

# Heckerling Musings 2011

February 2011  
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## Introduction

The 45<sup>th</sup> Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 10, 2011. I have summarized some of my observations for the week, as well as other observations from developments over the last several weeks. My goal is not to provide a general summary of the presentations; the summaries provided on the American Bar Association Real Property, Trust & Estate Law Section website ([http://www.abanet.org/rppt/meetings\\_cle/heckerling](http://www.abanet.org/rppt/meetings_cle/heckerling)) that is prepared by a number of reporters, coordinated by Joe Hodges, do an excellent job of that. In addition, there are excellent summaries provided by Martin Shenkman on the Leimberg Information Services reports. This is merely a summary of observations of selected items during the week. I sometimes identify speakers, but often not. However, I take no credit for any of the outstanding ideas discussed at the Institute — I am merely relaying the ideas of others that were discussed during the week.

Much of the discussion at the Institute focused on planning issues in light of the passage of the “Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010” (which I have generally shortened in this summary to the Tax Relief Act of 2010, or TRA 2010. Many speakers discussed the effect of TRA 2010 on their particular topic, some noting that the Act is a “sea change” for estate planning. Speakers throughout the week addressed new planning paradigms and creative planning strategies in light of the Act.

### 1. Brief Overview of TRA 2010

The “Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010” was enacted December 17, 2011. It is referred to as “TRA 2010.”

#### a. *Relief Other Than Transfer Tax Provisions.*

- (1) *Income Tax Rates.* Taxpayers at every income level would have the lower rates enacted in EGTRRA continued for two years. The top rate, on taxable income above \$379,150, will stay at 35% instead of increasing to 39.6%. (Two-year cost: \$186.8 billion)
- (2) *Itemized Deductions.* The personal exemption phase-out and itemized deduction limitation were both repealed for one year under EGTRRA. The repeal of both of these provisions is extended for an additional two years. This is important, for example, with respect to deductions available for large charitable contributions. Prior to the phase-out of the limitations on itemized deductions, the allowable total amount of itemized deductions was reduced by 3% of the amount by which the taxpayer’s adjusted gross income exceeded a threshold amount that was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80%. For high income taxpayers, reducing the otherwise allowable charitable deductions (as well as other itemized deductions) by as much as 80% is a substantial tax detriment. (Cost: \$20.7 billion)
- (3) *Capital Gains and Dividends Rates.* Lower capital gains and dividend rates are extended for two years. The lower rates are: taxpayers below 25% bracket - 0%, taxpayers above 25% bracket - 15%. If those rates expire, the rates would become 10% and 20%, respectively, and dividends would be taxed as ordinary income. (Cost: \$53.2 billion)
- (4) *Social Security Tax Cut of 2%.* All taxpayers, including self-employed individuals, have a one year reduction in the “social security payroll tax” of 2 percentage points in 2011. For individuals, the employee rate is reduced from 6.2% to 4.2% (the old age, survivors, and disability insurance tax on the taxable wage base

(\$106,800 in 2010)). The employer tax rate remains at 6.2%. For self-employed individuals, the rate is reduced from 12.4% to 10.4% for taxable years of individuals that begin in 2011. (Cost: \$112 billion)

- (5) *Alternative Minimum Tax.* The AMT exemption amounts are increased to \$47,450 (\$72,450 for joint returns) for 2010 and to \$48,450 (\$74,450 for joint returns) for 2011. (Over 20 million households are spared from tax increases averaging \$3,900 as a result of this change.) (Cost: \$136.7 billion)
  - (6) *IRA Charitable Rollover.* Among the tax extenders are the IRA Charitable Rollover provisions, which technically expired at the end of 2009. The IRA Charitable Rollover is extended for two years, through 2011, which allows individuals who are at least 70 ½ to transfer up to \$100,000 per year directly from an IRA to a qualified public charity (not a donor advised fund or supporting organization) without being treated as a taxable withdrawal from the IRA. The transfer can be counted toward the required minimum distribution. The measure applies to all charitable distributions throughout 2010, and distributions made any time during 2010 or in January of 2011 can be counted toward the \$100,000 limit for 2010. Individuals who have already taken their 2010 required minimum distributions cannot “undo” those distributions and instead make a charitable distribution to satisfy their 2010 required minimum distributions. (Cost: \$979 million)
  - (7) *Estate, Gift and GST Tax Cost.* Like the other provisions of TRA 2010, the estate, gift and GST provisions apply for only two years. (Cost: \$68.1 billion)
- b. *Two-Year Tax Relief.* TRA 2010 generally provides various transfer tax provisions that apply for just two years. This is accomplished first by extending the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) generally for two years. (TRA 2010 § 304 says that section 901 EGTRRA applies “to the amendments made by this title,” which refers to all of the transfer tax provisions in title III of TRA 2010. The Senate amendment as originally proposed referred to “amendments made by this section,” which was nonsensical. If that had not been changed, the transfer tax changes in TRA 2010 would have been permanent under a literal application of the substantive statutory language (although the heading for § 304 did correctly refer to “this title”). However, the word “section” was changed to “title” before the Senate and House vote. Interestingly, getting congressional approval for this important technical change was quite difficult.
- c. *Estate, Gift and GST Tax Exemptions and Rates.* TRA 2010 generally sets the estate, gift and GST exemption at \$5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The \$5 million exemptions generally apply beginning in 2010 [TRA § 302(f)], except that the gift exemption remains at \$1.0 million for 2010 [TRA § 302(b)(1)(B)].
- d. *Estate Tax in 2010 — Default Rule, Estate Tax Applies; Election For Carryover Basis To Apply Instead.* The estate tax applies to estates of decedents dying in 2010, with an estate tax exemption of \$5.0 million and a rate of 35%. TRA 2010 § 301(a). Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 may elect to have the modified basis rules of § 1022 apply. TRA 2010 § 301(c). The statute does not specify when or how this election is made. Section 301(c) says the election is to be made “at such time and in such manner” as prescribed by the Secretary of the Treasury or his

delegate (interestingly, not requiring regulations). The IRS may promulgate a new form to make this election.

An IRS technical advisor has indicated informally that the election for reduced basis in lieu of paying estate tax will not be made on the decedent's final income tax return, but IRS officials are considering the possibility of having the election made simply by filing Form 8939 instead of filing Form 706.

Making the election will not change that the decedent is still treated as a "transferor" for purpose of the GST tax system. TRA 2010 § 301(c)(last sentence).

e. *Extension of Time to File and Pay Estate Tax and GST Tax and to Make Disclaimers.*

- (1) *Estate Tax Extension.* The estate tax return and payment date of estate tax is extended to no earlier than nine months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 through December 16, 2010. After the nine-month extension, is it also possible to get another six-month extension under § 6018? We don't know, but that may be covered in guidance from the IRS about issues for 2010 estates.

The due date for the carryover basis report is not extended. TRA 2010 § 2301(d)(1)(A) (extension applies to any return under § 6018 "as such section is in effect after the date of this enactment of this Act *without regard to any election under subsection (c).*") The IRS issued a draft of Form 8939 for comments on December 16, 2010. The draft form does not include instructions. A senior IRS official has indicated informally that the IRS will issue guidance that the due date of the Form 8939 will be extended to no earlier than October 15, 2011. (As indicated above, the IRS is emphasizing that the Form 8939 should not be filed with the decedent's final income tax return but should be filed separately.)

An email message from Curtis L. Freeman (IRS Senior Technical Advisor, Tax Forms & Publications) to Carol Cantrell dated January 20, 2011 requests the ABA to "help spread the word that Form 8939 (nor anything else) is not filed with the decedent's final income tax return, but rather filed by itself." (This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed *with* the return of tax imposed by chapter 1 for the decedent's last taxable year" [(i.e., the decedent's final income tax return] (emphasis added).

- (2) *Disclaimer Extension.* The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent who dies between January 1 and December 16, 2010 is extended to nine months after the date of enactment. [TRA § 301(d)(1)(C).] Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers sometimes refer to nine months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. Section 2518(c)(3) may provide a way for getting around a continuing state law 9-month limitation on disclaimers.

Section 2518(c)(3) provides that a transfer that does not qualify as a disclaimer under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons

who would have received the property had it been a qualified disclaimer under local law.

The legislative history to § 2518(c)(3), passed in 1981, says that mere acts of receiving property to be able to make a transfer complying with the statute are not treated as acceptance that would preclude a disclaimer. “[T]he individual’s direction of the transferor to the individual who would have taken under local law pursuant to an effective disclaimer will not be construed as acceptance of the property.” H. Rept. 97-201, 1981-2 C.B. 352, 392. The Tax Court has made clear that §2518(c)(3) applies to a transfer made by the original beneficiary, not by the executor.

“The transferor (i.e., the beneficiary) referred to in section 2518(c)(3) is not the same transferor of section 2518(b)(i.e., the estate or executor). Section 2518(c)(3) assumes that a transfer to the beneficiary has already occurred under local law because a disqualified disclaimer did not avoid the transfer. That beneficiary can still avoid the effects of the disqualified disclaimer by making a written transfer to the person who would have received the property (e.g., a surviving spouse) had the beneficiary made an effective disclaimer.”

There must be a “written transfer” for § 2518(c)(3) to apply. Case law has held that a purported “disclaimer” that has no effect under state law does not satisfy the transfer requirement. *Bennett v. Commissioner*, 100 T.C. 42 (1993). In *Bennett*, purported disclaimers did not satisfy state law (among other things, they were not timely). The estate argued that the disclaimers satisfied §2518(c)(3), but the court disagreed because the beneficiaries did not make “actual written transfers of their interests in the Memorial Trust to the person who otherwise would have received those interests had the disclaimers been valid under local law.” The court stated that §2518(c)(3) “should not be viewed as a catch-all provision to save defective or disqualified disclaimers” but that it applies when a “would be disclaimant makes an actual written transfer to the person who otherwise would have received the property had the disclaimer been valid under local law.” The court quoted some of the legislative history:

“In order to provide uniform treatment among States, the committee believes that where an individual timely transfers the property to the person who would have received the property had the transfer made an effective disclaimer under local law will be treated as an effective disclaimer for Federal estate and gift tax purposes provided the transferor has not accepted the interest or any of its benefits.” H. Rept. 97-201, 1981-2 C.B. at 392.

Section 2518(c)(3) requires a written transfer of the person’s “entire” interest in the property disclaimed. There is no law as to what that means (and no regulations have been issued regarding § 2518(c)(3)). The legislative history is scant as to the meaning of this requirement:

“A transferor will not be considered a transfer of the entire interest in the property if, by reason of the transfer, some or all of the beneficial enjoyment in the property returns to the transferor or the transferor has any period after the transfer to control the beneficial enjoyment from the property.” H. Rept. 97-201, 1981-2 C.B. at 392.

It is not clear whether that means that the person's entire interest in a particular "severable" interest (such as the income interest) must be disclaimed or whether literally the entire interest in the property must be disclaimed. Alternatively, is it sufficient for a person to disclaim her entire interest in an undivided one-half interest in Blackacre, or must her entire interest in Blackacre be transferred?

If the disclaimant lives in one of the few states that has a state gift tax, an issue with making transfers that qualify as disclaimers under § 2518(c)(3) is that a state gift tax will apply to the transfer, if it is not a transfer that constitutes a disclaimer under state law.

