth safe harbor may apply to distributions from an exempt trust to a new trust if there is no shift in beneficial interest to a lower generation or extension of time for vesting in the new trust (as discussed in Item 50.a below).

g. **Income Tax Issues**.

(1) *Grantor*. Who is the grantor of the new trust? Treating the trustee as the grantor would make no sense. The decanted trust is likely viewed as an extension of the original trust for this purpose.

(2) *Impact of Decanting on Trust DNI*. When a distribution is made from the trust to a new trust, it appears that DNI is swept out of the old trust to the new trust. If the entire trust is moved to a new trust, is there a new trust for tax purposes? PLR 200736002 says that a decanting of the entire trust into a separate trust will be treated as the same trust for income tax purposes (having the same tax ID number, etc.). *See also* PLR 200607015 (trustees' appointment of trusts to new trusts with administrative changes was not viewed as a distribution or termination and did not result in income realization under §§661 or 662). The position of treating the new trust the same as the old trust if the entire trust is decanted could be changed by future guidance. If less than the entire trust is decanted to a new trust, the distribution may be treated like other discretionary distributions, generally carrying out DNI to the new trust.

(3) *Conversion to Non-Grantor Trust.* Termination of grantor trust status during the grantor's lifetime can result in recognition of gain and, logically, the increase in the basis of assets held by the then-nongrantor trust. *See* Rev. Rul. 77-402, 1977-2 C.B. 222; Reg. §1.1001-2(c)Ex. 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985). On the other hand, converting a non-grantor trust to a grantor trust probably does not cause recognition of income.

(4) *Negative Basis Property*. Normally when there is a transfer of assets, any *Crane* gain (assets with liabilities in excess of basis) is recognized. However, §643(e) says that when a trustee makes a distribution there is no gain recognition unless the trustee elects

to have gain recognized. There is tension between those two concepts. Leave the negative basis asset in the old trust unless you get a ruling from the IRS or unless it is being transferred from one grantor trust to another grantor trust.

50. GST Impact of Reformation Proceedings and Modification of Grandfathered Trusts Regulation

The GST tax generally does not apply to any transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985. (Such trusts that were irrevocable on September 25, 1985 are often referred to as "grandfathered trusts.") If a trust created in any of these grandfathered situations is subsequently modified, an issue arises as to whether that modification will be treated as a constructive addition to the trust or otherwise cause the trust to lose its exemption from the generation-skipping transfer tax.

a. **Modification Regulation for Grandfathered Trusts**. Final regulations were adopted on December 20, 2000 that substantially relax the IRS's historical positions on modifications to grandfathered trusts. The regulations provide four safe harbor situations, in which changes will not affect grandfather status.

Because no general rule is stated, it is unclear what happens if a trust modification does not fall within any of the four safe harbors. One of the examples in the regulations concludes that failure to meet any of the four safe harbors in that particular situation would cause loss of grandfather status. Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 4. However, the Preamble to the final regulations suggests that failure to meet any of the four safe harbors does not necessarily mean that grandfathered status is lost, by observing that "*most* of the modifications that will not affect the exempt status of a trust will be covered by the safe harbors in the final regulations." (emphasis added).

The first three safe harbor tests allow pretty broad modifications, even including extension of the trust beyond the termination date in the original trust in some circumstances. However, those first three safe harbor tests only apply in limited circumstances, including:

(1) changes that can be made pursuant to a trustee's discretion under the trust agreement or state law without the approval of a court or any beneficiary and if the terms of the governing instrument of the new trust or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend vesting of any interest in the trust beyond a described perpetuities period; the described perpetuities period is determined based on the lives of persons in being when the original trust became irrevocable plus twenty-one years plus, if necessary, a reasonable period of gestation;

(2) court approved settlements of bona fide disputes regarding administration or construction of the trust if (i) the settlement is the product of arm's length negotiations, and (ii) the settlement is within the range of reasonable outcomes under the governing instrument and local law regarding the issues involved in the settlement; and

(3) judicial construction to resolve a potential ambiguity or drafting error if (i) the judicial action involves a bona fide issue, and (ii) the construction is consistent with

applicable state law that would be applied by the highest court of the state. Reg. §26.2601-1(b)(4)(i)(A-C).

The fourth safe harbor test applies in many more situations, but the permitted types of modifications are limited. The modification may not shift any beneficial interest in the trust to a beneficiary in a lower generation, and the modification must not extend the time for "vesting" of any beneficial interest in the trust beyond the period provided in the original trust. Reg. §26.2601-1(b)(4)(i)(D)(1).

The fourth safe harbor would allow a modification to split a single "spray" trust into separate trusts for the respective beneficiaries. Reg. §26.2601-1(b)(4)(i)(E) Ex. 5. For example, assume a trust provides for discretionary distributions to all of the settlor's children. For whatever reason, the children want to go their separate ways, and wish to create separate trusts for each of the respective children. There could then be different trustees, investment philosophies, distribution philosophies, etc. for the separate trusts. That was not permitted under the IRS's prior ruling position. Be aware of possible income tax issues with this type of modification that arguably changes the nature of some of the beneficiaries' rights in the trust.

Another common change that should be permitted under the fourth safe harbor is a modification of a trust to allow property to remain in trust past the distribution date in the original trust until a beneficiary reaches a later age. That should be satisfactory if the trust is vested for estate tax purposes (but to be totally safe, also vested for state law purposes to be sure that the "vesting" requirement is satisfied) as of the same time as the original trust.

For a detailed discussion of the GST modification regulations for grandfathered trusts, see Harrington, McCaffrey, Plaine & Schneider, *Trust Modification Prop. Regs. And Other Significant GST Tax Developments*, 92 J. TAX'N 212 (April 2000).

b. **No Ruling Position Regarding Modification of Grandfathered Trusts Covered by Safe Harbors**. There have been a number of private rulings dealing with permissible modifications of grandfathered trusts. Rev. Proc. 2007-3, 2007-1 IRB 108 provides that the IRS will not rule on a proposed modification of a grandfathered trust if the modification is "similar to a factual scenario set forth in one or more of the examples" of Regulation §2601-1(b)(4)(i)(E). That ruling policy only applies to grandfathered trusts. Presumably, the IRS will still rule on the effects of modifications to exempt trusts as a result of GST exemption allocations (and indeed there are a host of tax issues—income, gift, and estate inclusion issues—that may arise other than just the effect on the GST exempt status of the trust).

c. **Modification of Exempt Trusts**. There is no regulation or other formal guidance dealing with the effects of modifying exempt trusts for which GST exemption has been allocated to the trust. There have been various private rulings (*e.g.*, PLRs 200615001 & 200417014) acknowledging that no formal guidance has been issued and stating that "at a minimum," a modification that would not affect the exempt status of a grandfathered trust should not change the exempt status of a zero inclusion trust. (The "at a minimum" phrase implies that it may be possible to make even more permissible changes to a zero inclusion trust than to a grandfathered trust.)

51. POTENTIAL GAIN BY BENEFICIARY UNDER COTTAGE SAVINGS

In *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgage loans were considered "substantially identical" by the agency that regulated the financial institution. In defining what constitutes a "material difference" for purposes of §1001(a), the Supreme Court stated that properties are "different" in a sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent or if they confer "different rights and powers." *Cottage Savings*, 499 U.S. at 564-565. The Supreme Court held that mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements and that the taxpayer realized losses when it exchanged the loans. 499 U.S. at 566.

The Supreme Court concluded that an exchange of property gives rise to a realization event under §1001(a) if the properties exchanged are "materially different," and that any change in what one owns by any means can result in a taxable disposition. For example, the IRS has taken the position that the conversion of a straight income interest to a unitrust interest will result in gain to the beneficiary under *Cottage Savings,* unless the change is pursuant to the highest court of the state or pursuant to a state statute. Reg. § 1.1001-1(h) says that the severance of a trust does not generate gain, including no gain recognition to the beneficiary under *Cottage Savings*.

The IRS has ruled, in various rulings, that there are no income tax consequences of proposed reformations, divisions or distributions into further trusts if the beneficiaries' interests before and after the proposed action are not "materially different." *E.g.*, Ltr. Ruls. 199951028 & 199951009. However, some practitioners have reported that they have been unable to obtain favorable income tax rulings when a trust is being modified or divided. For a discussion of a negative ruling, see Barbara Sloan, *Consequences of PLR 200231011:* Cottage Savings *or Cottage Industry?*, 29 ACTEC J. 102 (Fall 2003). Planners should be particularly careful if any beneficial interests are being revised in the modification (which is permitted in certain circumstances under the regulations addressing the modification of trusts grandfathered from the GST tax).

Commentators have noted that the IRS's reported position, treating beneficiaries as engaging in taxable exchanges for income tax purposes in some situations involving modifications, divisions, or transfers in further trust, seems highly inappropriate.

> One flaw in the application of *Cottage Savings* to reformations, divisions or distributions is that the beneficiary is not 'exchanging' anything. In fact, many of the rulings no doubt involve spendthrift trusts where the beneficiary has no state law authority to effect an exchange. If the division or distribution is authorized under the terms of the trust, the change is a consequence of the trust terms, and not a consequence of the beneficiary's actions. If the beneficiary's consent is required, so that it is easier to characterize the change as an exchange, in most cases, the beneficiary receives an interest that is the same type of property she or he had before the change. If the interest is 'materially different' for any reason, a gift usually has occurred as to that difference, not a sale, and no gain should be realized. Only the most extreme cases should result in recognition of gain, such as when a beneficiary is bought out of a trust for cash." *See* Harrington, McCaffrey, Plaine & Schneider, *Trust Modification Prop. Regs. And Other Significant GST Tax Developments*, 92 J. TAX'N 212, n.16 (April 2000).

Items 52-60 are observations from a seminar by Gregory V. Gadarian, Shirley L. Kovar, and Neill G. McBryde, Cleaning Up the Mess: Determining and Implementing Testator/Grantor Intent

52. Remedies Beyond Invalidating Will or Trust; Proving Testator/Settlor Intent

Equitable remedies are available for effectuating a testator's intent beyond just invalidating a will. Planners may previously have assumed that a valid will is controlling unless it can be attacked on the grounds of undue influence or lack of capacity. Other remedies are available, but many attorneys have not been familiar with them. Equitable remedies may be available even under some of the normal pathways used to reach intended results (such as disclaimers, post-death reformation or modifications, corrections based on a scrivener's error, or decanting). Those remedies, however, may not be available in particular circumstances or maybe insufficient.

Proving testator intent under the various equitable remedies typically requires preponderance of the evidence (over 50%) or sometimes by clear and convincing evidence (70-75 percent). Evidence to establish intent includes testimony from various individuals including acquaintances beyond just family members as well as reviewing attorney files and emails. Full blown discovery will be needed in contested proceedings.

53. Constructive Trusts

a. **General Description Regarding Creation of Constructive Trusts**. If an individual transfers property to a person in reliance on that person's express or implied agreement to hold the property for another, no express trust is created, but the transferee holds the property under a constructive trust for the agreed purposes and persons. Restatement (Third) of Trusts §18. Constructive trusts are also sometimes referred to as secret trusts. The underlying premise is avoiding unjust enrichment. Persons who benefit from the will or trust as drafted are typically family members, making it hard to prove that the testator had a contrary intent.

   Whether the agreement to hold the property for a third person was made prior to or at the time of the execution of the trust is immaterial as long as it is made before the date of death of the testator/settlor. An agreement that induces the testator/settlor to refrain from revoking a will or trust is as effective as one that induces making a will or trust. The agreement can be express or implied. No specific words are required, and the agreement may be evidenced by express conduct. It may be affirmed by silence; mere acquiescence may be sufficient to establish the agreement. Restatement (Second) of Trusts §55(1), cmt. c-d (1959).

b. **Uniform Trust Code**. Some provisions of the Uniform Trust Code suggest that it does not apply to constructive trusts (see the comment to §102), but §102 expressly recognizes that the Code applies to "trusts created pursuant to a statute, judgment, or decree that requires the trust be administered in the manner of an express trust." In addition, §106 provides that the Code is supplemented by "[t]he common law of trusts and principles of equity."

c. **Statute of Wills**. The Statute of Wills (established by common law or by statute in some states) requires that any testamentary disposition of property be made in writing and signed by the testator in the presence of witnesses. The Statute of Wills does not

prevent the imposition of a constructive trust. The rationale is that the testator bequeathed his property to the "wrong" beneficiary who then holds the property in constructive trust for the "right" beneficiary. Therefore, the provisions of the Statute of Wills are followed because the disposition as stated in the will is respected, but the court's imposition of an equitable remedy transfers the property to the intended beneficiary.

d. **Clear and Convincing Evidence Standard; Dead Man's Statute**. A clear and convincing evidence standard applies for establishing secret trusts. (This is contrasted with other equitable remedies which generally just require a preponderance of the evidence.) The dead man's statute generally excludes testimony of oral communications with a decedent by a person testifying on behalf of his or her own interest. This can be important if the only testimony of the decedent's intent comes from conversations between the intended beneficiary and the decedent. However, the dead man's statute would not preclude counsel from testifying and would not prohibit other forms of communication such as emails.

54. Other Equitable Remedies

a. **Unjust Enrichment**. Even though the constructive trust (secret trust) doctrine is premised on unjust enrichment, there is a separate unjust enrichment remedy distinguished from secret trusts. Restatement (Third) Restitution and Unjust Enrichment §46. It applies if assets that would otherwise have passed by donative transfer to a claimant are diverted to another recipient by fraud, duress, undue influence, or other intentional misconduct. There is obviously some degree of overlap with the secret trust theory, and pleadings will typically include all of the various remedies.

b. **Specific Performance**. Specific performance is a broader remedy in some respects than other equitable remedies; a third party beneficiary may enforce a contract even though not a party to the contract. Corbin on Contracts §5.9; Restatement (Second) of Contracts §302. If the intended beneficiary can prove by a preponderance of the evidence that a contract existed that was intended to benefit the beneficiary, he or she can bring the action for specific performance.

c. **Quasi-Estoppel**. This cause of action is not widely established, but some states have cases clearly establishing this remedy (such as North Carolina). There is no necessity of showing detrimental reliance.

55. Disclaimers

Disclaimers may be helpful in some situations in carrying out the testator's intent. For example, beneficiaries may disclaim so the property passes to a surviving spouse, who will transfer property to an intended beneficiary. A primary concern with using disclaimers is whether the last step will happen; whether the surviving spouse (for example) will actually transfer the asset to the intended beneficiary.

56. ESTATE TAX CONSIDERATIONS OF EQUITABLE REMEDIES

In settling controversies in order to effectuate a settlor's intent, if qualifying for the marital deduction or charitable deduction is important for property to a passing to a spouse or charity, there must be a bona fide contest which seeks to enforce a claim under state law. There must be an adversarial proceeding, and the parties may not simply negotiate on their own. At least for the marital deduction, the *Bosch* decision applies, meaning that the decisions of lower courts are not binding on the IRS. The IRS often challenges the validity of property passing to a spouse or charity under the settlement of the controversy unless it is convinced that the controversy is adversarial and that the settlement is a bona fide resolution of the dispute.

57. ORAL TRUST

Section 407 of the Uniform Trust Code recognizes that a trust may be created orally only if established by clear and convincing evidence. Section 20 of the Restatement (Third) of Trusts provides that trusts created orally to hold personal property will be enforced. Oral trusts to hold personal property are recognized in most states. An oral trust remedy is an action that should be included in the pleadings along with other possible remedies. Some states (such as North Carolina) recognize oral trusts for real property.

58. SUMMARY OF EQUITABLE REMEDIES

These equitable remedies are not just "pie in the sky" theories of Restatements and Trust Codes. Equitable remedies are seeing increased support among the courts and state legislatures to achieve results that reflect a testator's or settlor's intent. Courts have begun to embrace constructive trusts whether they are secret trusts or whether they are grounded in other equitable remedies such as unjust enrichment, specific performance, or quasi-estoppel.

59. CONTRACT TO MAKE A WILL

a. **General Description**. A contract to make a will arises when a testator promises to devise specific property to a beneficiary in his will assuming the general requirements for a contract are met (offer, acceptance, and consideration). If the testator fails to devise the property to the contractually-designated devisee, the cause of action accrues. This action is based on the law of contracts and not the law of wills; the claimant must prove the existence of a valid contract.

   Contracts to make wills may become more commonly used in the future in connection with portability rather than using trusts. (Spouses may agree to leave property outright to the surviving spouse, with an agreement that the surviving spouse will execute a will leaving the property to intended beneficiaries following the surviving spouse's subsequent death.)

   Remedies for breach of contract are typically damages or specific performance, but specific performance is not really applicable to a dead person.

b. **Estate and Income Tax Cases**. Claims under a contract to make a will are typically filed as claims against the estate, so a §2053 estate tax debt deduction may be possible. Regulations under §2053 clarify that if the claim is essentially to receive a donative transfer and nothing was received by the decedent "in money or money's worth," no §2053 deduction is available. For example, in *Estate of Huntington v. Commissioner*, 100 T.C. 313 (1993), an individual claimed a breach of a contract between a couple to execute reciprocal wills. The court determined that the claims were based on an asserted right to inherit from the decedent's estate as distinguished from creditors' claims against an estate, and no §2053 deduction was allowed.

The underlying premise of the claim also governs the income tax consequences. If the claim is for an intended bequest, no deduction is allowed but the property would be received as a request free of income tax. If the premise is that the claim is owed in consideration of past services, a §2053 deduction is allowed to the estate, but the payment will be compensation income to the recipient.

60. Intentional Interference With Expectancy Of Inheritance (IIEI)

a. **General Description**. Intentional interference with the expectancy of inheritance (IIEI) has been recognized at the national level since 1979, when the Restatement (Second) of Torts described it as follows:

> One who by fraud, duress, or other tortious means intentionally prevents another from receiving from a third person an inheritance or gift that he would otherwise have received is subject to liability to the other for loss of the inheritance or gift. §774B.

In 2012, California became the 26th state to recognize IIEI as a cause of action in *Beckwith v. Dahl*, 205 Cal. App. 4th 1039.

b. **Significance**. (a) IIEI has become a mainstream cause of action that is generally recognized. (b) Drafting attorneys have become targets of the tort. (c) In some states, an IIEI action may be viewed as violating a no contest clause (but that is not the case currently in California).

c. **Concerns Creating Limitations on IIEI Cause of Action**. Courts have expressed several concerns with the IIEI cause of action, which in turn has led to limitations on the cause of action.

(1) Will it create a dual track for litigation, separate from probate court actions?

(2) The probate code is devoted to inheritance disputes and the probate court is the preferable if not exclusive forum to resolve these types of disputes.

As a result of these concerns, courts generally recognize an IIEI cause of action only if there is no adequate remedy in probate.

d. **Elements of IIEI Cause of Action**. *Beckwith v. Dahl* listed five elements of the IIEI cause of action: (i) expectancy of an inheritance; (ii) causation; (iii) intent – that the defendant knew of the plaintiff's expectancy and deliberately interfered with it; (iv) the interference must be "independently tortious" (meaning that the underlying conduct must be wrong for some reason other than the fact of the interference, such as undue influence, fraud, etc.); and (v) damages resulted from the interference of the defendant.

In addition, *Beckwith* observed that "most states [also] prohibit an interference action when the plaintiff already has an adequate probate remedy."

e. **Inadequate Remedy in Probate**. There is little discussion in cases about the "inadequate probate remedy" requirement. Several cases that have addressed this requirement are *Gianella v. Gianella*¸234 S.W.3d 526 (2007) and *Huffey v. Lea*, 491 N.W.2d 518 (Iowa 1992). For example, relief sought in a civil petition for IIEI would typically include a request for a jury trial, punitive damages, and damages for pain and suffering. Those remedies are not available in the probate code, and if that is enough to satisfy the inadequate probate requirement, it would almost always be satisfied. Perhaps the reference is to substantially the same relief or comparable relief.

   Munn v. Briggs, 185 Cal. App. 4th 578 (2010) held that the presence of a no contest clause was not sufficient to establish an inadequate remedy in probate. Otherwise, it reasoned that a no contest clause will be meaningless because any contestant could simply file an IIEI claim instead of a will contest.

f. **Equitable Remedies**. Equitable remedies may be available in an IIEI case. For example, some cases have imposed constructive trusts when claimants were able to establish IIEI claims.

Items 61-70 are observations of a seminar by Martyn Christopher Gowar, Robert C. Lawrence III, Jen-Marc Tirard, and Tina Wustermann, Civil Law Issues for Common Lawyers: Is "Civility" Possible and If So, How?

61. Consultation Required

In representing a client with international contacts (such as owning offshore assets), coordinating with counsel in the jurisdiction where there are other contacts (such as property ownership) is essential.

62. Fundamental Differences of Common Law v. Civil Law System Regarding Successon Matters

a. **Forced Heirship***.* Civil law countries typically recognize forced heirship rights whereas a fundamental principle of common law countries is the freedom of testamentary disposition. For example, in France estates are divided into two distinct elements: the "réserve" and the disposable portions. The reserve cannot be disposed of by gift or will other than to descendants and the surviving spouse. The children are generally entitled to a portion of the reserve (1/2 if there is one child, 2/3 if there are two children, and 3/4 if there are three or more children). The disposable portion can be left to anyone.

b. **Marital Property Regimes.** Civil law countries typically recognize community property. Many allow persons about to marry (or even allow spouses after married) to choose their matrimonial regime. For example, they could choose that all assets would be community property, or that all assets would be separate property, or could designate the regime for particular assets. While most states in the U.S. do not recognize community property, the non-community property states in the U.S. have has moved toward protecting spouses' rights by adopting elective shares systems.

c. **Domicile vs. Habitual Abode or Nationality**. Common law states traditionally use the concept of domicile (one's permanent home) to determine what jurisdiction's law of succession controls, whereas civil law countries typically use the concept of habitual residence (*i.e.*, where one is residing) or nationality. Interestingly, the term that is used in France is "domicile" (pronounced "dom i ceel"), but the meaning of that term in France is close to the concept of habitual residence. The 1989 Hague Convention on Succession (discussed below) generally rejects the concepts of domicile and situs but uses the concepts of habitual residence and nationality as the keys to govern conflict rules for succession issues.

d. **Trusts.** Many civil law states do not recognize trusts, although some recognize concepts that are similar to trusts (such as the fideicommissum, referred to in some countries is as a "fideicomiso"). Some civil law countries that do not recognize the trust concept nevertheless recognize trusts that were validly created under another country's laws if the trust complies with mandatory rules of the civil law country.

   Interestingly, France historically recognized trusts, but following the French Revolution, the Napoleonic Code (which was exported to many countries) abolished trusts; most of the land had been owned in trust-like entities. While France does not recognize the trust concept, the French courts for over a hundred years have recognized the effects in France of foreign trusts provided they comply with the mandatory rules of French law. For example, the foreign trust would be disregarded if it was established with the sole purpose of depriving some of the heirs of their revenue.

e. **Law of Unity vs. Movables/Immovables**. Many civil law countries apply a single or unitary law to all assets (whether real or personal property) of a decedent. Depending on the jurisdiction, this unitary law may either be the law of the decedent's nationality (citizenship) or of the decedent's last domicile (now trending toward habitual residence rather than domicile). In contrast, common law countries differentiate the law that is applied based on whether assets are characterized as real or personal property (*i.e.*, immovables vs. movables).

63. General Approach of U.S. Courts Regarding Succession Issues Impacting Multiple Countries

a. **Jurisdiction.** First, the court will determine that it has jurisdiction (which can be either in rem or in personam jurisdiction). This was an issue in the initial *Renard* case in New York.

b. **Choice of Law**. Next, the court will determine under conflict of laws rules which law will apply for a given issue (such as the construction, validity, or interpretation of a will or trust). This can have a dramatic impact on whether the civil law or common succession rules will apply. The analysis involves a two-step process: characterizing the property interest and choosing the appropriate law to be applied to the respective property interests.

   The property interest is characterized as real or personal property. As an example, under New York law an interest in an apartment coop is treated as personal property but a condominium is real property. How a particular property is characterized may vary among jurisdictions.

After characterizing the property the court determines what law applies to the various property interests. Procedural issues are typically governed by the law of the forum. As to substantive issues, the traditional rule has been to apply the law of the situs for real property and to apply the law of the domicile for personal property. The courts look to the law of the jurisdiction having the most significant relationship to the dispute or particular issue. (For real estate, this would typically mean applying the law of the situs of the real estate.) There may be an emerging trend of deviating from the doctrinal rules and balancing the relevant policies of the different jurisdictions and determining the choice of law matters to reflect the relative interests and policies of the interested jurisdictions as well as the presumed intent of the testator.

c. **Renvoi**. Once a court is directed under its own choice of law rules to apply the law of another jurisdiction, the court will apply the substantive local law of the other jurisdiction as to that issue, and if renvoi applies it will also apply the "whole" law of the other jurisdiction including both its substantive law and choice of law rules.

64. Renvoi

A country's choice of law rules may include applying renvoi–to consider not only the substantive law of another jurisdiction, but the whole law of that country, including its choice of law rules.

> Example: Country A is a unitary law jurisdiction based on a decedent's nationality and accepts renvoi. A court in Country A assumes jurisdiction of an English citizen's will. It will apply English law rules (because of the English nationality). Under renvoi, it would also apply England's choice of law rules, which applies the law of the last domicile to personal property and the law of the situs to real property. Therefore, the court in Country A will apply the last of the last domicile to personal property and law of the situs to real property.
>
> On the other hand, if Country A did not accept renvoi, the court would apply the local law of England to all of the decedent's property, regardless of whether it is real or personal property.
>
> As another example (using the facts of *In re Schneider's Estate*, 96 N.Y.S.2d 652 (Sur. Ct.)), a New York court determined the validity of a testamentary disposition of real property in Switzerland by a New York domiciliary. Under the New York choice of law rules, the law of the situs applied, so New York applied Swiss law (which had forced heirship). Under the Swiss unity-of-succession principle, the Swiss courts would apply the law of the testator's domicile to all of his property (real or personal). Therefore, the court applied New York law to uphold the disposition of the real property even though it did not comply with the forced heirship rules of Switzerland.

There are three approaches to renvoi. (1) Some countries do not apply renvoi at all. If a court applies the law of another jurisdiction, it applies only the substantive law of that jurisdiction, not its choice of law rules. (2) Most countries that accept renvoi use "single reference" renvoi. If another jurisdiction's law applies, the court applies the substantive law and choice of law of the other jurisdiction. (See the example above regarding the

Schneider's Estate facts.) (3) A few jurisdictions apply "double-reference" renvoi. In the example above from the *Schneider's Estate* facts, when Switzerland applies the New York law under its unity-of succession principles, it would apply New York's substantive law *and* New York's choice of law rules, which would mean that Switzerland law would apply to the real estate. (In effect, double reference renvoi can sometimes have the effect of canceling out single reference renvoi.)