**Practical Planning Pointer:** A deed or assignment should be used, reflecting the intent that it constitute a qualified disclaimer under § 2518(c)(3) and that the assets pass to the same persons who would receive the assets if there had been a valid disclaimer under state law.

- (3) *Reporting Generation-Skipping Transfers.* The due date for filing a report of any generation-skipping transfer made in 2010 is also extended to nine months after the date of enactment. TRA 2010 § 301(d)(2). This applies to all generation-skipping transfers made in 2010, not just those from decedents dying before the date of enactment. (There is no extension of time for filing a return to make timely allocations of GST exemption (or elect out of automatic allocations) for "indirect skip" transfers to trusts that are not direct skips.)
  - (4) *Extended Due Date — September 19, 2011.* The due date is extended to no earlier than nine months after the date of enactment (or September 17, 2011, which is a Saturday, so the extended due date would be no earlier than September 19, 2011).
- f. *Portability.* The executor of a deceased spouse's estate may transfer any unused estate exemption to the surviving spouse. TRA 2010 § 303. The portability concept is accomplished by amending I.R.C. § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" (\$5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." I.R.C. § 2010(c)(2), as amended by TRA § 302(a).
- (1) "DESUEA." The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under I.R.C. § 2001(b)(1)"). The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a strict "privity" requirement (discussed below).
  - (2) *Statute of Limitations on Review of Predeceased Spouse's Estate to Determine Unused Exclusion Amount.* Notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. I.R.C. § 2010(c)(5)(B), as amended by TRA 2010 § 303(a).

- (3) *Must be Timely Filed Estate Tax Return and Election for Predeceased Spouse's Estate.* The Act continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.)

It is possible that the IRS will develop a "Form 706-EZ" if the estate is filing only for the purpose of making the portability election.

- (4) *Only Last Deceased Spouse's Unused Exclusion Amount Applies.* Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i), as amended. An explanation of TRA 2010 by the Joint Committee on Taxation reiterates that this requirement applies even if the *last* deceased spouse has no unused exclusion and even if the *last* deceased spouse does not make a timely election. Joint Committee on Taxation Technical Explanation 52 n.57.

- (5) *Privity Requirement.* A spouse may not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to as the "privity" requirement. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1's unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" has no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. However, Example 3 of the Joint Committee on Taxation Technical Explanation appears inconsistent with this conclusion. While inconsistent with the statutory language, the Joint Committee on Taxation Technical Explanation appears to adopt a concept that the surviving spouse's estate would first use any deceased spousal unused exclusion at the death of a surviving spouse, leaving more of the surviving spouse's own exclusion that could be used by his or her surviving spouse in the event of remarriage.

- (6) *Applies for Gift Tax Purposes.* Portability applies for the gift exemption as well as the estate exemption. TRA 2010 § 303(b)(1) amends I.R.C. § 2505(a)(1), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year..." (Under § 2505(a)(2), the credit amount is further reduced by the amounts of credit allowable in preceding years.) The applicable credit amount under § 2010(c) includes the deceased spousal unused exclusion amount, so that amount is also included in the gift exemption amount.

- A surviving spouse may consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if a new spouse predeceases or if the basic exclusion amount is decreased.
- There is no way under the statutory language that a surviving spouse can make a gift to utilize her deceased spousal unused exclusion amount without using



her own basic exclusion amount. However, Example 3 of the Joint Committee on Taxation Technical Explanation apparently disagrees.

- The recapture/clawback issue discussed below can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exclusion" for making gifts. If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much deceased spousal unused exclusion for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. This may result in additional estate taxes being due at the donor's death. The clawback issue in this context may be resolved differently than in the context of making gifts under a larger gift exemption than the estate exemption that exists at the donor's death.
- (7) *Does Not Apply for GST Tax Purposes.* Portability does not apply to the GST exemption.
  - (8) *Effective Date — Decedents Dying After 2010.* The provision applies to the estates of decedents dying and gifts made after 2010. TRA § 303(c)(1).
  - (9) *Only Available Two Years.* Like the rest of the estate and gift tax provisions in TRA 2010, the portability provision expires after 2012. The apparent anticipation is that Congress will extend this benefit following 2012, but there are no guarantees. In light of this, few planners may be willing to rely on portability and forego using bypass trust planning in the first deceased spouse's will.
  - (10) *Reasons for Using Trusts Even With Portability.* There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) there is no assurance that portability will apply after 2012, (b) the deceased spousal unused exclusion amount is not indexed, (c) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (d) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (e) there is no portability of the GST exemption, and (f) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.
  - (11) *Not Available For Non-Resident Aliens.* If a non-resident alien ("NRA") spouse dies first survived by a citizen spouse, there is no DESUEA because the NRA is merely entitled to a unified credit of \$13,000 under § 2102 and does not have a "basic exclusion amount" that could be partly unused. If the citizen spouse dies first, the surviving NRA is not entitled to an exclusion under § 2101(c)(2) that includes the DESUEA, but is merely entitled to a unified credit of \$13,000 under § 2102.
  - (12) *Priority for Treasury Guidance.* Portability is not on the Treasury priority guidance plan. However, there are informal indications that the Treasury will issue guidance on portability and that it will be a priority, right behind providing guidance for 2010 decedents' estates.

- g. *Gift Exemption and Change in Method for Calculating Gift Tax.* The gift exemption remains at \$1,000,000 in 2010. TRA § 302(b)(1)(B). Beginning in 2011, the gift exemption amount is the same as the estate tax exclusion amount, or \$5.0 million. The gift exemption (as well as the estate and GST exemptions) is indexed from 2010 beginning in 2012. Following amendments in TRA 2010 §§ 301(b) & 302(b)(1), § 2505(a)(1) provides that the unified gift tax credit is:

“(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year ...”

(The last phrase, beginning with “which would apply if the donor died as of the end of the calendar year” is the clause that provides portability of the gift exclusion.)

For gift tax purposes, the gift tax calculation includes subtracting a unified credit, and the amount of unified credit available for a particular year is determined after subtracting the amount of credit already used from prior gifts. In calculating the amount of credit used on prior gifts, use the gift tax rate for the year of the current gift to determine the tentative tax on the applicable exclusion amount that was applicable for offsetting the gift tax on prior gifts. [TRA § 302(d)(2), amending I.R.C. § 2505(a).]

The effect of this change is to “correct” an anomaly that existed under prior law. If an individual had made gifts before 2010 over \$500,000, the gifts used more credit (calculated at 37% and 39% rates) than gifts would use at a 35% rate. The result was that donors who had made prior taxable gifts over \$500,000 could not make additional gifts in 2010 (at a 35% rate) equal to the difference between \$1 million and the prior gifts. (For example, a donor who had made taxable gifts before 2010 of \$961,538.46 would not be able to make additional gifts in 2010 [calculating the credit at a 35% rate] without paying gift tax.)

The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax. If a donor has made gifts in prior years in excess of the gift exemption amount for those respective years, the donor can make additional gifts in 2011 equal to the difference between \$5 million and the gift exemption used in prior years without paying current gift tax.

- h. *Change in Estate Tax Calculation Method Regarding Effects of Prior Gifts.* Generally speaking, the estate tax calculation method of § 2001(b) is designed (1) to tax the estate at the highest estate tax rate brackets, taking into consideration prior gifts (by determining the tax on the combined taxable estate plus adjusted taxable gifts and subtracting the taxes on just the adjusted taxable gifts), and (2) to reflect that the individual has already utilized unified credit that would otherwise be available at death for any taxable gifts made previously (this is done by reducing the amount of tax that is subtracted attributable to just the adjusted taxable gifts by the amount of unified credits attributable to those adjusted taxable gifts.)

The estate tax calculation method is changed to reflect the effects of changing gift tax rates. The calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. § 2001(b)(1).

- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The Form 706 instructions for the "Line 7 Worksheet" clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)
- Step 3: Subtract the applicable credit amount.

TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The gift unified credit equals –

- (1) the estate tax applicable credit amount for the year of the gift (§ 2505(a)(1)), less
- (2) the aggregate gift unified credits for preceding years (§ 2505(a)(2)), and as discussed above regarding the calculation of the gift tax, TRA 2010 amends § 2505(a) to provide that in calculating the aggregate gift unified credits used in prior years under § 2505(a)(2), rates in effect for the year of each current gift are used in lieu of the actual rates of tax in effect during the preceding years.

- Controversial Calculation Issue: "Recapture" vs. "Clawback" If Estate Exemption Is Reduced in the Future ("Line 7 Issue").* If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the \$5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet) which would be the credit amount for an applicable exclusion amount of \$5 million. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction in arriving at the gift tax payable" for purposes of the estate tax calculation.) The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the approach in the Form 706 instructions and in Letter Ruling 9250004 would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate. That means that the gift unified credit amount would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously.

That situation, of the estate tax unified credit amount being lower than the gift unified credit amount for prior years, has never happened. It is not clear whether the Form 706 instructions would apply literally in that circumstance or not. On the other hand, if the amount of the chapter 12 tax on just the adjusted taxable gifts, to be subtracted from the tentative tax in Step 2 and reported on Line 7 of the Form 706, is calculated assuming the *gift* unified credit amount were determined on just the lower estate tax applicable

exclusion amount, there would be chapter 12 tax that would be subtracted in Step 2, thus giving the estate the benefit of having removed the “excess” exclusion amount from the estate without gift or estate tax.

Here is a different way of stating the issue: One of the purposes of the estate tax calculation procedure is to reflect that using gift exemption also uses the estate exemption. Does that mean that it uses the estate exemption only to the extent of the estate exemption at death, or does it require a “recapture” to the extent that the gift exemption utilized exceeds the estate exemption?

There are indications from Congressional staffers that the “clawback” effect if the exclusion amount is reduced in future years was not intended.

A number of respected planners believe that there will be no clawback. In any event, the result is uncertain. One attorney has summarized it well: “One person’s glitch is another’s tax logic.”

- j. *Tax Apportionment.* Tax apportionment of the “clawback” estate tax, if it applies, would be important. However, unless a state apportionment statute specifically allows apportioning estate taxes to donees of lifetime gifts, there would seem to be no ability to do so in the will. Of course, if the donees of lifetime gifts are also recipients under the will, estate taxes attributable to the lifetime gifts could be apportioned to the donees and treated as an advance against their share of the estate passing under the will.

One possible approach may be to have a type of net gift agreement with the donees of the gifts, so that they would agree to pay the estate tax attributable to the adjusted taxable gift inclusion in the event the exclusion amount is reduced in later years. Whether there would be any offset in determining the amount of net gift attributable to such agreement is not clear, because of the speculative nature of whether and by how much the estate exclusion might be reduced in future years. *See McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev’g*, 120 T.C. 358 (2003). In *McCord*, the donees assumed all gift, GST and estate tax liability attributable to the transfer, specifically including potential estate tax liability under the gift tax gross-up rule of § 2035(b) if the donor were to die within three years. The Tax Court viewed that potential liability as too speculative to consider as an offset to the gift value. The Fifth Circuit reversed, viewing it as even less speculative than the “built-in gains tax” discount that has been allowed in recent years. However, if a reduction in the exclusion amount did occur such that the donees had to reimburse the estate for the additional estate tax, that reimbursement right would likely be an estate asset subject to inclusion in the gross estate.