65. U.S. Decedent Avoiding Forced Heirship on French Real Estate

Assume a U.S. couple (U.S. domicile and residence) with three children owns a French vacation home. Under U.S. choice of law principles, the French home devolves under the law of France (law of the situs) so forced heirship would apply to the home. But the contents of the home and the French bank account will devolve under U.S. succession law (no forced heirship). Typically the U.S. couple would want the surviving spouse to own the French home. If the home were in the U.S., that could be accomplished in their wills or by owning the home as joint tenancy with right of survivorship, but France does not recognize joint tenancy. The three children will receive a ¾ interest in the home by forced heirship. Several solutions are possible to avoid that result.

(1) The most common approach is the convert the French home into movable property, which can devolve under U.S. succession law. The home could have been purchased in the name of a French "société civile immobilière" (or SCI). (It is a hybrid between a corporation and a partnership but it is a look-through vehicle for income tax purposes). It is treated as moveable so the law of the decedent's domicile (the U.S.) would apply without forced heirship. Similarly, the U.S. couple should be able to use an U.S. LLC, but some French taxing authorities take the position that the LLC should be taxed as a corporation under French law.

(2) Another solution is to insert a "tontine clause" in the deed when the property was originally purchased. Under French law, a property purchased *en tontine* is a legal fiction in which neither party is recognized initially but on the death of one party the other is deemed to have owned the property since its original purchase. The tontine clause is subject to an unfavorable tax regime, however.

(3) A better solution is to combine an SCI with a tontine arrangement in the articles of association of the SCI purchasing the property. That achieves the same result as joint tenancy but without tax consequences on the death of the first to die.

66. U.S.-Switzerland Cross Border Estate Administration Issues

If a U.S. citizen dies in Switzerland, as to property in the United States, the individual can opt for the law of a U.S. state to apply. For example, the individual could elect for New York law to apply. (Do not just elect U.S. law to apply; questions could arise as to which state's succession laws apply.) The Swiss court will issue a Swiss certificate of executorship to the executor. New York law would apply regarding who receives the property, but Swiss law would control procedural issues. The Swiss executor would need an ancillary probate in the U.S. to obtain access to assets in the U.S.

If a U.S. decedent has Swiss assets, the executor would obtain letters of administration in the U.S. Those letters of administration are recognized by Swiss banks if they are duly certified and legalized and not limited territorially to the United States.

67. Hague 1960 Convention on Form of Testamentary Dispositions

The Hague Conference on Private International Law in 1961 adopted a Convention on the Conflicts of Law Relating to the Form of Testamentary Dispositions, which adopted rules for recognizing the validity of the execution of wills. A testamentary disposition is formally valid if it complies with the internal law of (i) the place or execution, (ii) the nationality of the testator at the time of execution or at the time of death, (iii) the place of habitual residence either at the time of execution or at death, and (iv) the situs if the assets are real property. Separate conflict rules apply with respect to capacity questions.

This Convention has been adopted in 41 countries, but not the United States.

68. Hague 1984 Convention on Trusts

The Hague Conference on Private International Law adopted a Convention on the Law Applicable to Trusts and on their Recognition (the "Convention on Trusts") in 1984. A main purpose is to assist civil law countries in interpreting trusts.

The primary choice of law provision is that the law chosen in the written trust instrument controls. If no applicable law is designated, the law of the jurisdiction with which the trust is most closely connected controls. (Article 6)

Article 13, 15, and 16 place conditions on this choice of law general rule. Article 15 says that the Convention will not prevent the application of provisions of law designated by the conflicts rules of the forum concerning certain mandatory laws, such as the rights of minors, marital rights, succession rights, transfer of title, creditors' rights, and protection of third parties acting in good faith. Article 13 does not require civil law jurisdictions to accept the trust to the extent that the most significant elements of the trust are closely connected with a country that does not recognize trusts.

The Convention on Trusts has been ratified by 11 countries, but not the United States (due largely to opposition from Louisiana).

69. Hague 1989 Convention on Succession

The Hague Conference on Private International Law adopted a Convention on the Law Applicable to Succession to the Estates of Deceased Persons (the "Convention on Succession") in 1989.

Article 3 provides conflicts rules absent a specific designation of applicable law by the testator. It abandons traditional concepts of immovable/movable property, domicile, and situs. Instead the concepts of habitual residence and nationality (citizenship) apply to both immovable and movable property. If the testator has the same habitual residence and nationality, that jurisdiction's laws apply (unless the testator has designated that a particular

law should govern as allowed in Articles 5 or 6). If they are not the same, the law of the habitual residence controls if the testator lived in that jurisdiction continuously for five years prior to death. If neither of the above applies, the law of the testator's nationality controls unless the decedent was more closely connected with another jurisdiction.

Article 5 discusses the testator's ability to designate the law that governs successions. The testator can generally choose the law of habitual residence or nationality at either the time of execution of the will or at death.

Article 6 allows the testator to incorporate the substantive law of any legal system to govern particular assets in the estate (*e.g.*¸ selecting New York law to govern assets located in New York), but may not designate a law that would contravene the succession principles of the law governing his whole estate. For example, the testator could not designate New York law in a manner that defeats forced heirship claims arising under French law. (Therefore, to avoid forced heirship, a civil law resident must first become a habitual resident of a common law jurisdiction, then designate the laws of that jurisdiction under Article 5, and either rely on the law so designated or designate another common law jurisdiction for particular assets under Article 6.)

70. EU Regulation on Successions

The European Succession Regulation No. 650/2012 of July 4, 2012 (also known as Brussels IV) creates a new set of private international law rules governing cross-border successions for persons who die on or after August 7, 2015. It creates a single law of succession that governs both movable and immovable property, adopting a unity-of-succession approach. The applicable law will be the country of habitual residence at the time of the decedent's death unless the deceased was "manifestly more closely connected" with another state or unless a Brussels IV state determines that applying the law of another state would be "manifestly incompatible with the public policy of the Brussels IV state. Very importantly, the testator can instead choose in his will to apply the law of his nationality (regardless of whether that state of nationality is a member state). The law applies universally, and will apply to assets of decedents dying on or after August 7, 2015 that are in one of the EU member states (except that UK, Denmark, and Ireland have opted out).

This approach may avoid forced heirship that would otherwise apply. For example, if a New York domiciliary and resident owns real estate in France, under the general principle of the EU regulation, New York law should apply to the succession of the worldwide assets (including the French real estate). But this includes the New York conflict of law rules, and under New York law, the succession of real estate is governed by the law of the situs, leading back to the application of the French forced heirship rules. However, the regulation allows the New York resident to elect in his will to have the New York succession law apply, which would exclude the forced heirship rules.

Planning Tip: Including such an election in wills is very important for persons owning real estate in a foreign country in any of the EU member states covered by the EU regulation or who may be moving to one of those member states.

Items 71-76 are observations from a seminar by Christopher J.C. Jones and Paul S. Lee, Running the Basis

71. Increased Emphasis on Basis Planning Issues

a. **Historical Approach*.*** Planning approaches prior to the passage of ATRA included the following: (1) use the applicable exclusion amount as quickly as possible during life, (ii) avoid estate tax inclusion at every generation, (iii) the basis step-up at death was less important because of low capital gain rates, (iv) income tax considerations were secondary in estate planning, and (v) the state of one's residence had no significant effect on the estate plan (there was an enormous amount of uniformity in state estate tax costs).

b. **New Math*.*** The differential between income tax costs of selling assets and the combined federal and state estate tax rates is small (and sometimes non-existent). For some assets that generate tax at ordinary income rates upon their sale, the differential is actually negative. There must be an increased emphasis on giving consideration to planning that can take advantage of the basis step-up while still minimizing transfer taxes.

c. **Indexing of the Estate Exemption*.*** Indexing of the estate exemption will mean that an increasing number of clients will have no estate tax concerns whatsoever, making planning for income tax basis adjustments even more important. The indexing of the applicable exclusion amount creates the significant likelihood that aside from very large estates, the estate tax exclusions may shelter most (even large) estates from the federal estate tax. Estimates are that the current $5.43 million exclusion will grow to about $7 million in 10 years, and to about $9 million in 20 years. At that point, a couple could have $18 million in their combined estate without federal estate tax—and generate very substantial income tax savings with a stepped-up basis on the $18 million of assets (but only if the client dies with the right kind of assets [highly appreciated assets] and if the applicable exclusion amount has not been used at the person's death).

c. **State Specific Planning**. The state of residence of the grantor and beneficiaries can dramatically alter the planning choices. The difference between income rates on sales vs. estate tax rates varies significantly among the states, depending on whether the state has a state estate tax and/or income tax. The difference ranges from 2.9% in California to 28.2% in Washington.

d. **Basis Significance and General Description.** Basis is a taxpayer's investment in property. It impacts a variety of tax issues including depreciation and the amount of gain realization upon the sale or exchange of an asset. An asset's initial basis or original basis is its cost (sometimes referred to as "cost basis"). Adjustments can be made to the initial basis for a variety of things including additions to basis for capital improvements and capitalized expenditures, and reductions to basis for depreciation and depletion.

   Basis is especially important for wealthy people—they may not have much ordinary income but will have a lot of capital gains. A taxpayer's basis in assets often dictates financial decisions to avoid delaying paying capital gains taxes.

   Obtaining a basis adjustment at death (as discussed below) can be advantageous if the asset is subsequently sold (and some assets generate taxes at higher than the typical 23.8% federal income tax rate on capital gains, including the §1411 tax). Indeed, for a

"negative basis" asset (for example an asset that has been depreciated or refinanced and that has debt far in excess of the asset's basis), obtaining a basis step-up can result in more income tax savings than the estate tax cost attributable to the asset. Savings (at ordinary rates) can also result for depreciable assets (generally over 39 ½ years) or depletable assets (example, minerals, with generally highly accelerated depletion deductions).

e. **Basis Adjustment-Property Acquired by Gift**. Basis transfers on the date the donor relinquishes dominion and control over property, not necessarily the day on which title passes. For appreciated property, the donee's basis is equal to the donor's basis increased by gift tax paid on the appreciation (but not to exceed the asset's fair market value) at the time of the gift. (The gift tax attributable to the appreciation can be added to basis regardless of whether the donor or donee pays the gift tax.) The rule is different for depreciated property, to prevent low-bracket donors from transferring their losses to high-bracket donees. For depreciated property (i.e., the fair market value is less than the adjusted basis of the property), the donee's basis is the donor's basis for purposes of determining the amount of gain on a later sale but is the lower fair market value of the property on the date of the gift for purposes of determining the amount of loss on a later sale. (The Code does not specifically address a sale that is made at a price between the FMV at the date of the gift and the adjusted basis, but there is neither gain nor loss recognized in that event.)

f. **Basis Adjustment-Property Acquired From a Decedent.** Section 1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate (§1014(b)(9)), and there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine subsections of §1014(b).

g. **Summary of Planning Approaches With the New Estate Planning Math**.

- Estate planning is infinitely more complicated than in the past, depending on a wide variety of variables such as how long the client lives, spending, the size of the estate, investment return expectations, income tax character of assets, the expected timing of the sale of assets, investment and non-investment income relative amounts, the state of the residence of the grantor and beneficiaries, expected inflation, etc.
- Use the applicable exclusion amount as little as possible, leaving as much assets in the gross estate as possible for a basis adjustment at the individual's death.
- Tax basis management will be a crucial part of estate planning and should be considered in tandem with potential transfer taxes in making planning decisions.
- Estate tax *inclusion* can save income taxes if a decedent has excess exclusion amount that would otherwise be unused.
- The state of residence of the grantor and beneficiaries becomes very important, giving rise to different types of planning. Planners must ask their clients where they will likely live when they die and where their children and grandchildren likely will live.

h. **Consider Tax Nature of Assets.** Some assets do not benefit from a basis step-up, including cash and income in respect of a decedent assets (*e.g.*, retirement plan assets). At the other end of the spectrum, the sale of some assets generates a tax at ordinary income rates (*e.g.*, creator-owned copyrights, trademarks, patents and artwork). Another type of high-tax asset is a "negative basis" commercial real property limited partnership interest (where the real estate has been fully depreciated and the developer has withdrawn cash from the partnership). The calculations also differ depending on the state where the individual lives. Measuring the transfer tax against the potential income tax savings will vary for these different types of assets.

   A categorizing of the types of income that benefit from a basis step-up, from highest to lowest is as follows: creator-owned intellectual property; negative capital account commercial real property/limited partnership interests; investor/collector-owned artwork, gold and collectables; low basis stock or other capital assets; Roth IRA assets (the recipients do not recognize income on receipt of distributions so effectively receive the benefit of a basis step-up); high basis stock; cash; capital assets with unrealized loss; variable annuities; and traditional IRA and qualified plan assets.

i. **Grantor Trust Flexibility**. Grantor trusts afford substantial flexibility; they can maximize wealth transfer by allowing the trust assets to compound income tax free (because the grantor pays the income tax on the trust income), but the grantor can repurchase low basis assets from the trust prior to the grantor's death. The grantor could purchase the assets by exercising a swap power or, if there is no swap power, by a negotiated sale. Preferably, the purchase would be made with cash or high basis assets, because the grantor trust may keep the same basis of assets transferred to it in the purchase transaction. In case the repurchase happens in a death-bed situation, a line of credit should be prearranged so that the loan and purchase could be accomplished quickly. (Having the appreciated assets in an LLC so that only a simple LLC assignment is needed to document the title transfer can facilitate the purchase.)

   Alternatively, the purchase could be made with a high interest rate note from the grantor to achieve more wealth transfer with a plan to pay off the note before the grantor's death because the trust may have a low (or zero) basis in that note. The grantor may need to borrow funds from a third party lender to be able to pay off the note to the grantor trust. This could be prearranged so that the borrowing and payment could be accomplished very quickly if the grantor determines that death is imminent. If the grantor's estate does not have sufficient cash to repay the third party lender (and does not want to sell the assets that the grantor purchased from the trust), the grantor trust could purchase the receivable from the bank so that the grantor's estate would owe the payment to the trust (which it might satisfy with the asset that received a basis adjustment at the grantor's death).

   In order to facilitate death bed transactions, make sure that the grantor's power of attorney or revocable trust authorizes the borrowing and purchase transactions.

72. DOUBLE "STEP-UP" IN BASIS

There are various circumstances in which the basis of a couple's assets may receive a basis adjustment at *both* spouses' deaths.

a. **Community Property.** Spouses in community property states get a basis step-up on all community property regardless of which spouse dies first. §1014(b)(6). The rationale of the basis step-up for both halves of community property goes back to 1948 when the marital deduction was instituted. The general thinking was that husbands would likely own all of the marital assets and husbands were likely to die first, so a full basis step-up would be available for all marital assets for most couples at the first spouse's death. If only the decedent's one-half of community property received a basis step-up, community property states would be disadvantaged compared to common law states. The rule for community property is now based on outdated assumptions, but it continues.

   Any separate property could be converted to community property (through a "transmutation agreement"). *See, e.g.*, TEX. FAM. CODE §4.202; TEX. CONST. Art. XVI, Sec. 4.202. But a question arises as to whether that is a transfer that might trigger §1014(e) if the "recipient" spouse dies within one year.

b. **Elective or Consensual Community Property Trusts (Alaska and Tennessee)**. For couples that do not live in community property states, the spouses might create community property by conveying assets to a "Community Property Trust" under Alaska or Tennessee law. See the discussion in Item 1.l of the ACTEC 2013 Fall Meeting Musings found here and available at www.bessemer.com/advisor. If real estate is involved, contribute the real estate to an LLC and transfer interests in the LLC to the Alaska or Tennessee Community Property Trust. The trustee in Alaska or Tennessee should preferably have possession of trust assets to minimize possible disputes with the IRS over the application of appropriate conflicts of laws principles. Some planners have reported audits of such trusts in which no questions were raised about the community property treatment of the assets.

   Owning assets as community property vs. separate property has real life consequences, including (1) ownership and disposition on death or divorce, (2) management rights, and (3) what property is liable for debts of a spouse.

c. **Section 1014(e) Statutory Provision**. Section 1014(e) provides that the basis of property received from a decedent will be equal to the decedent's basis immediately prior to death, rather than its estate tax value, if appreciated property had been given to the decedent within one year before the date of death and if the property passes back to the original donor (or his or her spouse). In applying §1014(e), though, the devil is in the details—it is a poorly worded statute with many ambiguities. In particular, what does it mean for property to be acquired by the donor—what if the property passes to a trust for the donor? For an excellent analysis of §1014(e) and planning ramifications, see Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning,* LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014).

   Here is §1014(e) in its entirety:

   > (e) Appreciated property acquired by decedent by gift within 1 year of death.
   >
   > (1) In general. In the case of a decedent dying after December 31, 1981, if--

(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

(2) Definitions. For purposes of paragraph (1)—

(A) Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

(B) Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.

If property is given to an individual in hopes of getting a basis increase at the individual's death, several initial planning steps are in order. (1) Make sure the individual does not have creditors who would take the property. (2) Having a medical directive for that person is better than having a living will, so there is more flexibility for keeping the individual alive past the one year date if the property will return to the original donor. (3) There is no risk of §1014(e) applying if the donor is happy with the asset passing to someone other than the original donor at the individual's death.

d. **Joint Spousal Trusts.** Some planners have proposed having the spouses contribute assets to a joint trust and providing that the first decedent-spouse will have a testamentary general power of appointment over the entire trust. Several private letter rulings, beginning with PLR 200101021, have ruled that this approach is workable to facilitate funding the credit shelter trust at the first spouse's death (in case the first decedent-spouse would not otherwise have insufficient assets to fund a credit shelter trust fully). *See also* PLRs 200604028, 200403094, 200210051.

   Another goal of the joint spousal trust is to achieve the result that applies to community property—to obtain a basis step-up on all assets in the trust, regardless which spouse contributed assets to the trust and regardless which spouse dies first. Section 1014(e) provides that no basis increase is available if a gift is made to someone who dies within a year and leaves the property back to the original donor. (Section 1014(e) is discussed in more detail below.) All of the rulings that have addressed the basis issue for joint spousal trusts so far have held that a basis increase is *not* available at the first spouse's death with respect to assets that were contributed to the trust by the other spouse. The IRS reasoned that assets are given from the surviving spouse to the decedent-spouse at the instant of the decedent-spouse's death and then returned to the surviving spouse—obviously within one year of the gift—therefore no basis adjustment is permitted under §1014(e). *See also* PLRs 200604028, 200413011, 200403094, 200210051 & TAM 9308002.

e. **Adjustments to Joint Spousal Trusts to Increase Arguments for Basis Adjustment**. Whether the assets pass to a QTIP trust or a credit shelter trust for the surviving spouse, arguably §1014(e) would not apply on the theory that the asset did not pass back to the donor for purposes of this income tax statute but into a trust for the benefit of the donor (even if the assets pass to a QTIP trust that is included in the surviving spouse's gross

estate for estate tax purposes). *See* Letter Ruling 9026036 (reversed as to other issues and reissued as PLR 9321050) (basis adjustment denied under §1014(e) only for life income interest in QTIP for original donor spouse).

Some planners have suggested making adjustments to the straightforward joint spousal trust to provide better arguments that the entire trust estate would receive a basis adjustment at the first spouse's death. *See* Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1,* 40 EST. PLAN. 3 (Oct. 2013); Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2,* 40 EST. PLAN. _ (Nov. 2013). The authors suggest that if any of the surviving spouse's assets that were contributed to the joint trust are used to fund a credit shelter trust, that would be a separate credit shelter trust of which the surviving spouse may not be a beneficiary (or only addable as a beneficiary by independent trust protectors), or which may be less likely to provide benefits to the surviving spouse based upon restrictive language or the need to receive consent from an adverse party. The authors note that, if challenged by the Service, this approach of restricting distributions to the surviving spouse should provide a higher probability of success for receiving a stepped-up income tax basis. For further discussion of the JEST approach, see Item 8.c of the Heckerling Musings 2015 and Current Developments summary found here and available at www.bessemer.com/advisor.

If the approach of using a trust protector to add the donor as a discretionary beneficiary at some later time is used, consider delaying the addition until after the statute of limitations has run on the determination of gain from a sale of the property in question. One approach may be to sell the asset soon after if it is acquired from the decedent (which should generate very little gain) and later repurchase similar (or even identical) assets (there are no wash sale rules for recognition of gain purposes). That would start the 3-year statute of limitations on assessment of additional income tax.

For a discussion of the legislative history to §1014, commentary opinion that a discretionary trust interest created by a decedent for an original donor should not be subject to §1014(e), and further planning strategies, see Item 8.c of the Heckerling Musings 2015 and Current Developments summary found here and available at www.bessemer.com/advisor.

f. **Section 2038 Marital Trust.** Another possible strategy to achieve a basis step-up for all marital assets at the death of the first spouse is a "Section 2038 Marital Trust." As an example, H creates an irrevocable trust for W as a discretionary beneficiary (H could be the trustee) providing that on W's death the assets pass to her estate. H retains the power to terminate the trust prior to W's death; if the trust is terminated, the assets would be distributed to W. The gift is complete when the trust is created (unlike the joint revocable trust) but the gift qualifies for the gift tax marital deduction (even though the trust is not a QTIP trust) because W is the only beneficiary so her interest is not a "nondeductible terminable interest," Reg. §25.2523(b)-1(a)(2). If W dies first, the assets are in her estate under §2031 and if H dies first the assets are in his estate under §2038. For a more complete discussion, see Item 8.e of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

73. TRANSACTIONS EFFICIENTLY USING DEBT TO MAXIMIZE BASIS

Some planners have suggested that the prime planning strategy should be to acquire lots of assets by debt. Professor Ed McCaffery summarizes this prime planning strategy in four words: "Buy, borrow, and die." The gross value of the assets would receive a basis adjustment.

Using debt also can facilitate transfer planning when the client does wants to retain low basis to take advantage of a basis step-up at death.

a. **Debt to Facilitate Transfer Planning**. Assume the client owns property worth $10 million that has been fully depreciated. The client wants to engage in transfer planning to reduce his taxable estate but does not want to transfer the low basis asset (to avoid giving up the basis step-up that would otherwise be available at the client's death). 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. The debt must be bona fide and for adequate and full consideration. §2053(c)(1)(A). 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. The full debt can be deducted even if the property is valued at less than fair market value under the special use valuation rules. Rev. Rul. 83-81.

b. **Debt to Finance Swap Transaction.** This same approach would apply if the grantor borrows from a bank to purchase appreciated assets from a grantor trust. For example, if a client with a $10 million estate repurchases $9 million of low basis assets from a grantor trust, using borrowed funds to make the cash payment, the client's gross estate would be $10 million + $9 million of assets received from grantor trust, or $19 million. The full $19 million would receive a basis step-up, but would have a taxable estate of just $10 million with a $9 million debt deduction). If the client were able to get some of the $9 million of proceeds out of the estate using transfer planning strategies, the net taxable estate would be even lower.

c. **QTIP Trust Debt.** What if a QTIP trust owns appreciated assets worth $5 million with outstanding debt of $3 million? Is $5 million of assets include in the gross estate under §2044 with a $2 million debt deduction? Section 2044(a) includes in the surviving spouse's gross estate "the value of any property to which this section applies [*i.e.*, for which a QTIP election was made] in which the decedent had a qualifying income interest for life." Section 2044(c) says: "For purposes of this chapter and chapter 13, property includible in the gross estate of the decedent under subsection (a) shall be treated as property passing from the decedent." Does this mean that $5 million is included in the estate (with a $3 million deduction) or just the net $2 million value?

If the decedent does not owe the $3 million debt, it may not be deductible under §2053. Section 2053(b) allows the deduction of administration expenses for administering property not subject to claims (which would include expenses of administering QTIP property, *see* TAM 9121002), but there is no similar explicit provision regarding debt claims. The estate may be in a better position to argue for full inclusion and a debt deduction if the decedent guarantees the loan or if there is joint and several liability of the trust and the decedent for the debt.

74. Forcing Estate Inclusion

If a beneficiary has substantial excess estate exemption, causing inclusion in the beneficiary's estate (up to the beneficiary's excess estate exemption) may afford a basis adjustment at the beneficiary's death without resulting in any federal estate taxes. For example, if a credit shelter trust is used at the first spouse's death and the surviving spouse has excess estate exemption amount, these strategies could be used to cause some or all of the credit shelter trust assets to be in the surviving spouse's gross estate to achieve a basis adjustment at his or her subsequent death. The same strategies could apply to any other beneficiary of a trust who has excess estate exemption. Strategies that may be considered for these purposes are briefly listed below. Each of these strategies, addressed in considerably more detail Item 7.c-g of the Hot Topics and Current Developments Summary (December 2014) found here and available under Insights at www.Bessemer.com/Advisor, include the following:

- Distributions to a beneficiary;
- Exercise of limited power of appointment to make an appointment to a discretionary appointee;
- Independent party with power to grant a general power of appointment to a beneficiary;
- Formula general power of appointment; and
- Delaware tax trap (which allows the beneficiary to have control over whether to force inclusion of trust assets in the beneficiary's gross estate by the way in which the beneficiary exercises a limited power of appointment).

75. Reverse Estate Planning—Using Parent's Exemptions

A client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise if the parent dies within a year of when the client creates the trust) and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. Melissa Willms (Houston) has referred to the planning as the creation of the "Accidentally Perfect Grantor Trust," with this example:

> Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $10,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment.) When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million. The trust assets, when added to Mary's other assets, are well below the estate tax exemption of $5 million. Mary's executor uses some of Mary's $5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property, (i) it can't be attached by her creditors, (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax, (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax, and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Mickey R. Davis and Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% 'Medicare' Tax: What Estate and Trust Professionals Need to Know*, UNIV. OF TEXAS SCHOOL OF LAW 61ST ANNUAL TAX CONFERENCE (December 2013).

a. **Gift Tax Issues**. The trust is a gift by the client, using the client's gift exemption. But the sale to the trust and the payment of income taxes by the grantor may leverage the appreciation of assets in the trust, making use of the client's gift exemption advantageous.

b. **Estate Tax Issues–Parent's Estate**. The trust assets contributed to the trust will be included in the parent's gross estate under §2041. The assets that are sold to the trust may also be included in the parent's gross estate, although issues can arise as to whether merely the *net* value of those assets (i.e., net of the debt that the trust owes to the client) is included in the estate. *See* Reg. §20.2053-7 ("if the decedent's estate is not so liable [for the amount of the mortgage or indebtedness], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need by returned as part of the value of the gross estate"). Having the parent guarantee the trust indebtedness would create a stronger argument for including the full value of the trust assets in the parent's gross estate (to receive a basis adjustment for the assets). The client anticipates that the parent will have plenty of estate exemption so that the parent will pay no estate tax. (If the client thinks that the trust assets may grow to the point that the value exceeds the parent's estate exemption, the trust could include a formula general power of appointment for the parent, to the extent that inclusion of the trust assets in the parent's estate would not cause the parent's gross estate to exceed the exemption amount. If that is done, the trust might also provide that only assets subject to the general power of appointment would remain in trust for the benefit of the client.)