Another concern with such a net gift-type agreement is that the value of the contractual obligation to pay the additional estate tax may be consideration received that could result in gain recognition under *Dietrich* (unless the donee is a grantor trust). Such gain recognition may result even if the value of the contractual obligation to pay the additional estate tax is not certain enough to be recognized as an offset in determining the value of the gift for gift tax purposes. Letter Ruling 200210018.

What if the taxable gifts are so large that the remaining assets in the gross estate are not sufficient to pay all of the added estate tax? The entire probate estate would be applied to estate taxes (or other expenses that have priority over estate taxes), but there does not appear to be any way for the IRS to collect the remaining tax deficiency from the gift recipients if the gifts were made at least three years before death. I.R.C. §

2035(c)(1)(C)(for purposes of chapter 64 subchapter C relating to the liens for taxes, property transferred within three years of death is treated as being included in the gross estate). (If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes, as addressed above, that obligation presumably would be an estate asset that the IRS could pursue for payment.)

k. *Overview of Considerations of Using and Estate Tax Effects of Using \$5 Million Gift Exclusion.*

(1) *How Much Can the Donor Afford to or Want to Give?* While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? See Item 4.b below for further discussion of this initial critical issue.

(2) *“Rainy Day Fund” Considerations.* The donor may wish to make gifts in a way that the donor (or the donor’s spouse) could retain some use of the assets in case needed as a “rainy day” fund. One possible approach would be to make gifts to a lifetime credit shelter trust for the donor’s spouse (or even trusts created by each of the spouses for each other with enough differences so they are not treated as “reciprocal” trusts for tax purposes). Alternatively, self-settled trusts may be considered in jurisdictions that allow discretionary distributions to the settlor without subjecting the trust to claims of the settlor’s creditors (and therefore estate inclusion). These issues are explored further in Item 4.d-g below.

(3) *Can Make Gifts of Full Additional Gift Exemption Amount.* The amendments to § 2505 mean that a donor can make gifts equal to the difference between the current applicable exclusion amount for gift tax purposes and the amount of prior taxable gifts without having to pay gift tax, even if the donor has previously made gifts exceeding the then available gift exemption amount.

(4) *Gift Does Not Remove Gift Assets From Base For Calculating Estate Tax But Does Not Result in Increasing Aggregate Taxes.* Gifts in effect are just an “advance” on distributions from the estate (without gift tax as long as the gifts do not exceed the exclusion amount), but the gifts are included in the transfer tax base. The amount of the additional estate tax attributable to the taxable gifts is the amount of the taxable gifts times the estate tax rate. Because of this effect, it is still preferable, to the extent possible, to shift value that would otherwise be in the taxable estate without making taxable gifts (e.g., using strategies such as GRATs, sales to grantor trusts, fractionalization discounts, paying income taxes on grantor trusts, etc.).

Making gifts never increases the total aggregate transfer taxes as opposed to just retaining the assets and paying estate tax on the full amount (unless the gift assets were to depreciate, in which event it would have been better not to have made the gift).

(5) *Utilization of GST Exemption.* Making current gifts and allocating GST exemption to the gifts means that future increases in value of the trust will also be GST exempt without having to allocate additional GST exemption. Even if there is a “clawback” for estate tax purposes if the estate tax exemption is later reduced

below \$5 million, there would be no clawback of the use of the \$5 million GST exemption.

- (6) *Use Exemptions Now in Case They Are Later Reduced.* TRA 2010 affords what may eventually be a window of opportunity to make gifts of \$5 million without paying current gift tax and to allocate \$5 million of GST exemption. Those exemption amounts could be reduced in the future.
- (7) *Gift Advantages and Disadvantages.* Even though the overall transfer tax is generally the same whether or not gifts are made, other factors can make gifts advantageous, including removal of appreciation/income for gift assets from gross estate (generally resulting in an eventual tax savings equal to the appreciation/income removed times the estate tax rate), utilizing fractionalization discounts, and paying income taxes on income from grantor trusts that receive gifts. If GST exemption is allocated to the gift, these advantages also apply to increase the amount in the GST exempt trust compared to funding the GST exempt trust at the individual's death. Being able to make larger gifts without paying gift taxes increases these advantages.

In addition, if gift taxes are paid and the donor lives more than three years after making the gift, the gift tax amount is removed from the gross estate. Also, if the estate tax rate is later increased, there will be tax savings generally equal to the amount of the gift subject to payment of gift taxes times the amount of the percentage rate increase.

Gifts can be disadvantageous from an overall tax cost perspective if a) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or b) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

- (8) *Potential Clawback of Tax Attributable to Excess Exemption If Estate Tax Exemption Is Later Reduced.* If the Form 706 instructions are followed, and the Line 7 gift tax offset amount is calculated using the applicable exclusion amount for the year of the gift, the estate will pay estate tax on all of the taxable gifts, including the excess of the exclusion utilized by gifts over the estate tax exclusion amount.

The issue, stated briefly, is this: If gifts are made under a gift exclusion amount that exceeds the estate exclusion amount, does the excess amount pass free of gift or estate taxes? For example, if the estate tax rate increases to 45% and if the exemption decreases to \$3.5 million, the tax exposure hinging on this issue is \$675,000 (i.e., \$1.5 million x 45%).

If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost at the first spouse's death. For example, if there is a \$5 million gift in 2011 and the donor dies in a year in which § 2001(g) remains in effect but the estate tax exemption has been reduced to \$3.5 million and the rate has been increased to 45% and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be \$1,227,272.73 if the Line 7 gift offset is determined under the Form 706

instructions approach. (Check:  $[\$1,500,000 + \$1,227,272.73] \times 45\% = \$1,227,272.73$ .)

Even if the “clawback” applies, the estate will not pay more estate taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.

- (9) *Effects of Paying Gift Tax If Rates Stay the Same or the Rates Later Increase.* If gifts are made requiring the payment of gift tax, if the donor dies within three years of the gift (so that the gift tax is brought back into the estate), and if the estate tax rate is the same as the gift tax rate, there is no reduction in the combined gift and estate tax. The gift tax merely “prepays” the transfer tax, but the advantages of making gifts above would apply. By using the rates in effect at the date of death to calculate the gift tax that would have been payable on the adjusted taxable gifts, the system grants an advantage to making gifts at a lower rate than the ultimate estate tax rate. The amount of savings is generally equal to the amount of gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate.
1. *GST Tax — Overview of Changes.* The general GST effects of the amendments in TRA 2010 are summarized below. A more detailed discussion of changes and planning implications is in Item 5 below.
    - (1) *GST Applicable Rate in 2010 is Zero.* For all of 2010, the GST tax “applicable rate determined under section 2641(a)... is zero” for all generation-skipping transfers made in 2010. [TRA 2010 § 302(c).] This change in nomenclature (rather than the provision of prior law that all of chapter 13 does not apply to generation-skipping transfers after 2009) makes clear that generation-skipping transfers may be made in further trust.
    - (2) *GST Tax Applies After 2010.* TRA § 301(a) in effect repeals § 2664 added by EGTRRA, which section provided that Chapter 13 would not apply to generation-skipping transfers after 2009. This change is made effective for transfers made after 2009. However, as discussed immediately above, TRA § 302(c) provides the special rule resulting in a zero GST tax rate for generation-skipping transfers in 2010.
    - (3) *GST Exemption of \$5.0 Million for 2010.* The GST exemption equals the estate tax “applicable exclusion amount under section 2010(c) for such calendar year.” I.R.C. § 2631(c). Because the estate tax applicable exclusion amount is changed to \$5.0 million for 2010, TRA § 302(a)(1), the GST exemption is \$5.0 million for 2010. This is important, because it clarifies that there is up to \$5.0 million of GST exemption that can be allocated on a timely basis to transfers to trusts in 2010, and that the donor of direct skip gifts in trust in 2010 should generally opt out of automatic allocation of the GST exemption to those 2010 direct skip gifts.
    - (4) *GST Exemption in Future Years.* The GST exemption for 2011 will also be \$5.0 million. The \$5.0 million amount is indexed from 2010, beginning in 2012. (The GST exemption amount is the same as the estate tax applicable exclusion amount, and the estate tax exclusion amount is indexed from 2010 beginning in 2012.

TRA 2010 § 302(a)(1).) If the GST exemption amount is not changed by future legislation, after the TRA sunsets following 2012, the GST exemption will be \$1.0 million, indexed from 1997.

- (5) *GST Tax Rate After 2010.* The “applicable rate” for determining the GST tax is the maximum estate tax rate times the inclusion ratio of the trust. I.R.C. § 2641(a). Because the maximum estate tax rate is 35%, the GST rate is also 35% (except that the rate is zero for generation-skipping transfers in 2010).
- m. *Section 2511(c) Deleted.* Section 2511(c), added by EGTRRA, provides that transfers to non-grantor trusts are treated as gifts. That section, which has raised considerable confusion, is fortunately deleted.
- n. *Sunset Provision of EGTRRA.* Section 901 of EGTRRA says that the Code will be interpreted as if the provisions of EGTRRA had never been enacted with respect to estates of decedents dying after, gift made after, and generation-skipping transfers after 2010. However, there are many taxpayer favorable provisions in EGTRRA that might conceivably expire under EGTRRA § 901.

Most of these uncertainties are resolved for 2011 and 2012. TRA 2010 § 301(a) says that each Code provision amended by subtitles A or E of title V of EGTRRA “is amended to read as such provision would read if such subtitle had never been enacted.” These subtitles only address the estate and GST tax repeal following 2009 and carryover basis.

All of the other provisions of EGTRRA would be given effect for 2011 and 2012, including the reduction of estate and gift tax rates (subtitle B), increase of unified credit exemption equivalent and GST exemption and setting the gift exemption at \$1.0 million (subtitle C) (but TRA 2010 also increases the gift exemption beginning in 2011), replacing the state death tax credit with a state tax deduction (subtitle D), expansion of conservation easement rules for estate tax purposes (subtitle F), modifications of GST provisions, including automatic exemption allocations, retroactive allocations, qualified severances, modification of certain valuation rules, and the GST “9100 relief provisions”(subtitle G), and the relaxation of the requirements for deferred estate tax payments under I.R.C. § 6166 (subtitle H). This eliminates the concern about the effect of the sunset rule in EGTRRA on all of those other provisions for 2011 and 2012.

However, TRA 2010 provides for temporary tax relief (generally for just two years), and TRA 2010 § 101(a) states that Section 901 of EGTRRA is applied by replacing “December 31, 2010” with “December 31, 2012.” This means that the sunset rule of EGTRRA is now delayed for two years, until following 2012. All of the uncertainties that we have had previously about the EGTRRA sunset provision remain, but are “punted forward” for two years to 2013.

## **2. Legislative Proposals Not Included in TRA 2010**

A bill introduced by Senator Baucus on December 2, 2010 included various provisions that were not included in TRA 2010. The following provisions in the Baucus bill and several other proposals that have received some attention over the last several years were not included.

- a. *Farmland.* Estate taxes on farmland could be deferred under the Baucus bill until the farmland is sold or transferred outside the family or ceases to be used for farming, subject to a never-ending complex estate tax recapture provision when the farmland was later sold, transferred outside the family, or ceased to be used as farmland.