c. **Estate Tax Issues–Client's Estate**. The parent will be treated as the transferor of the trust after his or her death, so the client can be the trustee, a discretionary beneficiary (as long as the client cannot make distributions to himself beyond amounts needed for health, education, support and maintenance), and can have a testamentary limited power of appointment over the trust—all without causing inclusion in the client's gross estate—as long as the client's state has passed legislation providing that the client is

not treated as the settlor of the trust for creditor purposes (*i.e.*, overriding the traditional "relation back" doctrine—see Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor for a detailed discussion of the "relation back" issue). A variety of rulings involving "joint spousal trusts" have made clear that the person who held the general power of appointment is treated as the transferor to the trust for estate tax purposes, not the original transferor. PLRs 200604028, 200403094, 200210051, 200101021. *See* John Bergner, *Waste Not Want Not–Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41st Annual Heckerling Inst. on Est. Pl. ch. 14 (2007).

d. **Income Tax—Grantor Trust.** The client will likely create the trust as a grantor trust as to the client. Following the parent's death, there is a strong argument that the trust continues as a grantor trust as to the client under Reg. §1.671-2(e)(5) if the parent does not exercise the general power of appointment. *See generally* M. Gans, J. Blattmachr, & D. Zeydel*, Supercharged Credit Shelter Trust℠,* 21 PROBATE & PROPERTY 52, 55 (July/August 2007). If the parent exercises the general power of appointment, the deemed grantor of the trust changes for purposes of the grantor trust rules, and the trust would no longer be a grantor trust as to the client. *See* Mickey Davis, *Basis Adjustment Planning*, 2014 STATE BAR OF TEX. ADV. EST. PL. & PROB. COURSE ch.10 at 21 (2014).

e. **Income Tax—Basis.** The assets should receive a basis adjustment at the parent's death because the assets are included in the parent's gross estate (but see the discussion above regarding estate tax consequences for the parent as to whether only the net value of trust assets are included in the estate). If the parent dies within a year of when the client makes the gift to the trust and if the assets pass back to the client, §1014(e) would prevent a basis adjustment. If the assets merely pass to or remain in a trust of which the client is a discretionary beneficiary (or may be added by someone as a discretionary beneficiary after some point in time), §1014(e) may not apply, in which event a basis adjustment would be allowed, as discussed in Item 72.c-e above.

f. **GST Tax Issues**. The parent could allocate his or her GST exemption to the trust at the parent's death. The parent will be treated as the transferor to the trust for GST tax purposes. §2652(a)(1)(A); Reg. §26.2652-1(a)(1).

g. **Practical Uses**. Having a "permanent" $5 million indexed estate tax exclusion amount makes this type of planning realistic; the client can feel very comfortable that the parent will not have estate tax concerns even with the general power of appointment over the trust assets.

   Similarly, a beneficiary of a trust who has a limited power of appointment might appoint the assets to a trust in which a third party (such as a modest-wealth parent) has a testamentary general power of appointment. The assets would receive a basis adjustment at the parent's death, hopefully no estate taxes would be payable by the parent, and the parent could allocate his or her GST exemption to the assets.

76. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

a. **Significance**. Using partnerships is the only way proactively to change the tax basis of non-depreciable assets without death or a taxable event. (A tax professor at Emory Law

School referred to partnerships as “tax basis centrifuges.” Paul Lee calls Subchapter K “Subchapter Kryptonite.”)

b. **Section 754 Election.** A passive approach for using partnerships to achieve a basis adjustment is to allow the older partner to die and make a §754 election to get an inside basis adjustment on the partnership assets attributable to the basis step-up in the deceased partner’s interest in the partnership. Merely relying on §754 in this manner, however, is not optimal for three reasons. (1) Because of valuation discounts, the deceased partner’s outside basis (equal to the discounted value of his partnership interest) is reduced. (2) The inside basis adjustments of the partnership assets are merely book entries for the benefit of the estate and its distributees, requiring a separate set of books. Adjustments would be required for all partners (requiring separate books for each of them) when partnership distributions or sales of partnership interests occur or when a partner dies. (3) The inside basis adjustment applies pro rata to all appreciated assets in the partnership, not just to a single asset that the partnership wants to sell or re-depreciate.

c. **Distributions of Low Basis Assets to Older Partner.** Consider making in-kind distributions of property to an older partner prior to his death. The partner generally receives in-kind distributions of property with a basis equal to the partnership’s basis in that asset, but not in excess of the partner’s outside basis in his partnership interest. If the partner has a low basis in his partnership interest, the partner will receive the asset with a low basis. The partner will die owning the low-basis asset and will obtain a basis step-up not limited by discounts.

d. **Basis Strip and Basis Shift.** Assume (in a greatly oversimplified example) that a partnership has two assets, one with a high basis and one with a low basis, and assume the assets have been in the partnership for over 7 years so that there are no mixing bowl or disguised sales rules that apply. The partnership wants to sell or re-depreciate the low basis asset, so would like to achieve a basis adjustment for that asset. The preferred approach is to make a liquidating distribution of the high basis asset to the older partner. The distribution results in the older partner receiving the asset with a zero basis (assuming his outside basis in his partnership interest was zero). (This is referred to as a “basis strip.”) He will die with the zero-basis asset and get a full basis step-up, not impacted by discounting of the partnership interest. As long as a §754 election is in place, the stripped basis that was lost (when the high-basis asset was distributed, converting it into a zero basis asset) is moved to the low-basis asset remaining in the partnership for the benefit of the younger partners. The estate could contribute its high-basis asset (after the basis step-up at death) back into the partnership.

   The net effect of this strategy is (a) an immediate full basis step up on the asset for which a basis adjustment is needed, (b) not limited by valuation discounts, (c) basis has effectively been moved from one high basis asset to another low basis asset, (d) this was accomplished without anyone dying, and (e) without gain recognition.

   Achieving this result in a real world situation beyond the oversimplified facts described above requires complex partnership tax structuring. The complex structuring includes using partnership divisions (to separate a particular high basis and low basis asset into a separate partnership, and to make the §754 election just for that separate partnership; if the partners keep the same percentages in the separated partnerships, both of them are considered continuation partnerships without any change in §704(c) responsibility.)

e. **Section 732(d) Election.** Even if a §754 election is not in place and is not made when an event occurs that would otherwise trigger an adjustment because of the election (*e.g.*, the death of a partner), the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within 2 years of the date of death and if the successor partner makes an election under §732(d).

Items 77-89 summarize observations from a seminar by Turney P. Berry and Jeffrey C. Thede, Giving the Business…to Charity

77. Planning Challenge in Giving Business Interests to Charity

The owner of a business could easily just prepare a stock or LLC member interest assignment conveying the interest to charity. The charity probably does not want to own or manage a business, so the charity would likely look to sell its interest in the business. A business interest could even be conveyed to a private foundation (though the excess business holdings rule would mean that the charity would eventually need to sell the business to someone). That works as long as the foundation sells the business to an unrelated person.

The difficulty is that no one wants to do that—typically the goal is for the business or family to purchase back the business interest that is conveyed to the charity.

78. Substantiation Letter Requirement

Since 1993, no income tax charitable deduction is allowed for any contribution of cash or other property valued at $350 or more unless the donor receives "contemporaneous written acknowledgment" from the charity before the earlier of the actual filing date or the due date (including extensions) for filing the return that claims the deduction, or else the deduction is disallowed in its entirety. §170(f)(8); *See Durden v. Commissioner*, T.C. Memo. 2012-140 (charitable deduction was denied for cash contribution to church because receipt letter did not have the required sentence that the taxpayer did not receive any goods or services and receipt of a proper letter after the taxpayers received the notice of deficiency was not sufficient). (This requirement applies even to trust-form private foundations of which the donor is the sole trustee.) There is no similar requirement for the gift or estate tax charitable deduction, but the donor must provide information that may be requested by the IRS. For charitable gifts by S corporations or partnerships, the receipt need only be given to the entity, even though the shareholders/partners may claim the flow-through deductions on their personal returns. Reg. §1.170A-13(f)(15).

79. Appraisal Requirements

The donor must obtain a "qualified appraisal" of property valued at more than $5,000 (with some exceptions, discussed below) and attach an "appraisal summary" (Form 8283) to the income tax return claiming a charitable deduction, or else the deduction is disallowed in its entirety. §170(f)(11)(C)-(D). (The $5,000 threshold applies on an annual basis for all gifts

of the same or "similar" items even if made to different organizations.) An appraisal is not required for gifts of cash or publicly traded securities and is not required for non-publicly traded stock if the deduction involved is less than $10,000. Reg. §1.170A-13(c)(2)(ii).

Most of the reported cases have required strict compliance with the appraisal rules, but a few cases have recognized substantial compliance with the rules.

80. Private Foundation Restrictions—Generally

Punitive taxes are imposed on foundations, foundation managers, and "disqualified persons" involved in:

- Self-dealing actions (§4941);
- Failure to make qualifying grants of a minimum amount each year, typically 5% (§4942);
- Excess business holdings (generally more than 20% (less the amount held by disqualified persons) of the voting stock in a corporation holding an active business (or profits interest of a partnership; the 20% limit is increased to 35% if effective control is not held by disqualified persons); the charity has five years to dispose of excess business holdings acquired by gift or bequest (§4943);
- "Jeopardy investments" (§4944); and
- "taxable expenditures," including grants for impermissible purposes (§4945).

Charitable Remainder Trust Application. The self-dealing restrictions apply to CRTs (§4947(a)(2)), but the excess business holdings and jeopardy investment restrictions apply only if the designated income beneficiaries include charitable organizations (§4947(b)(3)).

Charitable Lead Trust Application. The self-dealing restrictions apply to CLTs, but the excess business holdings and jeopardizing investments restrictions apply only if the present value of the charitable income interest exceeds 60% of the fair market value of the trust assets at creation (§4947(b)(3)).

81. Self-Dealing Prohibition and Exceptions

a. **Significance**. Potential self-dealing transactions are scary from a planner's standpoint. If there are uncertainties in the creation of an exempt organization, the application can be submitted and revised as needed in order for the IRS to grant a favorable ruling. If a transaction arises that might be self-dealing, the taxpayer can submit a ruling request through the normal process, but that is expensive. For smaller transactions, the planner may make its best call and file returns. If the planner is wrong, the taxpayer must pay penalties AND undo the transaction (and undoing the transaction may be *very* difficult). The government could even make a criminal fraud argument against the return preparer (one of the panelists was an expert witness in a criminal fraud case involving an allegation of a failure to report a self-dealing transaction). The lack of certainty can be most troubling.

b. **General Rule**. The self-dealing rule effectively prohibits almost any transaction between the foundation and a donor, members of the donor's family, or other "disqualified persons" (as described in §4946). This *generally* includes sales, leases, loans,

compensation payments (but a private foundation can pay reasonable compensation to a disqualified person, §4941(d)(2)(E)), or providing services. §4941. The restriction applies regardless of the sufficiency of consideration, and the IRS has no equitable authority to excuse harmless violations.

c. **Probate Exception**. Under the very important "probate exception," a transaction relating to a foundation's interest in property held by an estate (or revocable trust becoming irrevocable on the grantor's death) is permissible if:

(1) the personal representative or trustee either has a power of sale, a power to reallocate the property to another beneficiary, or is required to sell under an option that was binding when the estate received the property;

(2) the transaction is approved by the court;

(3) the transaction occurs before the estate is terminated;

(4) the estate receives an amount that equals or exceeds the fair market value of the foundation's interest in the property at the time of the transaction, considering the terms of any outstanding option that applied when the estate received the property; *and*

(5) the transaction either (i) results in the foundation receiving something at least as liquid as what it gave up, (ii) results in the foundation receiving an asset related to its exempt function, *or* (iii) is required under a binding option. Reg. §53.4941(d)-1(b)(3).

d. **Purchase With Promissory Note Under Probate Exception**. One of the substantial advantages of the probate exception over the "corporation adjustment" exception (discussed below), is that the corporate redemption exemption requires a cash purchase, and the estate exception does not require a cash purchase. Accordingly, if a will leaves stock of a family business to a foundation, and if the family wishes to purchase the stock, the purchase is often accomplished under the estate exception so that the family members can give a promissory note to the estate for the stock, and the note will then pass to the foundation. The note is typically at least as liquid as the stock itself (at least if the note is negotiable), and the primary issue is whether the note equals or exceeds the value of the stock that was purchased.

The IRS stopped issuing probate exception rulings in 2012 "in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust." Rev. Proc. 2012-4. The IRS has continued each year since with that same no-ruling policy. Recent rulings have affirmed, however, that notes can be used to purchase assets from an estate under the probate exception. *See* PLR 201407023 ("except in the case of the receipt and holding of a note pursuant to a transaction described in §53.4941(d)-1(b)(3)," quoting Reg. §53.4941(d)-2(c)).

Interest Rate. Can the AFR be used on the note? When the IRS was issuing rulings, it gave favorable rulings in several situations for promissory note with AFR interest rates. PLRs 201206019, 201129040, 200124029. In these rulings, however, the taxpayer represented that the note had a value equal to the purchased property and the IRS made specific reference to that representation in its conclusion. Reg. §53.4941(e)-1(f) says that fair market value is determined pursuant to Reg. §53.4942(a)-2(c)(4), which in turn references principles stated in §2031. There is no specific authority in §2031 for using the §7872 AFR rate for valuing loans for estate tax purposes. Some commentators are skeptical about being able to use the AFR interest rate on a note with

a face value equal to the value of the property being purchased under the probate exception. *E.g.,* Richard Franklin & Jennifer Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355, 361-362 n.15 (Winter 2013) ("The basic idea of the self-dealing rules is to prohibit a disqualified person from gaining an advantage at the foundation's expense. To construe the estate administration exception as allowing a disqualified person to garner a bargain rate of interest using the current low AFRs would seemingly violate the sprit [sic] of the self-dealing rules.").