- b. *Special Use Valuation.* The Baucus bill would have increased the special use valuation adjustment amount from \$750,000 (indexed to \$1.0 million in 2010) under current law to \$3.5 million (indexed from 2009 beginning in 2011).
- c. *GRAT 10-Year Minimum Term.* The Baucus bill included the proposal in the President's Budget Proposal for the last two years of a GRAT 10-year minimum term. Under the proposal, grantor retained annuity trusts must have a 10-year minimum term, the annuity amount cannot decrease in any year, and the remainder interest must have a value greater than zero determined at the time of the transfer to the trust. At this point, there has been no indication whether the deletion of this provision reflects Congressional policy not to impose a 10-year minimum term on GRATs, or whether the Congressional writers are just saving this revenue raising provision for subsequent legislation.
- d. *Consistency of Basis.* The Baucus bill also included the consistency of basis proposal in the President's Budget Proposal for the last two years. The basis of property in the hands of heirs would be the same as its value as finally determined for estate tax purposes, and the basis of property in the hands of donees for purposes of determining loss would be limited by the fair market value (under I.R.C. § 1015) as finally determined for gift tax purposes. (This provision in the Baucus bill was retroactive, applying to "transfers for which returns are filed after the date of enactment.")  
  
As with GRATs, the deletion of this provision may just mean that it is being saved for future legislation when revenue offsets will be needed because this is a revenue raising provision.
- e. *Section 2704.* TRA 2010 (as well as the Baucus bill) does not contain any provisions addressing I.R.C. § 2704 (as requested in the President's Budget Proposal the last two years). (This provision has not been included in *any* statutory proposal.)
- f. *State Death Tax Deduction.* The extension of the estate tax provisions of EGTRRA means that the state death tax credit did not get reinstated in January 2011 (which would have caused the re-emergence of state death taxes in many states that just have a "federal credit pick-up system" and that therefore have no state estate taxes if there is not a federal death tax credit). Furthermore, some have speculated that as a revenue raiser, Congress may at some point delete the deduction for state death taxes that now exists under I.R.C. § 2058. That was not done in TRA 2010.

### 3. General Estate Planning Approaches In Light of TRA 2010

- a. *Instability and Unpredictability.* We are now looking at a very unstable system. Over the last 10 years, exemptions and rates changed in a stable progressive way. Exemptions have exploded from \$2 to \$3.5 to \$5 million in the last several years. How can we advise clients going forward? It is extremely difficult to predict what will happen in 2013. At some point, will Congress began worrying how to pay for tax relief? Will China stop buying US bonds, so that Congress becomes worried about deficits and deadlock occurs with nothing happening in 2012 and the estate tax returning to a \$1 million exemption 55% rate system in 2013? It is hard to handicap whether there will be small exemptions, large exemptions, or estate tax repeal following 2012. The probabilities really don't matter to an individual client. "When you are dealing with a sample of one, probabilities don't matter."

“We have been taught a lesson. We don’t know what Congress will do from moment to moment, let alone in two years. This time, at least we know to warn clients that there is a tremendous amount of uncertainty, and we can’t predict exactly what will happen.” - Carol Harrington

- b. *Predictions.* Predictions as to what will happen in 2012 vary significantly.

*Beth Kaufman.* There are at least four possible outcomes: (a) The 2011-2012 system becomes permanent; (b) the transfer tax system becomes a biannual tax extender; (c) there is complete political gridlock like in December 2009, and the system reverts back to a \$1 million exemption 55% rate system temporarily until Congress can reach agreement; or (d) estate tax repeal gets passed.

Political considerations also enter into the uncertainty. The two-year extension through 2012 happens to throw the debate into the 2012 presidential election. Politicians are increasingly campaigning on problems that the other guys created, and political games could lead to gridlock.

The push for estate tax repeal could come from experience in 2011-2012 with estimates of only 5,000-6,000 taxable estates per year with revenue estimates of about \$15 billion, down from \$50 billion annually in 2001. The argument would be that the lower revenue does not justify all of the bureaucracy and private sector planning and that there should be other tax collection mechanisms.

*Sam Donaldson.* A rebuttal to the de minimis revenue argument is that the revenue is still substantial. A Congressional Budget Office estimate, based upon the \$3.5 million exemption/45% rate system estimated a ten-year revenue of \$168.1 billion, representing 1.2% of all federal revenues. However, that would completely fund the entire Department of the Interior and many other federal government agencies. Sam Donaldson quips, “if the exemption is increased to \$5 million, maybe the estate tax could fund fish but not wildlife.” Michael Graetz points out that the estate tax pays  $\frac{3}{4}$  of the cost of Homeland Security.

*Dennis Belcher.* We all have a tendency to think tomorrow will look like today. That’s why people buy high and sell low. However, tomorrow will not necessarily look like today. The debate over the estate tax in December 2010 included political trading with no associated “price tag.” If the price tag does not matter again in 2012, we could very well end up with repeal. However, if the price tag does matter in the future, there could be a very different result. The revenue loss may be only \$15 billion annually now, but it could be increasing significantly. The sad reality is that the estate tax system could become a part of the annual debate over tax extenders.

*Carol Harrington.* The odds of now passing legislation with sound tax policy because Congress has seen the errors of its ways seems rather silly. Having negotiated for 10 years, it’s hard to see that congressman will compromise on this. When this comes up in the next lame duck session in 2012, President Obama will not be worried about getting reelected (he will either have been defeated for a second term, or will be in a second term without possible reelection). The economy, the makeup of Congress, etc. will be very different. “After they finish torturing us-- something they enjoy doing-- they’ll eventually straighten it out.”

*Michael Graetz.* The \$5 million exemption and portability are here to stay. However, the rate structure is more vulnerable to changes. Whatever is done may be on temporary basis. It is a mistake to believe the repeal proponents have given up.

*Lou Mezzullo.* In light of the low number of the estates that will file estate tax returns and pay tax, generating a very small percentage of the federal revenue, is likely that the estate tax eventually will be repealed.

- c. *Impact on Planners' Practices.* Planners will be very busy the next two years. Some planners say they have received more *client initiated* requests for estate planning reviews over several weeks than over the last five years. Look at what you enjoy doing. If your clientele is an “under \$5 million” practice, there is already effective tax repeal. Much the same situation exists for \$10 million couples if we end up with a \$5 million exemption with portability. But there are still many things for planners to do. Some say that estate planners are social workers for the wealthy. Clients are really looking for planning for long-term management and preservation of their assets and distribution planning. State estate taxes and income taxes will become more important in planning practices. Planners will need to persuade their clients of the value of addressing the wide variety of non-tax issues in planning estates.
- d. *Increased Focus on Client's Individual Goals and Customized Drafting To Meet Those Goals In light of Inherent Uncertainty.* Previously, planners could ask clients about their goals, and then structure those goals into a fairly standardized credit shelter trust /marital share planning approach. In the future, it will be imperative to focus on client goals in light of very unpredictable tax changes, rather than just tweaking the standard tax planning structure around the client's goals. Bruce Stone: “Clients tell us where they want their estates to go, not Congress, tax lawyers, or estate planners. Neither do state legislatures when they draft statutes to say what formulas mean.”

*Formula Driven Approach Based on Exemption Amounts.* Planners for their entire careers have used instruments driven by standard formula clauses. The academic debate has been over issues such as whether to use pecuniary versus fractional formulas, or pre-residuary versus residuary bequests of the credit shelter or marital bequests. Standardized formula clauses could be used in the past because of stability in the estate tax system. That is no longer the case. Why are you still drafting documents to leave a formula amount, which will be based upon what a small group of people in Washington decide? What client in his or her right mind will want a document with that kind of uncertainty? Drafters must stop drafting wills where *nobody* can know what the formulas will mean.

The standard formula driven approach can still work in a truly harmonious family situation. The maximum exemption amount can pass to the credit shelter trust and the balance to the surviving spouse, without concern for what Congress does to the formulas. Even then, what if Congress repeals the estate tax — what will the formulas mean then?

For really wealthy clients, standard formula drafting will be sufficient. The exemption amount is just a nuisance anyway for them. In addition, for “Ward Cleaver” clients, the standard formula approaches will work fine. For other clients, documents will have to be customized to meet the detailed goals. The document does not necessarily have to address what happens if the exemption is \$1 million, \$2 million, \$3.5 million, \$5 million, or \$10 million, but the core principles of the distribution plan must be identified to customize the plan in light of uncertain tax laws.

Planners should keep detailed notes of the client's goals in light of a variety of possible future tax law situations.

*Customization Example.* Consider the following as an example of the type of customization using “floors and ceilings” that will be needed in the new paradigm of uncertainty. A client with a \$6 million estate has a spouse and two children by a prior marriage. The client wants to leave at least \$3 million for supporting the spouse, but wants the overall estate divided so that it ultimately passes one-third to the spouse and two-thirds to the two children. Leaving \$3 million outright to the spouse would leave \$1 million short of the desired amount to pass eventually to the two children. The plan would be drafted to shift some of the spousal bequest to a QTIPable trust so that at least \$4 million would eventually pass to the two children. The remaining \$3 million would pass to the children, but not in excess of the federal estate exemption amount. If the federal exemption is less than \$3 million, the difference would pass to a QTIPable trust. If there is a state estate tax with a state-only QTIP election, there could be further limits on the bequest to the children to utilize a separate QTIP trust to avoid state estate taxes at the client's death. It will no longer be possible to just explain a standard credit shelter trust and sell a document based on that model.

*Statements of Intent.* Draft statements of intent regarding the core goals, making them sound as much like the client as possible. They will help if the court needs assistance in interpreting the document, rather than just having the sterile words of a formula. That sort of planning brings value to the client.

- e. *Testamentary Drafting Patterns for Building Flexibility.* In this world of tremendous uncertainty regarding future tax systems, there is tension among (i) planning for federal estate tax savings, both at the first spouse's and second spouse's deaths, (ii) planning for state estate tax savings, and (ii) planning for basis step up if there are no estate tax concerns.

(1) *General Planning Strategy.*

(a) First, make sure the federal marital deduction is available at the first spouse's death whether by an outright bequest, QTIP trust, or general power of appointment trust (state estate tax planning flexibility is increased by using “QTIPable” trusts; state estate tax planning may be further simplified by deathbed gifts to utilize the federal gift and estate exemptions because gifts are generally not included in the state estate tax base);

(b) Second, make sure the surviving spouse has the flexibility to shelter the assets from estate tax at his or her subsequent death. For example, an outright bequest to the spouse with credit shelter trust provisions in the event of a disclaimer can work in a homogeneous family situation, but a QTIP trust may be needed for other situations (the portion for which no QTIP election is made is not includable in the surviving spouse's estate under §2044); and

(c) Third, following the first spouse's death, leave the flexibility for causing assets to be included in the surviving spouse's estate to obtain a basis step up at his or her death if there are no estate tax concerns (generally by permitting distributions to the spouse under a very broad “best interests” standard or by granting someone the power to cause the spouse to have a general power of appointment).

- (2) *Disclaimer Approach.* The simplest approach is to leave the entire estate to the surviving spouse, but provide that any disclaimed assets would pass into a trust having the spouse and/or other family members as beneficiaries. The disclaimer approach has the advantage of simplicity in a homogeneous family situation. It may become the preferred approach for “low net worth clients.” If there are state estate tax concerns, the disclaimed assets should pass into a QTIPable trust if the state recognizes a state-only QTIP election. If there are no state estate tax concerns or if the state does not recognize a QTIP election, the disclaimed assets will likely pass to a trust similar to standard credit shelter trusts.