Term of Note. Planners are comfortable using a 10 year note—but not a 99 year note. A 30-year note is a standard home mortgage length, but is beyond the comfort range of many planners for purchases under the probate exception.

e. **Corporate Adjustment Exception**. Stock redemptions (and other corporate transactions) between a foundation and a corporation that is a disqualified person (generally one that is owned more than 35% by disqualified persons, §4946 (a)(1)(E) & (a)(3)) are permissible if:

(1) the corporation offers to all the shareholders the opportunity to redeem "all the securities of the same class … subject to the same terms and conditions";

(2) the redemption offer constitutes a "bona fide offer" to redeem from all the shareholders; and

(3) the redemption price is "no less than fair market value." §4941(d)(2)(F); Reg. §53.4941(d)-3(d)(1). The IRS has issued various favorable rulings even in situations in which the parties anticipate that only the foundation's interest will be redeemed. *E.g.*, PLRs 200720021, 9338046, 9108030, 9015055.

Cannot Use Promissory Note. Generally speaking, loans from a foundation to a corporate disqualified person are impermissible self-dealing. PLR 9347035 approved a redemption under the corporate adjustment exception with an "installment payment arrangement," but that PLR was revoked in PLR 9731034 ("Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the … regulations").

f. **Similar Rules for DAFs and SOs**. Similar rules apply for donor advised funds and supporting organizations. The Pension Protection Act of 2006 added certain transactions involving DAFs or SOs as automatic "excess benefit transactions" under §4958, subject to excise taxes as high as 200%. In some ways, these rules are more restrictive than the private foundation self-dealing rules and the class of disqualified persons is broader. An excess benefit transaction includes any grant, loan, compensation, or similar payment from the fund to donors, fund advisors, or a very broad variety of other disqualified persons, as well as distributions resulting in more than an "incidental benefit" to a donor, fund advisor, or other disqualified person. §§4958(c)(2), 4966, 4967. In some respects, however, the rules for DAFs and SOs are narrower than for private foundations. For example, if a $30 million business is owned 1% by the family and 99% by a DAF, and if the DAF's 99% interest is redeemed for cash (using the proceeds from a bank loan) for $20 million (leaving the family owning all of the stock of a business with a net worth of $10 million), the excess benefit restrictions do not literally apply because there has been no distribution to a disqualified

person. ("The excess distribution rules apply to things like tables at an event. It is an insult to our intelligence--like we can't be more offensive than that?")

82. Excess Business Holdings Restriction

A private foundation can hold only very limited interests in an unrelated business enterprise. For a corporation holding an unrelated active business, the foundation and disqualified persons together generally may not own more than 20% of the voting stock, but this is increased to 35% if a third person has effective control §4943(c)(2)(A)-(B). If all disqualified persons together own no more than 20% of the voting stock, the foundation can own nonvoting stock (in any amount). §4943(c)(2). Similar rules exist for partnerships and LLCs, but a foundation may not hold any business enterprise operated in proprietorship form. A business that derives at least 95% of its gross income from "passive sources" is excepted from these rules. If a foundation has excess business holdings, there are varying rules as to how long the foundation has to dispose of the interest. For example, if it acquired the interest by gift or bequest, if has five years (§4943(c)(6)), and the IRS in its discretion can grant another five-year extension if the foundation can show that it made diligent efforts to dispose of "an unusually large gift or bequest or diverse holdings or holdings with a complex corporate structure" but was unable to dispose of the holdings within the initial five-year period except at substantially below fair market value. §4943(c)(7).

The excess business holdings rules do not generally apply to DAFs and SOs.

83. Charitable Gift to Single Member LLC Owned By Charity

Notice 2012-52 provides that for purposes of §170(b) (*i.e.*, for income tax purposes) a gift to a single member LLC owned by the charity is treated as a contribution to the charity. (The charity, rather than the LLC, satisfies the substantiation requirements.) To avoid confusion, the IRS encourages the charity to disclose in its acknowledgement of the contribution that the LLC is wholly owned by the charity and is treated by the charity as a disregarded entity. This can be very helpful, for example, if someone is contributing real estate (with inherent liability for accidents occurring on the property or with a potential environment liability). The charity could form a single member LLC to hold the property to segregate any liability associated with the property from the charity's assets.

Presumably, the IRS will apply the same rule for purposes of the gift and estate tax charitable deduction, but there is always the danger that the IRS would not follow the same approach in perceived abusive transactions.

84. Charitable Gifts of C Corporation Stock

a. **Practical Reality.** Attorneys get calls from charitable development officers who say they have been approached by a prospective donor who is selling its stock in a business and wants to involve the charity. Invariably, the transaction actually ends up involving an LLC taxed as a partnership, or an S corporation, or a C corporation that is selling its assets rather making a stock sale, or that is making a §338 election to be treated as a

sale of assets. (Of course, the other problem is that the deal sometimes has already been agreed to before the donor talks to the charity.)

b. **Charitable Bailout**. If there is no prearranged sale, a C corporation bailout is a common strategy. The donor donates some of the stock to charity (perhaps his children own the remaining stock), and in a non-prearranged transaction, the corporation redeems the charity's stock.

The first hurdle is getting over the prearranged redemption argument, which would treat the donor as having been redeemed and then contributing the proceeds to charity. *Palmer v. Commissioner* said the test is whether the foundation was legally obligated to redeem the stock when it received the shares. *See also* Rev. Rul. 78-197, PLRs 200321010, 200230004. The court in *Rauenhorst v. Commissioner* treated the IRS's position in Rev. Rul. 78-197 as a concession and strongly criticized the IRS for taking a position contrary to its then 25-year old published ruling.

If there is no prearrangement, the redemption can proceed for either a cash buyout or a note if the charity is not a private foundation. If the charity is a private foundation, and if the corporation is a disqualified person, the self-dealing rules apply, and the redemption can proceed only if the estate exception or corporate adjustment exception applies. A discussed above, a note cannot be used under the corporate adjustment exception. If the charitable contribution involves a bequest of the stock to a foundation, the probate exception may permit the redemption (if the redemption occurs while the estate still owns the stock), and a note can be used under the probate exception. PLRs 9312024, 9350038, 9112012, 0108024, 9042030. (These rulings approved redemptions for notes without discussing whether the subsequent note payments by the corporation would be self-dealing. Planners assume that the subsequent payments are permissible "and certainly that result is within the spirit of the rulings."

Assume that a business has redeemed a shareholder's interest in return for a note and that the shareholder dies owning the note but wants to leave it to charity. There is no problem if the charity is a public charity, but if the charity is a private foundation, and if the corporation is a disqualified person, the self-dealing rules come into play. Several rulings have allowed allocating a decedent's notes from a disqualified person to a foundation (PLRs 200729043 & 199924069), but the probate exception generally contemplates some transaction by an estate as opposed to a mere discretionary allocation. Some planners take little comfort in those rulings, especially in light of later rulings that authorize using an LLC in that circumstance (discussed in Item 85 below).

c. **Corporation Redemption Planning Opportunities**. Assume the client's children own 99% of the corporation (worth $10 million) and the client owns 1%. The client gives the 1% interest to charity. An income tax charitable deduction is allowed for the discounted value, (with say a 40% discount), or $60,000. The charity is not thrilled with owning the 1% interest, so it contacts the company about buying its interest. The company redeems the charity for the discounted value ($60,000). The children's wealth is increased by $40,000 as a result of buying the charity's interest at a discounted value. That seems totally plausible.

Push that. Assume the children own 51%, and the client owns 49% that is given to charity, which interest the appraiser values at $3 million (again, reflecting a 40% discount). The charity wants cash instead of stock in the closely held company. The corporation agrees to buy the charity's 49% interest for its appraised value of $3 million.

The corporation borrows money to buy the charity's interest at its discounted value. The children now own all of the company with a net value of $7 million (i.e., $10 million less the $3 million note). The children's wealth has increased by $2 million (going from one-half of a $10 million company to all of a $7 million company).

What if the children own the 1% voting stock and the client gives its 99% non-voting interest to charity, appraised with a 30% discount. If the company buys the charity's stock at a 30% discount, the entire discount amount inures to increase the children's wealth. (Still, the client must have charitable intent for that to make sense.) Has that pushed the envelope too far?

85. Using LLC For Conveying Existing Notes From Disqualified Person to Private Foundation Under Probate Exception

A series of private letter rulings have offered increasingly better alternatives of using LLCs for funding notes from a disqualified person to a foundation.

a. **PLR 200635017**. In PLR 200635017, notes from family members were contributed to an LLC. The notes were contributed to single member LLC and the owner wanted to fund a charitable trust at his death with nonvoting units in the LLC. (The voting units would be left to the decedent's descendants.) Family members were granted options to purchase the notes or the nonvoting units in the LLC from the owner or his estate. The ruling concluded that if family members exercised their option rights to purchase the notes or the LLC, that transaction would come within the probate exception and would not be self dealing. More importantly, if the option is not exercised and the foundation continues to hold the nonvoting units in the LLC that owns the note from a disqualified person, the ruling reasons that even though the LLC and the family members who owe the note are disqualified persons, the foundation's retention of the nonvoting units in the LLC and its receipt of passive income from the LLC would not constitute acts of self-dealing. The ruling pointed out that the foundation would have no right to force distributions from the LLC, and that the timing and amount of any distributions from the LLC would be uncertain.

b. **PLR 201407023**. PLR 201407023 opens the possibility of an owner selling a business to his children for a note, putting the note in an LLC, and leaving the LLC to the foundation. The note would be from a disqualified person (the deceased donor's children). The ruling quoted Reg. §53.4941(d)-2(c)'s statement that "except in the case of the receipt and holding of a note pursuant to a transaction described in §53.4941(d)-1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note." Therefore, leaving the note directly to a foundation would be an act of self-dealing. Even though the only asset of the LLC is the note from a disqualified person and the interest on the note will be the LLC's sole income, the ruling concludes that the distribution of nonvoting units in the LLC to a foundation at his death, and the continued retention of those nonvoting units, will not be an indirect act of self-dealing. The ruling does not rely on (or even mention) the probate exception but reasons that the foundation is merely receiving an interest in an LLC that holds a passive asset, not notes from a disqualified person, and emphasizes many distinctions between holding nonvoting units in the LLC and holding the note itself.

> Foundation's retention of a nonvoting interest in the LLC and its receipt of passive income from LLC, however, will not constitute any of the acts of self-dealing described in § 4941(d)(1) or § 53.4941(d)-2. The arrangement between the LLC and Foundation will neither be a loan nor an extension of credit. Section 53.4941(d)-2(c). Foundation would acquire nonvoting units in LLC by gift, rather than through a self-dealing transaction. As a holder of nonvoting units, Foundation will have a right to receive distributions only if LLC dissolves or it chooses to make current distributions, but the timing and amount of such distributions would be uncertain, and could not be compelled by Foundation. The Managing Members, holders of voting units, are given sole power to manage the affairs of LLC and determine the timing and amount of distributions. Additionally, Foundation cannot compel dissolution of LLC since it requires the vote of a holder of fifty percent of the voting units in addition to its own.
>
> Foundation will not have "control" over LLC (as defined in § 53.4941(d)-1(b)(5)) due to the lack of voting power to manage or operate LLC. We do not consider the power associated with the non voting interest in LLC as a necessary party to vote on the liquidation of the LLC to be the equivalent of a "veto power" within the meaning of section 53.4941(d)-1(b)(5) in that the other attributes of that interest lack any other powers with respect to operation and management. Furthermore, the liquidation of LLC in this context could result in a self-dealing problem for Foundation. Therefore, the retention by LLC of your daughter's note following your death would not be an act of direct or indirect self-dealing between Foundation and one or more disqualified persons under § 53.4941(d)-(1) or § 4941.

(A companion ruling was issued to the foundation. PLR 201407021.)

c. **PLR 201446024**. PLR 201446024 took this planning opportunity one step further—by having the estate create the LLC and contribute notes to the LLC before distributing nonvoting units in the LLC to a foundation. The decedent's estate owned a note from a disqualified person (from the lifetime sale of assets to an irrevocable trust created by the decedent). The notes had not been contributed to an LLC prior to the decedent's death. The estate proposed forming a single member LLC with voting and nonvoting units, contributing the notes to the LLC, and transferring nonvoting units in the LLC to a foundation. The ruling concluded that the exercise of the executor's power to contribute assets from the estate (specifically a note from a disqualified person) to a wholly owned LLC, the receipt of consideration by the estate of voting and non-voting units in the LLC, the subsequent sale of voting rights for cash equal to fair market value, and the distribution of non-voting units and cash from estate through a revocable trust to a foundation, will satisfy the probate exception to the self-dealing rules and will not constitute impermissible acts of self-dealing under §4941.

d. **Example Application of LLC Wrapper Strategy to Business Interests*.*** Assume that a taxpayer owns an office building and wants her son to manage the building, but wants to give the building to a private foundation. The foundation cannot lease the building to the children or negotiate a long-term management contract with the son. The taxpayer might complete the management contract, and contribute the building (subject to the management contract) to a wholly owned LLC. Donating the nonvoting units to a foundation during the taxpayer's lifetime may be treated as an indirect act of self dealing. If, however, the contribution of the building to the LLC and sale of voting units to the son and distribution of nonvoting units to the LLC were all approved by a probate court, could this transaction satisfy the probate exception? (A distinction from the rulings described above is that the LLC may be operating a business, which would raise excess business holdings issues, as compared to using an LLC merely to hold notes from a disqualified person.)

86. Charitable Gifts of Partnership or LLC Interests

a. **Donor Issues**. A charitable gift of a partnership interest may result in phantom ordinary income to the donor if the partnership has unrealized receivables or appreciated inventory or if there is any investment tax credit subject to recapture. §§47-50, 751(a). The gift could also accelerate any unrecognized installment gain in the partnership. Rev. Rul. 60-352.

   If the partnership has outstanding indebtedness, the donor may be treated as having received payment for his or her share of the partnership liabilities that are relieved, resulting in phantom capital gain income to the donor. §752.

   A gift of a partnership interest is treated as a gift of a capital asset, so a gift to a public charity would qualify for a deduction based on the full fair market value of the interest (but it may be subject to discounts).

   The same prearranged sale principles that apply to corporate redemptions might also apply to gifts and subsequent redemptions of partnership interests.

b. **Charitable Donee Issues**. A tax exempt organization pays tax on its unrelated business taxable income (UBTI). UBTI includes income from trade or business activities that are substantially unrelated to the organization's purposes. §512. Passive income does not generally constitute UBTI (§512(b)), unless the income results from debt-financing. If property that produces passive income is financed by acquisition indebtedness, the proportionate part of the gross income (including capital gain) is UBTI. §514(b). (The ratio for determining that proportionate part is the ratio of the average acquisition indebtedness to the average adjusted basis in the property during the year.) If the charity would pay a higher tax than the taxpayer on a sale of donated property, the donor may prefer to sell the property directly, and contribute the after-tax proceeds to charity in order to get more value to the charity.

   If the partnership is producing UBTI, the charity will want assurances that the partnership will make "tax distributions" to its partners so that the charity will receive cash flow to pay its income tax on partnership income.

   The charity will likely also want assurances that it will not be called upon to make future capital contributions to the partnership.

c. **Charitable Partnership Planning Opportunities**. A client owns $10 million of a concentrated stock portfolio. The client might contribute $10 million to a partnership for a 98% LP and 1% GP interest, and a trust for children contributes enough to own a 1% LP interest. The client gives the 98% LP interest to charity. The partnership sells the concentrated stock portfolio. The K-1 will reflect that 98% of the capital gain is allocated to the charity (on which it owes no income tax). Later, the family might buy the charity's 98% LP interest for FMV (say $10 million discounted by 30%, or $7 million). Now the family owns a $10 million company, for which it only had to pay $7 million. The client still must have charitable intent for this to make sense—the family is paying charity $7 million. But if, for example, the client wants to satisfy a big charitable pledge a transaction like this could accomplish the charitable gift goal and also accomplish a wealth shift to a trust for the client's children at the same time.

The charitable partnership was examined by the IRS National Office in 1999 and it passed muster, as long as everything is done on an arm's length basis.

87. CHARITABLE GIFTS OF S CORPORATION STOCK

a. **Exempt Organizations Can be S Corporation Shareholders**. Prior to 1998, a charitable organization was not a qualified S corporation shareholder. Charities are now qualified shareholders (§§1361(b)(1)(B) and (c)(6)), but CRTs and pooled income funds are still disqualified shareholders (they cannot qualify under the grantor trust, QSST or ESBT rules).

b. **All Income is UBTI**. There are not many charitable gifts of S corporation stock. A significant disadvantage is that the charity is taxed on *all* of the flow-through income of the S corporation as UBTI. §512(e). (This is contrasted to partnership interests owned by charities—only the flow-through income from partnerships that is attributable to UBTI activities is treated as UBTI to the chartable partner.) Further, capital gain realized on the sale of S corporation stock is also UBTI. §512(e)(1)(B)(ii).

c. **Using Supporting Organization to Reduce Charity's UBTI Tax Cost**. A strategy of reducing the UBTI tax cost to the charity is to have the S corporation stock held in a supporting organization (SO) for the organization. A corporate SO is entitled to a charitable deduction up to 10% of the UBTI, effectively reducing the tax cost by 10%. A trust SO is entitled to a charitable deduction for UBTI like individuals—thus generally qualifying for a 50% deduction if the SO supports a public charity, effectively cutting the tax cost by 50%. §512(b)(11).

d. **Excess Business Holdings**. Private foundations often may not hold S corporation stock because of the excess business holdings rule.

e. **Excellent Resource**. For an excellent resource addressing the effects of charitable gifts of S corporation stock, see Christopher R. Hoyt, *Charitable Gifts by S Corporations and Their Shareholders: Two Worlds of Law Collide*, 36 ACTEC L.J. 693 (Spring 2011).

88. CHARITABLE GIFTS BY BUSINESS ENTITIES

Charitable gifts by business entities can be a particularly effective strategy for gifts of highly appreciated, underproductive assets. The gift can be made directly to a charitable organization or to a CRT with a retained term-of-years interest for the business entity.

a. **C Corporations**. C corporations only receive a charitable deduction up to 10% of taxable income.

b. **C Corporation Maxed Out on Charitable Deductions**. If a C corporation would like to contribute more to charity than it can deduct under the 10% limitation, PLR 200715015 offers a planning strategy. A corporation formed a limited partnership (the other partner was the owner of the corporation), contributed some of its intellectual property to the partnership, entered into a license agreement to use the intellectual property in return for royalty payments to the partnership, and contributed the limited partnership units to a private foundation (created and managed by the owner). Because the partnership received 95% or more of its income from passive sources (*i.e.*, royalties), it was not an excess business holding and the royalty flow-through income was not UBTI

to the foundation (passive income is not UBTI unless it is generated by debt-financed property). The corporation would receive a 100% deduction for the royalty payments to the partnership and the royalty payments were not taxable income to the foundation—effectively having the benefit of a deduction for the additional value passing to the foundation.

c. **S Corporations**. Following the Subchapter S Revision Act of 1982, charitable contributions by S corporations are deductible proportionately by the shareholders (§1366(a)(1)), but a shareholder's deduction is limited to the shareholder's basis in the S corporation stock and any corporate indebtedness to the shareholder. §1366(d)(1). For an excellent discussion of the complexities of charitable gifts by S corporations, see Christopher R. Hoyt, *Charitable Gifts Made by S Corporations: Opportunities and Challenges,* 36 ACTEC L.J. 477 (Winter 2010).

   A shareholder's basis in its S corporation stock is generally reduced by any deductions passing through to the shareholder, but §1367(a)(2) stated that the shareholder's basis would be reduced only by the shareholder's pro rata share of the basis of the contributed property. This was a huge benefit to S corporation shareholders. The §1367(a)(2) favorable provision expired after 2013, but was extended to the end of 2014 by the "tax extenders" legislation enacted in the last several weeks of 2014. We will see if it gets extended again.

   If an S corporation that converted from a C corporation within the last 10 years wishes to sell appreciated property subject to the built-in gains tax of §1374, the built-in gains tax can be avoided by contributing the property to a charitable remainder unitrust. PLR 200644013 (no built-in gain recognition upon the contribution to the CRT or the trust's sale of the property within the 10-year recognition period).

d. **Section 337**. Corporations making large charitable contributions must be careful to avoid §337. Regulations to §337 provide that a taxable corporation is required to recognize gain or loss upon the transfer of "all or substantially all of its assets to one or more tax-exempt entities." Reg. §1.337(d)-4(a)(1).

e. **Partnerships and LLCs**. Similarly, gifts by partnerships or LLCs are deductible proportionately by the partners or members. §702(a)(4). The partner may deduct his or her share of the charitable contribution without regard to the partner's basis, but the partner must reduce its basis in the partnership to the extent of the partnership's basis in the property contributed. Rev. Rul. 96-11.

   Rev. Rul. 2004-5 provides that a trust that is a partner is entitled to a charitable deduction for the trust's distributive share of the charitable gift from the partnership's gross income—even if the trust has no charitable beneficiaries. The deduction is not disallowed under §642(c) "merely because the trust's governing instrument does not authorize the trustees to make charitable contributions." The key to receive a charitable deduction for a trust under §642(c) is that the contribution must be from income. Similarly, the contribution from the partnership must be from partnership income in order for the trust to use the charitable deduction.

   The Revenue Ruling does not address how the trust came to be a partner. Is there a limitation if the trust invests assets in an investment partnership as a way of being able to allow indirect transfers to charity with the trust receiving a charitable deduction—even though the trust instrument does not allow charitable distributions? There is no

such limitation suggested in the Revenue Ruling. (A possible strategy may be to have the trust make the investment in an investment partnership and make some small charitable gifts for several years and see if the IRS objects.)

89. Charitable Lead Trust Planning Strategies

a. **Backloaded CLT to Accumulate Funds for Private Foundation And Delay Requirement of Making 5% Annual Distributions**. Backloading of charitable lead trusts appears permissible. There is no explicit requirement that the charitable lead payments be uniform or only be graduated up to a certain maximum amount. The CLT could be structured so that relatively low charitable payments are made in early years. This would result in a delay of actual payments to a private foundation, thus delaying the time that the foundation must begin making 5% annual distributions. *See* Notice 2004-36 & Notice 2004-35. The CLT assts would likely be invested during this period with assets that do not generate substantial taxable income, because the trust would receive no current charitable deductions beyond the charitable payments that are actually made each year from the trust.

   For an excellent discussion of backloaded CLTs, see Paul S. Lee, Turney P. Berry & Martin Hall, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, 37 ACTEC L.J. 93 (Summer 2011).

b. **Transfer "Excess" Future Appreciation/Income to Family**. The economics of a charitable lead annuity trust (CLAT) work much the same as for a GRAT, except that the lead payments during the term of the trust are made to charity rather than to the grantor. If the assets produce combined appreciation/income in excess of the §7520 rate (2.0% for April 2015), the excess ultimately inures to the benefit of the family members who are the remaindermen at the end of the CLAT term.

   An alternate way of thinking about a CLAT is that a client may want to leave a specific amount (say $1 million) to the Red Cross at the client's death. The client is thinking that will be in 20 years. If the client dies early, does the client want the Red Cross still to receive the same $1 million (which has a much larger present value than the client was originally thinking). An alternative, in case the client dies early, is to use a testamentary lead trust. The Red Cross would still start receiving payments after the client's death (although a backloaded CLAT could be used), but the excess appreciation/income in excess of the §7520 rate would be building up for the family's ultimate use.

c. **Transferring Business Interest Using a CLAT**. A client might sell his business interest (perhaps to children). The note that the client receives for selling the business that is still owned at the client's death could be left to charity or could be left to a CLAT. This type of transaction was approved in PLR 200124029. The contribution of the note to the CLAT was approved within the probate exception to the self-dealing rule. A disadvantage of this approach is the loss of the basis step-up before the business interest is sold.

   Alternatively, the client might give his children an option to purchase the business from his estate following his death. The client's will might leave the business interest

(subject to the purchase option) to a testamentary CLAT. The children might exercise the option to purchase the interest from the estate in return for a long-term note. The sale by the estate would generate little taxable gains because of the basis step-up. The note would then pass to the CLAT.

As discussed above, a CLT is subject to the self-dealing rules for private foundations. The client's children would be disqualified persons, so their purchase of the stock that is bequeathed to the CLT would be a prohibited self-dealing transaction, *except* that the purchase from the estate will be approved by a court and will be structured to satisfy the probate exception to the self-dealing rules (discussed in Item 81.c-d above). The note payments may be structured so that the interest and principal payments would be sufficient to satisfy the charitable lead annuity payments from the CLAT. Taking into consideration valuation discounts when the children purchase the business interest from the estate, the interest payments on the note (and perhaps small principal payments as well) may be sufficient to fund the charitable annuity payments. The children would own the business; the CLAT would be structured to generate a 100% estate tax charitable deduction so that no estate tax is paid with respect to the value of the business interest; the children would be able to fund the annuity payments with distributions from the business; and the payments could fund a family foundation. (If the children are making charitable gifts in any event, the CLAT charitable payments may replace their charitable gifts during the term of the trust.)

Turney Berry cynically observes a problem with this plan—it is so favorable that family members will want the patriarch/matriarch to die now while the interest rates are low. "We encourage our older clients not to get flu shots."

For an outstanding resource discussing the planning opportunities and technical challenges of transferring business interests using testamentary CLATS, see Richard Franklin & Jennifer Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355 (Winter 2013).

Items 90-94 are observations from a seminar by Dennis Reardon and Ann Burns, Entering and Exiting Tax Planning Techniques in the Current Tax Law Environment

90. MUST CONSIDER BASIS IMPACT IN MAKING TRANSFER PLANNING DECISIONS

a. **The Problem**. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 40% estate tax savings on that appreciation to offset the loss of basis step up on the full value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue. Carlyn McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999).

In weighing the potential estate tax savings vs. the income tax cost as a result of the transfer, bear in mind that the family has flexibility as to when the income tax is incurred (*i.e.*, when the asset will be sold after the transferor's death), but the estate tax must be paid 9 months after the date of death.

b. **Examples**.

Example: A gift is made of a $1 million asset with a zero basis. The asset would have to appreciate from $1,000,000 to approximately $2,470,000 (**147% appreciation!!**) in order for the estate tax savings on the appreciation to offset the loss of basis step up (*i.e.*, $1,469,135 post-death appreciation x 0.40 = 2,469,135 total gain (assuming zero basis) x 0.238 [assuming the donee is in the top income tax bracket]).

Example: A sale is made of an asset worth $5 million with a basis of $2 million (and, therefore, a built-in gain of $3 million) to a grantor trust for a 9-year note bearing interest at 1.75%. Assuming an estate tax rate of 40% and a capital gains tax of 23.8%, the formula to determine when the amount of appreciation ("X" in the formula below) is sufficient for the estate tax savings to start to outweigh the income tax cost of losing the basis step up is:

$$0.40(X) = 0.238(3{,}000{,}000 + X)$$

Therefore, X = $4,407,407.