Is a disclaimer by a surviving spouse invalidated by subsequent grant of a general power of appointment to the spouse? A possible analogy is that the IRS has approved “reverse QPRTs” where the children later decide to give the parent the right to live in the house for a period of time, if the children’s decision was an independent action that was not pre-planned. However, it would raise the question of whether the disclaimer satisfies the “pass without direction of the disclaimant” requirement.

- (3) *QTIP Trust Approach.* An alternative approach is to leave the entire estate into a trust for which a QTIP election could be made. Marital deduction qualification at the first spouse’s death is available by making the QTIP election. To the extent the election is not made, assets would not be included in the surviving spouse’s gross estate under § 2044. State estate tax planning is flexible with QTIPable trusts, particularly if the state recognizes a “state-only” QTIP election. (See Item 7 for further discussion of state estate tax planning issues.) “Clayton QTIP” provisions could be included to provide that the assets would pass to a different type of trust to the extent that the federal QTIP election is not made.

While either of the disclaimer or QTIP approaches can be used to afford flexibility in addressing federal and state estate tax planning issues at the deaths of either of the spouses, further planning is needed to afford the flexibility of basis step-up planning at the surviving spouse’s subsequent death.

- (4) *Basis Step-Up Flexibility; Broad Distribution Powers.* One method of causing estate inclusion if the surviving spouse has no estate tax concerns is to give the independent trustee broad authority to make distributions to the surviving spouse, such as under a “best interests” standard. An advantage of this approach is its simplicity, but possible disadvantages are discussed below.
- (5) *Basis Step-Up Flexibility; Independent Party With Power to Grant General Power of Appointment.* The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse’s unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse’s creditors. Howard Zaritsky points out that he prefers this approach to the broad distribution powers approach. Making physical distributions to the spouse may be mechanically cumbersome, particularly in a deathbed situation. The mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment. The surviving spouse may be elderly and have management issues

with respect to outright ownership of the assets, or may be susceptible to pressure to make transfer to related family members or caregivers.

- (6) *Basis Step-Up Flexibility; Formula General Power of Appointment.* The general consensus is to discourage the use of formula general powers of appointment, granted to the extent that the power would not result in the payment of estate taxes. There is concern that the beneficiary could have indirect control over all of the trust assets as a result of the formula grant of the power, meaning that the beneficiary would have a general power over all of the trust assets for tax purposes. If the formula operates without regard to the availability of a marital or charitable deduction, the formula no longer accurately grants a general power to cause basis step-up even though there would be no estate tax.
- (7) *Basis Step-Up Flexibility; Triggering “String” Provision.* To build in flexibility for achieving a basis step-up at the death of a transferor, consider purchasing appreciated assets from a grantor trust prior to the transferor’s death or taking steps to trigger the “string” provisions of §§ 2036-2038. Planning flexibilities in the analogous gift situation regard for achieving estate inclusion in the original donor’s estate are discussed below in Item 4.o below.

#### **4. Planning Approaches To Utilize Increased \$5 Million Gift Exemption**

- a. *Overview of Tax Effects.* The tax effects of gifts are summarized in Item 1.k above. The following is a brief summary.
  - A donor can make gifts of the full additional gift exemption amount without paying gift tax.
  - Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
  - Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
    - removal of appreciation/income of gift assets from the gross estate;
    - utilizing fractionalization discounts;
    - paying income taxes on income from grantor trusts to further “burn” the donor’s gross estate;
    - if the donor lives three years, gift taxes paid are removed from the gross estate; and
    - the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well.
  - Clawback — if the estate tax exemption amount is reduced below the current gift exemption amount, there is a possible “clawback” effect of having to pay estate tax on the excess gift exemption amount. For example, if the estate tax rate increases to 45% and if the exemption decreases to \$3.5 million, the tax exposure hinging on this issue is \$675,000 (i.e., \$1.5 million x 45%). If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost. For example if there is a \$5 million gift in 2011 and the donor dies in a year in which the estate tax exemption is reduced to \$3.5 million and the rate is increased to 45% and if the donor’s will leave the entire estate to a surviving spouse or charity, the estate tax will be \$1,227,272.73. Even if the

“clawback” applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death.

- There is a general belief that the estate tax “clawback” will not occur. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear.
- If a clawback of estate tax on the excess exemption amount should occur, the additional estate taxes probably cannot be apportioned against the donees, except in a state where the state apportionment statute allows apportionment against gift donees. If the donor dies within three years of making the gift, the IRS liens can reach the gift property. I.R.C. § 2035(c)(1). The donees could contractually agree to pay the additional estate tax under an arrangement similar to a net gift agreement, but that contractual obligation would likely allow the IRS to pursue the estate’s claim against the donees to collect the estate tax.
- If the donor pays gift taxes, the gift taxes are included in the gross estate if the donor dies within three years. Even in that situation, the gift tax merely “prepays” the transfer tax. If the estate tax rate is later increased above the gift tax rate that applied at the time of the gift, there will be savings equal to the amount of the gifts in excess of the gift exclusion amount times a percentage equal to the difference between the marginal estate tax rate and the marginal gift tax rate. If the donor lives at least three years after making a gift, any gift taxes paid on the gift will be removed from the gross estate for estate tax purposes.

- b. *How Much Can the Donor Afford to or Want to Give?* While substantial additional gifts can be made without having to pay gift taxes, the initial question is how much can the donor afford to or want to give? The increased estate exemption may mean that the donor is not as concerned about estate taxes as in the past. However, TRA 2010 only lasts for two years and the estate exemption could be decreased in future years; alternatively, the estate exemption could be increased or the estate tax could be repealed in future years in which event the donor may preferred to have retained the gift assets.

Spouses collectively could give up to \$10 million without having to pay gift taxes. Few couples can afford to give \$10 million without potentially impacting their lifestyle in later years. A primary concern will be “will I have enough left to live on?” How do you define what are “discretionary” assets? That is not for the planner to define. “It’s not the actual ability to make a gift that matters — it’s the *perceived* ability to make a gift and maintain one’s standard of living into the foreseeable future that matters.” As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a “rainy day” financial reversal (strategies are discussed below).

- c. *Gift Splitting.* If one spouse has most of the marital wealth, the couple can still take advantage of both spouses’ \$5 million gift exemptions by making the split gift election. § 2513. This can achieve the advantages of gifts with respect to \$10 million worth of gifts instead of just \$5 million.

A consenting spouse should be aware of possible effects of consenting to the election. Indeed, it may be appropriate to compensate the spouse for consenting to split gift treatment or it might be appropriate to amend a premarital agreement. For example, in return for agreeing to the split gift treatment, the donor spouse may agree that the consenting spouse can have the residence and leave it to anyone he or she wishes.

Fortunately, the election is just effective for gift and GST purposes (*see* § 2652(a)(2)), not for the purpose of treating the consenting spouse as the transferor for applying the estate tax “string” statutes (*see, e.g.*, Rev. Rul. 82-198, 1982-2 C.B. 206; Rev. Rul. 74-556, 1974-2 C.B. 300). However, possible bad effects may result for the consenting spouse. (1) At the consenting spouse’s death, one-half of the gift assets will be added to the estate as adjusted taxable gifts, and the estate tax calculation operates in a manner that the consenting spouse’s gift exclusion utilized in the split gift will effectively use up the consenting spouse’s estate tax exclusion amount as well. (As discussed in Item 1.i above, if the estate tax exclusion amount has decreased by the time the consenting spouse dies, this could result in additional estate taxes being payable by the consenting spouse’s estate even if all of the estate is passing to a surviving spouse.) (2) If the gift is included in the donor-spouse’s gross estate under some section other than § 2035 (for example, a QPRT may be included under § 2036), both halves would be included in the donor-spouse’s estate because the donor is treated as the transferor of both halves for estate tax purposes, but the consenting spouse’s unified credit is not restored. (If the assets are included in the donor spouse’s gross estate under § 2035, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but that only applies if the asset is included in the estate under § 2035.) I.R.C. § 2001(e). (3) If the gift is included in the donor’s gross estate under § 2035, as mentioned immediately above, the consenting spouse does not have to include one-half of the gift as an adjusted taxable gift under the estate tax computation, but the consenting spouse’s gift tax unified credit is not restored for purposes of later gifts by the consenting spouse. If there is any risk that the gift assets may be included in the donor spouse’s estate under any of the string statutes, the spouse should be especially cautious about whether to consent to split-gift treatment. *See generally* Zeydel, *Gift-Splitting — A Bondage of a Bad Idea? A Comprehensive Look at the Rules*, J. TAX’N (June 2007).

In light of these potential adverse affects for the consenting spouse, consider whether the consenting spouse should have separate counsel in considering whether to consent to split gift treatment.

- d. “*Rainy Day Fund*” Considerations; *Lifetime Credit Shelter Trust for Donor’s Spouse*. The donor may wish to make gifts in a way that the donor (or the donor’s spouse) could retain some use of the assets in case needed as a “rainy day” fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a “lifetime credit shelter trust” for the benefit of the donor’s spouse. The trust would be for the benefit of the donor’s spouse, containing very similar terms as in standard credit shelter trusts created in wills. In some ways, this is the ideal kind of trust for the spouse because the spouse is a discretionary beneficiary, can be the trustee, can have a limited power of appointment (exercisable at death or in life), and the trust may be protected against claims of both the donor’s and spouse’s creditors. The power of appointment could be broad enough to appoint the assets back to the donor. (Exercising the power of appointment in the donee-spouse’s will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse’s estate under § 2036(a)(1) if there was no pre-arrangement,



but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction, as discussed in paragraph f below. Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust, as discussed in paragraph d below.) If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment. The trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate (*see Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038), so that the trust could also be available for the benefit of a new spouse. With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the spouse under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

- e. *"Rainy Day Fund" Considerations; Lifetime Credit Shelter "Non-Reciprocal" Trusts.* Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created at the same time, and the trusts were of equal value. The Court said that the primary factor in determining whether trusts are sufficiently interrelated is "whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary." *Id.* If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Comm'r*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries). Another possible distinction would be for one trust to include the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary. For an extended discussion of the reciprocal trust doctrine in the context of

spouses creating lifetime QTIP trusts for each other, see Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed as to whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under section 2036(a)(2) or 2038. *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to section 2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm'r*, 68 F.3d 151 (6<sup>th</sup> Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm'r*, 140 F.2d 636 (8<sup>th</sup> Cir. 1944).