In order to achieve this appreciation in 5 years (with the assets growing to $9,407,407) and to make the interest payments, the investment must grow at about 7.3% per year.

In making these calculations for a particular client situation, consider both federal and state income and estate taxes.

c. **Avoiding or Delaying Income Tax Cost From Loss of Basis Step-Up**. The above formulas assume no turnover of the asset during the client's life. (If the asset is sold, the gain would be recognized in any event and the stepped-up basis advantage for holding the asset until death would disappear.)

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like-kind exchanges, basis step-up is not as important.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step-up is available under §1014 at the grantor's death for all assets in a grantor trust. *E.g.*, Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. TAX'N 148 (Sept. 2002). For further discussion of strategies to preserve basis step-up with respect to transferred assets at the taxpayer's death, see Item 7 of Estate Planning: Current Developments and Hot Topics (December 2014) found here and available under Insights at www.Bessemer.com/Advisor.

d. **Strategies For Effective Overall Outcome**. Strategies for achieving an overall advantageous result include the following:

- Transfer high basis assets, or transfer low basis assets that will be sold soon in any event, or transfer assets that will be held long after the decedent's death (but that is easier said than done; often the parents will want to transfer low-basis assets that

will be held in the family long-term (a closely-held business interest, family home, etc.) but that may be sold after the decedent's death;

- Review the client's income tax return with the CPA's input as to the income tax consequences of transfers;
- Coordinate the tax planning strategy with the investment strategy;
- Hedging techniques might be used (life insurance, private annuity, etc.) to offset the overall tax cost in case the transferor dies "early" before significant appreciation has occurred;
- A key mantra is building in flexibility to adjust to changing conditions, and having the grantor keep a swap power over grantor trusts affords great flexibility; and
- The planner should be comfortable with a variety of planning strategies and not force every family situation into one preferred strategy (such as GRATs for all clients).

e. **Annual Review**. Schedule an annual meeting to review how the planning is working. Should the note be refinanced? Compare the actual investment results with the projections of the revised "breakeven" date and the anticipated "end result." Should assets be exchanged into the grantor trust?

91. USE GRANTOR TRUSTS

Grantor trusts offer significant advantages, including their flexibility in addressing exit strategies. Advantages of using grantor trusts include:

(i) the grantor pays the income taxes on the trust income so the trust can grow 20-40% faster and the tax payments further reduce the grantor 's taxable estate (studies have shown that this is the most important factor in the long-term effectiveness of transfer planning strategies—even more important than discount or freeze planning aspects of transfer planning strategies);

(ii) the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and

(iii) the grantor has the flexibility to purchase back trust assets, in case the grantor prefers having assets that were transferred to the trust or if the grantor wants to reacquire low basis assets so they will receive a basis step-up at the grantor's death (the purchase should be made with cash or high basis assets because the income tax effects of purchasing low basis assets in return for a note are not certain).

Examples of the flexibilities of grantor trusts are that the grantor can keep the ability to end the grantor trust status when desired and distributions can be made to the grantor's spouse to pay the income taxes if desired (assuming the spouse is a discretionary beneficiary).

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a manner that is largely GST exempt.

In several pending Tax Court cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions (*Estate of Woelbing v. Commissioner*; *Estate of Beyer v.*

Commissioner). Planners should take careful steps to create the best defense around a §2036 argument.

92. GRAT; Practical Concern of Grantor's Quarterly Estimated Tax Payments

If a flow-through entity is transferred to the GRAT producing substantial flow-through income that will be taxed to the grantor, the grantor will need to make quarterly estimated income tax payments. If the GRAT makes annual annuity payments, will the grantor have the cash flow to make the quarterly estimated tax payments?

93. Life Insurance Trust Exit Considerations

a. **Maintaining Trust and Keep Coverage Are Two Separate Issues**. Whether the client should keep the irrevocable life insurance trust (ILIT) and whether the client should keep the insurance coverage in force are two separate issues. Even if the client no longer has estate tax concerns and does not need the trust for estate tax savings purposes, the family may still need the insurance coverage.

b. **Disadvantages of Terminating ILIT**. Maintaining the trust may be a very low-cost option. (The trust may not produce significant income so paying income taxes at the trust rates may not be a concern.) If the ILIT is terminated and the client later decides to use an ILIT to hold the policy, there will be a gift incurred by assigning the current value of the policy to the new ILIT and the three-year rule of §2035 would apply. Furthermore, the ILIT may be a receptacle trust designed to receive transfers from the insured's will or from other trusts.

c. **Distribution of Policies to Beneficiaries.** Review trust provisions that are applicable during the insured's life. If the trust permits, distribute the policy to the insured's spouse or children (or by stipulation of the spouse or children, to the insured). The children have $5 million gift exemptions, so the children may be able to transfer the policy back to the parent if that is desired.

d. **Transfers to Successor ILITs**. There may be beneficiary or tax reasons to revise the trust terms or to transfer the policy to a new ILIT with different administrative terms. This should be a trustee-to-trustee transfer that is not a gift. The three-year rule should not apply; this is a change based on changed circumstances and the grantor is not making a transfer. No consideration should be required if this is being done under the trustee's discretionary authority to make distributions. Ideally, ILITs should give the trustee broad authority to terminate the trust (beyond just a small trust termination provision allowing the trustee to terminate the trust if it falls below a certain value) or to decant the trust or to revise administrative provisions.

e. **Limited Power of Appointment**. If the spouse (or someone else) has a limited power of appointment that can be exercised currently, the appointment may provide an exit strategy.

f. **Trust Protector**. Similarly, a trust protector may have broad powers to terminate or change the trust.

g. **Distribution of Policy Among Beneficiaries; Paying Future Premium Payments**. If the policy is distributed to multiple beneficiaries when the ILIT is terminated, insurance companies may balk at transferring undivided ownership interests in the policy to multiple individuals. If the policy is owned by multiple individuals and the parent pays the premiums directly to the insurance company (rather than making cash gifts to the owners for them to make their pro rata portions of the premium payments), the resulting gift may not qualify for the gift tax annual exclusion if joint action by the donees is required to exercise rights of ownership of the policy. *See Skouras v. Commissioner*, 14 T.C. 523 (1950), *aff'd*, 188 F.2d 831 (2d Cir. 1951).

h. **Sale or Surrender of Policy**. The trust may sell or surrender the policy as an exit strategy if the coverage is no longer needed. Revenue Ruling 2009-13 describes the income tax treatment of surrenders or sales of life insurance policies. If the ILIT will surrender the policy, ascertain whether surrender charges will apply and whether the trust will recognize a gain (bearing in mind the IRS's position that the basis in the policy must be reduced by the annual pure insurance coverage cost).

i. **Is Coverage Needed?** In light of the increased estate exemptions, does the client still need the life insurance if its primary purpose was to pay estate taxes? Selling assets to generate liquidity when the client dies may be disadvantageous if values are depressed at that time. If there are market reversals of the client's assets (including retirement plans) might the coverage be needed in the future for the surviving spouse's support? If the insurance proceeds are not needed to pay estate taxes, this becomes an investment decision.

   Insurance term rates are often MUCH lower than 20 years ago, but this is not universally true. Companies have discounted term rates for healthy clients, as a marketing tool. But for clients who are not in the best health, term insurance costs are considerably more expensive.

94. FLP AND LLC EXIT STRATEGY ISSUES

a. **Reasons Exit May be Advantageous**. (1) The senior generation may want to avoid having a discount apply from owning limited partnership interests rather than owning partnership assets directly, which could impact the inside basis of the assets if a §754 election is in effect. (2) The parent may want to re-acquire interests that had been transferred to children so that a basis step-up is available at the parent's death. (3) The non-tax reasons for creating the FLP or LLC may no longer apply due to changed circumstances. (4) There are administrative costs of maintaining FLPs or LLCs (including added tax preparation costs).

b. **Consider Non-Tax Purposes**. Before terminating the FLP or LLC, re-consider the non-tax reasons for creating the entity. Those are real advantages that may be given up by terminating the partnership. These reasons could include providing appropriate governance, keeping liquid assets out of the hands of young people, commingling investments of families to get access to better investments, facilitating management, or providing a "parental pre-nup" (if the younger generation partners do not have pre-nuptial agreements, the FLP limits the authority to transfer ownership interests to the children's divorced spouses).

c. **Alternative Strategies to Avoid Discounts of Partnership Interests.** (1) Amend the governing documents to remove transfer restrictions or restrictions on the ability to force liquidation of the entity. (2) Include put rights for the limited partner or member interests at a pro rata portion of the full liquidation value of the assets. (3) The senior generation might re-acquire interests of all other partners, or at least the control interest (for example, if interests have been transferred to a grantor trust, the grantor might exercise a swap power to re-acquire interests from the trust). (4) Clients may have failed to administer the partnership properly, giving rise to arguments that the client should include assets of the partnership in the estate under §2036. ("We aren't hoping clients did not maintain proper formalities, but if they didn't we may be able to use this dysfunction.") (5) The partnership's assets could be distributed pro rata to the partners, or low basis assets might be distributed to the parent in redemption of its interest in the partnership. If the partnership was created within the prior seven years, distributing assets other than in a liquidating distribution may trigger gain.

Item 95-100 are observations from a seminar by Lorraine K. Cavataio, Todd A. Flubacher, and Lauren Wolven, Controlling from the Grave: Is Flexibility a Good Thing?

95. Desirability of Flexibility

Ron Aucutt at the 2014 Heckerling Institute on Estate Planning challenged the notion that "there is no such thing as an irrevocable trust." In his exploration of the issue, he ended up embracing change. In establishing the trust, the settlor expects the trust to work; for that to happen with changing circumstances, the flexibility to make changes may be necessary. With the rule against perpetuities extensions, trusts may last for hundreds of years.

"How can we be so arrogant as to think we can draft a trust that will last that long unless there is the flexibility to adapt to changing circumstances?" Another example is the growing need to deal with the "new biology technology" with respect to the determination of descendants.

96. Balance Required

Too little flexibility can cause the trust to be too restrictive, resulting in the inability to accomplish the desirable objectives in carrying out the settlor's intent and material purposes of the trust. Too little flexibility may require the parties to use more expensive and complicated techniques to modify the document, like decanting, merger, or court orders. But too much flexibility may permit the trustee or beneficiaries to trample over the settlor's intent or a material purpose of the trust. The drafting attorney is placed in the role of the client's "flexibility advisor."

97. Drafting Attorney's Inherent Bias About Flexibility

As in all aspects of estate planning, the attorney's bias often gets reflected in client decisions. Many of the provisions in trust documents carry an inherent choice between the

positions of enhancing flexibility and imposing restrictions. Whether intentional or not, drafting attorneys make choices in almost every trust provision they create about how flexible to design the trust structure. Basic trust provisions such as granting powers of appointment, the degree to which discretion is allowed for discretionary distribution decisions (beyond just health, education, support and maintenance), removal and appointment of trustees, choice of situs and governing law, or including directed trust provisions all reflect some degree of choice about what degree of flexibility is incorporated.

98. Tension of Representing Settlor vs. Crafting Workable Trust Provisions

The attorney's primary responsibility is to the client—who happens to be the settlor when the trust is being created. Some settlors may be "control freaks," having a very strongly felt attitude that he or she knows what's best for the beneficiaries and they should not be able to change anything. "I'm a control freak–including from the grave." The client may also have a basic distrust of the beneficiaries (which might be evidenced by severe and perhaps objective restrictions on distributions, unwillingness to allow beneficiaries to serve as trustees or have removal powers or to designate successor trustees, silent trust provisions, etc.) or of trustees. Even so, the attorney also has a duty in representing the settlor to structure the trust in a way that it is workable in order to actually carry out the settlor's intent. When a client starts out requiring extremely dogmatic inflexible provisions, the attorney should discuss the longer term implications of those directions in a variety of circumstances. Perhaps the client is not really as inflexible as the starting position would suggest.

When the attorney is in the role of working with the beneficiaries of that trust years later, no doubt issues will arise in which flexibility will be very important to the workability of the trust.

99. Trust Provisions That Can Provide or Restrict Flexibility

Various trust provisions can be used (or can be structured) in a way to provide additional flexibility in the administration of the trust or to make the trust more restrictive. Some of these provisions include the following.

- Division of trust responsibility, with bifurcated trustee powers or with direction advisors
- Distribution standards (ranging from a set dollar amount per month to a wide open "best interests" standard)
- Dealing with incapacity
- Pot trusts
- Precatory language
- Definition of issue, children and descendants
- Allowing use and enjoyment of trust assets
- Incentive provisions
- Silent trusts
- Powers of appointment
- Contingent powers of appointment

- Trustee powers
- Provisions protecting the trustee
- Selection of trust jurisdiction and authority to change trust situs and governing law
- Waiver of prudent person rule and rule against self-dealing
- Using different standards of liability for different trustees
- Discretionary accelerated divisions or distributions from trusts
- Optional special needs trust provisions
- Limitations on trustee qualifications or situs
- Permitting distributions among a broader "class" of beneficiaries
- Flexibility to alter grantor trust or non-grantor trust status of the trust.

100. Strategies for Trust Modification

Trust modifications may allow necessary adjustments to provide for flexibility in administering the trust. Of course, having to resort to some of these strategies may be more expensive and cumbersome than if the instrument had express provisions affording more flexibility.

The modification strategies include decanting, merger, administrative powers of amendment (if provided in the instrument), non-judicial settlement agreements and court ordered modifications. Some of these will involve virtual representation issues. For a summary of issues involving nonjudicial strategies for modifying trusts (including a discussion of virtual representation issues) see Items 66-75 of the ACTEC 2012 Summer Meeting Musings found here and available under Insights at www.bessemer.com/advisor.