- f. “*Rainy Day Fund*” *Considerations; Discretionary Trusts in Self-Settled Trust States*. Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a “rainy day fund” in the unlikely event that financial calamities occur, without triggering § 2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding “self-settled spendthrift trusts”: Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that § 2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential § 2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under § 2036 is tested at the moment of death, and § 2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as there is no prearrangement). *See* Tech. Adv. Memo. 199935003 (§ 2035 will apply if pre-planned arrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re-vest beneficial title or change the beneficiaries. (Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed § 2036. The “trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036” as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor “combined with other facts (such as, but not limited

to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." While this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under § 2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

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

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. See Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

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

- g. *“Rainy Day Fund” Considerations; Preferred Partnership.* Mil Hatcher has used preferred partnerships in his planning for many years. A preferred partnership can assist in leaving the donor with access to funds to maintain the donor’s lifestyle. He uses this example. Assume client has \$20 million of investable assets, producing \$800,000 per year (at a 4% withdrawal rate) for living expenses. If the client gives \$5 million, the 4% withdrawal amount would be reduced to \$600,000. The \$600,000 is sufficient currently, but what if the client were to need \$800,000 in a year? To assist with the client’s comfort level, the client would give \$5 million to children (or a grantor trust for them), would keep \$5 million (generating \$200,000 per year) and would contribute \$10 million to a preferred partnership. The client would receive a preferred partnership interest yielding 8% for \$5 million of the contribution, or \$400,000 per year. The other \$5 million would be contributed for a common interest owned by the client. The client would have annual cash flow of \$400,000 from the preferred partnership interest and \$200,000 from the retained \$5 million of investments. In addition, the client would own a \$5 million common interest in the partnership, hopefully generated growth of more than 4% per year, and distributions might be made with respect to the common interest if the client needed additional funds at some point in the future.
- h. *Taking Advantage of \$5 Million GST Exemption.* There are no assurances that the GST exemption will remain at \$5 million. Making a \$5 million gift and allocating the \$5 million of GST exemption that is currently available is one way of assuring that the full \$5 million GST exemption can be used. The safest way of utilizing the \$5 million GST exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) “had never been enacted,” there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and \$5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full \$5 million of GST exemption could be considered.
- i. *Views of Panelists Regarding General Approach Toward Utilizing \$5 Million Gift Exemption.*
- If you think the exemptions are going down in the future, take advantage of the gift exemption (and GST exemption, if appropriate) currently.
  - Reciprocal trusts for the spouses with different provisions are a possible planning strategy but will not be readily accepted by most clients.
  - Most clients do not want to make a \$5 million gift unless there is a real reason to do so. The “tax tail has wagged the dog but it won’t in the future. That’s why this \$5 million exemption is a sea-change.”
  - As to the “clawback” possibility, most panelists were of the “use it or lose it” mindset. If the client is in a position to do so, go ahead and make gifts utilizing the \$5 million exemption in 2011 or 2012. We don’t know what Congress will do in the future, and most planners are not losing sleep over the clawback possibility. “The exemption has never gone down, and being young and naïve, I think it will not go down. This may drag into 2013 and may take a new Congress or president, but I think this will work

out.” Another panelist: “You are young and naïve.” Another panelist: “She’s young, naïve, and right.”

- j. *Forgiveness of Outstanding Loans to Children.* Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the \$5 million gift exemption. A possible concern exists if there has been a repeated pattern of forgiving loan payments. If the IRS can establish intent from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.*, Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the “original intent” implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 (“debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules”).
- k. *Gifts to Grantor Trusts.* Making transfers to grantor trusts, where the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple \$5 million (or \$10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)’ gross estates over time.
- l. *Gifts to Grantor Trusts Leveraged With Loans.* A very simple additional strategy would be to make a \$5 million (or \$10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.
- m. *Gifts and Sales to Grantor Trusts.* Sales to grantor trust transactions traditionally are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The \$5 million gift exemption (\$10 million for couples) relieves many of those difficulties. For example, a couple could give \$10 million to grantor trusts, and sell \$90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from “burning” the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide “seed” equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a “leaky” freeze, but may leave the client in a much more comfortable position than making gifts of \$5 million (or \$10 million for couples). For example, a client may make a smaller gift, but make a sale of \$10 million. The client continues to have access to principal and interest on the \$10 million note, as compared to a \$10 million outright gift where there is no retained benefit. A “leaky” freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. “Don’t let the perfect get in the way of the good if the only way to get anything done is a leaky freeze.”

- n. *Highly Volatile Assets; GRATs or Gift/Sales Transactions With Minimal “Seed” Gift.* For highly volatile assets, a preferable approach may be to use GRATs rather than gift/sale transactions to avoid the possibility of wasting the client’s gift exemption if the volatile asset becomes worthless. Mil Hatcher observes that for highly volatile assets, the gift element in the gift/sale transaction should be minimized. This minimizes the risk of the highly volatile asset declining in value substantially, which may eliminate the value of the trust, and result in having wasted the client’s gift exemption. For example, if a couple might be interested in selling \$30 million of assets to a grantor trust, do not fund that trust with a \$10 million gift, but only fund it with a gift of \$3,333,000. Using a 9 to 1 ratio, that would still justify a sale of assets for \$30 million. If the couple wants to utilize the full \$10 million gift exemptions, give the remaining \$6,667,000 to another trust. This approach does not expose the other \$6,667,000 to the sale transaction in case the assets decline in value. (Alternatively, one grantor trust could be used, but the \$3,333,000 amount needed to support the sale would be contributed to an LLC, the member interests in the LLC would be given to the trust, and the sale would be made to the LLC, thus not putting at risk the other \$6,667,000 assets given to the trust.) Mil Hatcher observes: “A problem in the past was not coming up with enough seed money. In the future, the problem may be having too much seed money.”
- o. *Basis Step-Up Flexibility; Repurchase of Assets by Grantor, Triggering “String” Provision.* Consider steps to build in flexibility for achieving a basis step-up at the death of a transferor. Key to this flexibility will be making the gift to a trust rather than an outright gift.

One traditionally used method to achieve a basis step-up is for the grantor to repurchase appreciated assets from a grantor trust recipient.

Another approach is to draft the trust to give an independent trustee or other independent party the power to grant a testamentary limited power of appointment to the grantor. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from beneficiary to another. If so granted, this would cause inclusion in the grantor’s estate under § 2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 35% of the excess of the date of death value over the date of gift value is less than amount equal to 15% of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust.

Another possible approach would be to take steps to trigger the “string” provisions of §§ 2036-2038. For example, the parent may continue living in the house in a QPRT without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee-spouse’s estate for estate tax purposes if there are no estate tax concerns for the donee-spouse and if a basis step-up at his or her death would be desirable. These are the same strategies that could be used in creating trusts for a spouse in the testamentary context. See Item 3.e.(4-6) for a discussion of specific strategies.

- p. *GRATs.* GRATs may not be as favored when clients can make gifts of up to \$5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption*. Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard to value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The 10-year minimum term provision is not included in TRA 2010. Does that mean that rolling two-year GRATs can be created within the next two years before TRA 20120 sunsets? We cannot be sure. Congressmen may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill in 2011 that needs a revenue raiser to offset the cost of some new bill.

- q. *Life Insurance Transfers.* A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having \$5 million (\$10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a \$2 million premium can often purchase \$20 million of second-to-die life insurance coverage.

Split dollar agreements have often been used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used in the past, large gifts (within the \$5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the \$5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the

ability to make a \$5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to \$1 million after 2012.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a \$5 million (\$10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including going back to a \$1 million exemption/55% system).

- r. *Deemed §2519 Gifts from QTIP Trusts.* One way to make use of the \$5 million gift exemption is triggering § 2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the \$5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under § 2519. However, it is likely that § 2036(a)(1) would cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44<sup>th</sup> U. Miami Heckerling on Est. Plan. ch. 12 ¶ 1202.3 (2010).

For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under § 2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid § 2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the § 2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under § 1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

- s. *QPRTs.* One of the disadvantages of a qualified personal residence trust (QPRT) is that there is a significant (though highly discounted) gift element. The \$5 million (\$10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)
- t. *Same-Sex Couples.* Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased \$5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.
- u. *Equalizing Gifts to Children or Grandchildren.* A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra \$4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.



- v. *Gifts to Save State Estate Taxes.* Only several states have state gift taxes. In other states, gifts within the \$5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. (See Item 7.) A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.
- w. *Gifts May Impact § 6166 Qualification.* Closely held business interests often represent highly appreciating-high income producing assets that can be the perfect vehicle for gifts. Making \$5 million (\$10 million per couple) of gifts in a closely held business may take the business interest in the estate below the 35% of adjusted gross estate level needed to qualify for § 6166 estate tax deferral.

## 5. Generation-Skipping Planning Issues Under TRA 2010

- a. *GST Exemption Allocations; Opting Out of Automatic Allocations; Allocating GST Exemptions to "Indirect Transfers" to Trusts.* There is now 2010 GST exemption (\$5 million) that can be allocated on a timely basis to transfers that were made in trust during 2010.

It is VERY important to remember to "opt out" of automatic allocations to direct skip gifts in 2010 that are intended to pass to the current beneficiary rather than future generations. Because the GST tax rate is zero on direct skip gifts in 2010, allocating GST exemption to the transfer would waste the exemption (unless a direct skip trust will remain in existence for the life of the current beneficiary and then pass to younger generations). Dennis Belcher warns: "That will catch a lot of people. You can't say it enough times."

Be sure to calendar the date for opting out of automatic GST exemption allocations for any direct skips (unless the trust is intended eventually to pass to beneficiaries in younger generations than the current beneficiaries of the trust). (The due date is no earlier than September 19, 2011. If the direct skip was a lifetime gift, and if the individual's income tax return is extended to October 17, that also extends the gift tax return's due date to October 17, 2011.)

While TRA 2010 provides an extended due date (to no earlier than September 19, 2011) for reporting direct skip transfers, there is no extension of time or allocating GST exemption or opting out of automatic allocation for "indirect skip" transfers to trusts (i.e., transfers to trusts that are not direct skips). If an individual has made both direct skip gifts as well as indirect skip gifts, as a practical matter both should be reported, making GST exemption allocations or opting out of automatic allocations, on the same tax return under the normal filing cycle (April 18, 2011 or October 17, 2011 if the return is extended).

- b. *Disclaimers in 2011 Can Result in 2010 Direct Skips.* Disclaimers in 2011 may result in direct skips having been made in 2010 with a zero GST tax rate. For testamentary transfers, the general thinking is that direct bequests under the will are deemed to have occurred at the time of death for GST purposes. (Otherwise there would be too much possibility for manipulation of the GST tax system by indefinitely delaying the funding of bequests.) A corollary is that disclaimers also operate as of the date of death for

testamentary transfers. Under this reasoning, disclaimers made in 2011 (and keep in mind the extended period for disclaimers up to September 17, 2011 for estates of decedents who died before December 17, 2010, but the extended period does not apply to disclaimers of gifts) may result in transfers for younger generation beneficiaries that are treated as 2010 direct skips, thus qualifying for the zero GST tax rate.

If there is any question about whether acceptance may have already occurred, precluding the effectiveness of a disclaimer, consider filing a Form 709 to report the disclaimer as a nongift transaction, in order to start the statute of limitations on a gift allegation by the IRS.

- c. *Reporting 2010 Direct Skip, Taxable Distribution or Taxable Termination Transfers.* Should returns be filed to report 2010 generation-skipping transfers? Even though there is a zero GST rate, a return is still technically required. However, the issue of generation-skipping transfers with a zero rate has been around for 25 years; trusts with a zero inclusion ratio are not *exempt* from the GST tax — they just have a zero tax rate. However, “nobody filed tax returns for zero inclusion ratio trusts,” unless they were worried about what the inclusion ratio was. For direct skip gifts (or other generation-skipping transfers) in 2010, there is no uncertainty. The only purpose for filing a return would be to get the statute of limitations running, but with a zero tax rate, that does not matter. There are no penalties where no GST tax is due, because there are no information reporting penalties for GST tax returns. Carol Harrington’s advice: “File if you want to, but I am not planning to file GST tax returns to report 2010 generation-skipping transfers.”
- d. *Mechanics of Allocating GST Exemption for 2010 Decedents if the Carryover Basis Election is Made.* For 2010 decedents, the \$5 million GST exemption should be allocated on a Form 706 like always. If the estate makes the carryover basis election to opt out of the estate tax regime, the estate will not be filing a Form 706, and we do not yet know how the GST exemption allocations will be made. We expect that the IRS will provide guidance soon.
- e. *Addition at a Later Time of Upper Generation Beneficiaries to Direct Skip Trusts.* Some planners suggest that some independent party (an independent trust, a trust protector, or anyone other than the donor) could add upper level generations as discretionary beneficiaries to a skip person trust sometime after the trust is created without causing the trust to lose its status as a skip person trust (resulting in application of the move-down rule under § 2653 when the direct skip transfer was made to the trust). The older generation beneficiaries could only be added at a later time — long enough to provide comfort that such persons could not be viewed as having an interest in the trust currently. If non-skip persons (beneficiaries at the children level) could be added at a later time, in effect, the trust could benefit children and grandchildren without any GST tax being due when the trust is created in 2010 (because of the zero GST rate in 2010) or when distributions are made to grandchildren during the trust term or upon termination. There is some concern, however, that a court might ultimately find that to be an abusive “end-run” around taking advantage of the zero tax rate on direct skips in 2010.

A trust will be a skip person (and therefore, result in application of the move-down rule under § 2653) if a second generation below the transferor or more remote beneficiary has a right to receive current distributions or is a permissible current recipient of distributions and if there are no interests held by non-skip persons. § 2613(a)(2) (definition of skip

person trust) and § 2652(c)(definition of “interest”). If that is the case, it does not matter that non-skip persons may be contingent remaindermen or future beneficiaries. (The possibility that non-skip persons may receive benefits in the future applies under the statute and regulations only if there are no persons that hold interests in the trust when it is created (for example if no distributions can be made to anyone for a period of years).)

Some respected planners suggest waiting five years before upper generation beneficiaries are added. This would help to counter any argument that the non-skip person should be treated as an intended current beneficiary by implication or under some kind of application of a step transaction theory.

Another possible IRS argument is that nominally named beneficiaries can be ignored under § 2652(c)(2) if the interest is used primarily to postpone or avoid any GST tax. If the grandchild’s interest in the trust at the outset is ignored, the trust would have no beneficiaries with current interests, and § 2613(a)(2) says that future contingent beneficiaries are then considered in determining whether the trust is a skip person (but the interest of any person to whom the likelihood of a distribution is so remote as to be negligible [applying actuarial standards showing there is less than a 5% probability] is disregarded, Reg. § 26.2612-1(d)(2)). The IRS may view the children as have contingent future interests, thus causing the trust not to be a skip person at the outset, which would mean that the move-down rule would not apply, so subsequent distributions to grandchildren or more remote beneficiaries would be subject to the GST tax. There is not much guidance on how the nominal interest test is applied. In Letter Ruling 9109032 the IRS applied the statute to disregard temporary absence of an interest (for one year).

Some planners even suggest that the trust agreement could provide that older generation beneficiaries would automatically become discretionary beneficiaries after a stated period of time — such as five years, because then only lower level generation beneficiaries would hold current interests, thus literally making the trust a skip person.) However, other planners prefer a more conservative approach of not adding upper level beneficiaries at a later time.

*Conclusion:* There is concern if the plan all along is for the children to be added back as beneficiaries. Have some considerable delay before adding children as beneficiaries and they should only have discretionary interests.

- f. *Retroactive Exemption Allocation if Untimely Order of Deaths, What GST Exemption is Available?* Under § 2632(d) (added by EGTRRA), if a child (or certain other “G2” members) predeceases the transferor, the transferor may allocate unused GST exemption to any previous transfers to the trust on a chronological basis. How much GST exemption is available is not clear. Proposed regulations say only the GST exemption available at the time of the original transfer can be applied retroactively, but the statutory language of § 2632(d) suggests that the amount of GST exemption available immediately before the untimely death can be allocated. Accordingly, if the untimely death occurs in 2010 or later, GST exemption of \$5 million (indexed) should be available under the statutory language.
- g. *ETIPs Did Not End on January 1, 1010.* GST exemption cannot be allocated during an “estate tax inclusion period” (i.e., during any time that the trust assets would be included in the transferor’s estate if he or she died during that period). Under EGTRRA, Chapter 11 did not apply after 2009, raising the questions of whether ETIPs ended on January 1, 2010. Because the reinstatement of the estate tax to January 1, 2010 is retroactive,

- planners uniformly believe that ETIPs did not end at the beginning in 2010. This is the likely result regardless of whether the carryover basis election is made for a 2010 decedent, because the Joint Committee on Taxation Technical Explanation says that the carryover basis election is not intended to affect generation-skipping transfer tax rules. This issue regarding the effect of the carryover basis regime election obviously applies only to 2010 decedents, and for those decedents, the ETIP ends as of the date of death in any event. However, because TRA 2010 only applies for two years, we will have the uncertainty regarding ETIPs again on January 1, 2013 absent further legislation.
- h. *Basis Adjustment for Taxable Terminations at Death.* If a taxable termination occurs at the death of an individual, there is a basis adjustment under § 2654(a)(2) similar to the basis adjustment under § 1014. Does making the carryover basis election for 2010 decedents change that basis adjustment that applies to taxable terminations at death? Probably not, in light of the comment by the Joint Committee that making the carryover basis election does not impact generation-skipping transfer tax issues.
  - i. *65-Day Rule Cannot Be Used to Treat Taxable Distributions as Occurring in 2010.* The “65 day rule” under § 663(b) is an income tax rule and has no relevance for GST tax purposes.

## 6. Planning Considerations For Untimely 2010 Gifts

A donor who made gifts in 2010 and would pay a 35% gift tax may prefer to “undo” the 2010 transfer and instead make the transfer effective in 2011 when there is a \$5 million gift exemption. (If the client can afford to make gifts with other assets in 2011 to utilize the \$5 million gift exemption amount, there is no real problem with having made gifts and paying gift tax in 2010. If the donor lives at least three years, there is the advantage of taxing the transfer on a tax exclusive basis.)

- a. *Decision Tree.* Plan of attack: (1) Consider disclaimers, and if that is not available; (2) Consider rescission. Do not give up easily on “self-help” to undo the 2010 gift.
- b. *Disclaimer.*
  - (1) Is a disclaimer possible? (The extended time period for making disclaimers only applies to estates of decedents who died before December 17, 2010. It does not apply to disclaimers of gifts.)
  - (2) Has the donee accepted the property so that a disclaimer is no longer available? The IRS may be more generous than in the past in determining what constitutes acceptance, in light of the totally unforeseen legislative change extending the time for the disclaimer. “Merely taking delivery of an instrument of title, without more, does not constitute acceptance.” Treas. Reg. § 25.2518-2(d)(4). Perhaps depositing a check in one’s account may be allowed, but receiving interest or dividends or selling the asset or spending the proceeds would not be. If the donee reverses the transfer, perhaps any purported acceptance would be negated. Look carefully at state law. File a Form 709 to report the disclaimer as a non-gift transaction. That starts the statute of limitations as to whether the transfer has gift consequences for that year. (One accountant reports that she always files Form 709s for disclaimers to report them as non-gift transactions.)
  - (3) Determine where the disclaimed property will pass under local law. There may be a different result in different states. Look at all relevant states to see if there are

differences of whether property would pass. If the assets do not pass back to the donor as a result of the disclaimer, a disclaimer will not “undo” the 2010 gift. Gifts to trusts are particularly suspect; the disclaimed assets may not return to the settlor but to other trust beneficiaries. See generally Handler & Chen, *Formula Disclaimers: Procter-Proofing Gifts Against Revaluations by Service*, 96 J. TAX’N 231 (April 2002).

- (4) Apply relevant conflict of laws principles to determine which state’s law applies. (For testamentary transfers, it may be more likely that the law of the transferor’s domicile would apply than for inter vivos transfers. For gifts, the law of the donee’s domicile may apply.)
- c. *Rescission*. If a disclaimer will not work, consider rescission of the 2010 gift. If a gift is made under a mistake of a material fact, rescission may be possible under state law if the donees have not substantially changed their position in a way that would make the rescission unconscionable. The question is whether a business judgment of what legislation may or may not pass in the future is a mistake of fact or just an error of judgment. The most recent rescission case, *Breakiron v. Guidonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010), allowed rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the effect of the untimely disclaimer. In *Stone v. Stone*, (a 1947 income tax case) a rescission was permitted of gifts to children that were made under the mistaken assumption that the income tax from the gift assets would be shifted to the donees. In *Neal v. United States*, 187 F.3d 626 (3<sup>rd</sup> Cir. 1999), the donor relinquished a retained power to avoid triggering the old § 2036(c), which was later repealed retroactively. See also *Berger v. United States*, 487 F. Supp. 49 (Pa. 1980) (rescinded gift not taxed); cf. Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Rescissions have generally relied on a retroactive change in law or bad advice; no case has been located based on a wrong guess of what the law would be in the following year. Perhaps the mistake in *Neal* of not knowing that § 2036(c) would be repealed retroactively is analogous to not knowing that the gift exemption would be increased substantially for the following year.

The notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. See Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Completing a rescission in 2011 of a 2010 transaction may still be recognized for transfer tax purposes.

## 7. State Estate Tax Planning in Light of \$5 Million Federal Exemption Under TRA 2010

While state estate taxes are considerably lower than federal estate taxes, they are still significant. Planning for domicile of the client will still be important. Formula clauses should be reviewed in light of the increased federal exclusion amount. Some clients may have opted previously to fully fund a bypass trust even though doing so would generate some state estate tax at the first spouse’s death. The client may have been willing to do that with a \$3.5 million federal exclusion but may not be willing to do that with a \$5 million federal exclusion. For example, if the state has a \$1 million exemption (which is the case for most of the states that have state estate taxes), paying state estate tax on the excess \$4 million would incur \$391,600 of state estate taxes in some states if the state tax is charged against the bypass trust (leaving a net funding of \$4,608,400) and would

incur \$444,091 of state tax if the state tax is not paid out of the bypass trust. A possible strategy to avoid paying this state tax is to fund the bypass trust with only the state exemption amount and rely on portability to take advantage of the balance of the first deceased spouse's federal exemption amount. However, as discussed in Item 1.f, there are a variety of uncertainties in relying on portability (not the least of which is that the portability provisions expire in two years unless renewed by Congress).

In states that allow a state-only QTIP election, planning to accommodate the increased federal exemption amount is more flexible. For example, in states with a \$1 million state exemption, the bypass trust could be funded with the state exemption amount (\$1 million), and a "QTIPable" trust could be funded with the remainder of the federal exemption amount (the remaining \$4 million). A state-only QTIP election would be made for the \$4 million trust. In this manner, the full \$5 million federal exemption is utilized without incurring state estate taxes at the first spouse's death.

Gift planning may also save significant state estate taxes, because gifts are not included in the state gross estate base. The ability to make a \$5 million gift without federal gift tax means that very substantial state estate taxes may be saved via gift planning. This is particularly important for deathbed planning. Query whether states that have state estate taxes will move toward enacting state gift taxes as a backstop to the state estate tax.

## **8. "Best Practices" Summaries of General Planning Ideas in Light of TRA 2010**

### *a. Bruce Stone Ideas.*

- (1) Send a letter to clients soon about portability. Why? Business generation. Tell clients that portability is an option, but don't recommend in the letter that the client use portability. Information about the portability concept will spread in the public press, and clients will appreciate hearing it from you. (Bruce agrees that it is better to use credit shelter trust planning rather than relying on portability.)
- (2) If a credit shelter trust is used, leave flexibility to obtain a basis step up if the surviving spouse has no estate tax concerns. Bruce prefers the simple drafting technique of giving an independent trustee the authority to make distributions to the spouse based on best interests. In Florida that also allows decanting to a trust with a power of appointment. He prefers avoiding the complexity of granting or removing general powers of appointment.
- (3) If a client made taxable gifts in 2010, don't give up on rescission. Don't cross ethical boundaries, but do not give up on rescission.
- (4) If a beneficiary is willing to make a disclaimer from a 2010 estate to result in a direct skip, don't give up if it appears that there may have been acceptance. See if it is possible to restore the status quo and then make the gift. Maybe couple the disclaimer with a rescission. (Dummies will do these things and not report them. Good planners should at least explore alternatives if there is a reasonable shot of being authorized by applicable law.)
- (5) Do not forget to elect out of the automatic allocation rules for 2010 direct skips.
- (6) If there are doubts about whether to make the carryover basis election, get ready to go to court now. It is possible that no extension will be possible on the time frame for making the election (when it is announced). There are innumerable potential

conflicts of interest. Get ready now to go to court to get court approval of the decision.

- (7) Look at what makes you happy in your practice and how clients fit into that.
- (8) Use arbitration clauses in estate planning documents to get out of the court system and get into arbitration.

b. *Carol Harrington Ideas.*

- (1) It is now possible to use the full GST exemption (or any amount desired of the available GST exemption) without paying gift tax.
- (2) Leveraging opportunities also work for GST exempt trusts.
- (3) Estate planners will have a very busy couple of years.
- (4) Where is the transfer tax going? The political situation is very unstable. Even if the estate tax is repealed it may not stay repealed. We could go back and forth in future years on how extensively the transfer tax applies. Change creates a lot of work for attorneys.
- (5) Life will be different for estate planners. We will not have “cookie cutter” plans like in the past.
- (6) Clients with estates in the \$5-\$10 million range will be the hardest estate to plan. \$100 million clients will be easy.
- (7) We may have a constant recycling of transfer tax laws in annual extender packages.
- (8) Will clients pay for all of this back and forth? If not, the courts will have to resolve ambiguities that are created.
- (9) There will be plenty to do — everybody stay calm.
- (10) Prediction — there will be much increasing unpredictability.

c. *Mil Hatcher Key Idea.*

- (1) Don't be paralyzed. This may be the opportunity of a lifetime. Mil doesn't think we will have estate tax repeal, and the estate tax bite in the future could be worse. There could even be a clawback of the excess gift exemption — but that just means there is a window of opportunity now to make transfers without current transfer taxation.

## 9. Undoing Prior Transactions In Light of Increased Exemptions

If the estate and gift exemption remains at \$5 million or higher on a long-term basis, many clients will have no perceived estate tax concerns. Indeed, clients may be interested in “undoing” some previous estate planning transactions. Some possibilities include the following.

- (1) *ILITs.* If there are no estate tax concerns, the client may be reluctant to continue feeding premiums to a life insurance policy in an ILIT. Should trustees notify the settler and beneficiaries of the increased \$5 million exemption? Keep in mind that trustees have fiduciary duties to the beneficiaries and disappointed beneficiaries may raise concerns. “Tread carefully and communicate with trust customers. Make individual choices and not wholesale decisions.”

- (2) *QPRTs*. Parents may want to stop paying rent to their children or to a trust that owns the residence. “Reverse QPRTs” (discussed further in Item 16.b) may become more popular.
- (3) *FLPs and LLCs*. Transfer tax reasons for implementing FLPs and LLCs may be eliminated. The client will have to weigh the non-tax advantages of these entities against the disadvantage of having discounts that will minimize basis step up.
- (4) *Grantor Trusts*. The grantor may wish to stop paying income taxes on the grantor trusts income by “toggling off” the grantor trust status. Even more than in the past, there may be a desire for the grantor to repurchase appreciated assets from grantor trusts in order to achieve a basis step up at the grantor’s death.

## 10. Decision of Electing Carryover Basis Regime Rather Than Estate Tax Regime for 2010 Decedents; Carryover Basis Issues

- a. *Have a Process*. The executor should have a checklist and a process for making the decision. Fiduciaries are not guarantors of results, but they must demonstrate that they exercise their discretion. Projections and assumptions in the analysis should be documented and shared with the affected parties. In a Uniform Trust Code state, consent can be obtained from the beneficiaries including by virtual representation. If consents cannot be obtained from the beneficiaries, get court approval. The fiduciary will be in the crosshairs of whoever is disappointed. There is time to accomplish this, but the key is having a process with a checklist approach, documentation in the file of the analysis, and consents or court approval.
- b. *In Many Estates The Decision Will Be Easy*. The decision will be easy and straightforward for many estates: (1) The taxable estate may clearly be under \$5 million (select estate tax regime); (2) The taxable estate may be well over \$5 million and the current estate tax will substantially exceed the ultimate income tax that will be paid on appreciation (select carryover basis regime); (3) The estate may have appreciation that can easily be covered by the \$1.3 million and \$3.0 million (if applicable) basis adjustments (bearing in mind that retirement benefits and other IRD assets cannot receive a basis step-up in any event) (select carryover basis regime); or (4) The estate may be only nominally above \$5 million with a great deal of appreciation that cannot be covered by the basis adjustments (select estate tax regime). (However, even in those “easy” situations, the executor must determine whether the election will change the amounts of bequests passing under the will.)
- c. *Factorss on Decision Making Process*. The executor will have to consider a variety of factors in making the election decision, such as
  - whether the election will change the amounts passing under formula bequests (including that the election will result in assets passing under the “alternate non-marital deduction manner” if the will contains a “Clayton marital trust”),
  - the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets (keeping in mind that income tax rates may *exceed* estate tax rates) (35% estate tax for excess over \$5 million vs. 15% rate [but for recapture items the income tax rates could be 25%, 28% or even 35% and the income tax rates may be expected to increase in future years]),
  - anticipated future capital gains rates (and ordinary income rates for “ordinary income property”),



- anticipated state income taxes (including determination of domicile of the beneficiaries and their personal income tax situations),
  - anticipated dates of sale,
  - anticipated cash needs of beneficiaries,
  - the character of the gain (for example, the Joint Committee on Taxation Technical Explanation (p.40) says that “real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir”),
  - whether depreciation can be used to derive current income tax benefits even without selling an asset,
  - ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future,
  - weighing the present value of anticipated income tax costs against the current estate tax amount,
  - determination of which beneficiaries bear estate taxes and comparison to persons who bear income tax attributable to lack of basis step-up,
  - the election will result in no benefit of a deduction against federal estate taxes for the payment of state death taxes,
  - the election will result in no § 691(c) deduction for estate taxes attributable to income in respect of a decedent property,
  - the election will result in no ability to use a prior transfer credit under § 2013,
  - whether the election will impact the ability to make a QTIP election for only state purposes,
  - whether aggressive positions would be taken on the estate tax return or have been taken on prior gift tax returns (and whether there is any question whether disclosures on gift tax returns satisfied the adequate disclosure regulations) that would be highlighted by filing an estate tax return,
  - without the election, *both* halves of community property would receive a full stepped-up basis, and
  - whether the expenses of administering the estate will be increased (by making or not making the election).
- d. *Basis Adjustments.* If the carryover basis system applies, the estate is entitled to the \$1.3 million basis adjustment for assets passing to any beneficiary and the \$3.0 million basis adjustment for assets passing to a surviving spouse or “QTIP-type” trusts. Sam Donaldson quips, this is “free-basing.” Beth Kaufman says “that must be a West coast thing.” Sam puts it that the \$3.0 million spousal adjustment applies “if you are lucky enough to have a client who died of being nagged to death.”
- e. *Possible Impact on Amounts Passing Under Will.* If the election is made, chapter 11 does not apply, so there is no “applicable exclusion amount.” Even if that changes the literal meaning of formulas, will the local court determine that the election made many months after the date of death changes the construction of the will? If making the carryover basis election changes the amounts passing under the will, this would be a very important factor the executor also has to consider in making the election decision. Some state laws provide that assets passing under a will vest as of the moment of death, subject to the administration of the estate. Does it make a difference if bequests have already been funded? If there is any possibility that the election may impact the amounts of bequests

under the will, attempt to get consents of all of the parties. (Equitable adjustments among the parties may be appropriate.)

One Wall Street Journal commentator observed: “There’s another word for an executor who gets to choose how much money a beneficiary receives — defendant.”

Twenty states (including the District of Columbia) have statutes regarding the construction of formula “tax-free” bequest clauses for 2010. Eighteen of those state statutes refer to estate tax rules on December 31, 2009. Florida and South Carolina have “go-to-court” statutes that do not specifically apply 2009 law. Will formula “tax-free” bequests in those states mean that \$3.5 million continues to pass under the clause rather than \$5 million that could pass without estate tax under TRA 2010? Most of those state statutes say that the special construction applies only for 2010 decedents, but if the federal estate or generation-skipping transfer tax becomes effective before January 1, 2011, the statute will no longer apply as of the date the tax becomes legally effective. If the carryover basis election is made, does that mean the estate tax was not “legally effective” before the date of death, so the \$3.5 million construction continues to apply rather than having the statute sunset? If so, the tax-free formula bequest may be \$5 million if the estate tax applies but \$3.5 million if carryover basis applies. (A bill was introduced January 20, 2011 in Virginia providing that, among other things, [1] the formula in a will or trust would mean \$5 million, whether or not the carryover basis election is made, [2] that extrinsic evidence would be admissible for 2010 decedents to determine the testator’s intent in a proceeding commenced any time before January 1, 2012, even if it contradicts the plain meaning of the document, and [3] that interested persons may enter a binding agreement regarding the construction of the instrument and may seek court approval of the agreement.)

- f. *Holding Period.* The holding period is not automatically long term under § 1022, but there is tacking of the decedent’s holding period if the basis is determined in whole or in part by reference to the decedent’s basis. However, the basis is the *lesser* of the decedent’s basis or fair market value, and if the asset is depreciated and the basis equals the fair market value at death, there may be no tacking of the decedent’s holding period. That has been the position of the IRS in the past in other contexts, but we do not know if the IRS will apply that same argument in the context of the carryover basis regime.
- g. *Adjustments to \$1.3 Million Basis Adjustment.* The \$1.3 million amount is increased by net operating losses and capital loss carryovers. These generally would appear on the decedent’s final Form 1040. A complexity is that if there is a joint return, the surviving spouse may have gains that offset some of the losses and there is no guidance on how to determine the decedent’s share of the losses.

In addition, the \$1.3 million amount is increased by any losses that would have been allowable under §165 if the decedent’s property had been sold at fair market value before the decedent’s death. Section 165 allows both business losses and investment losses, excluding only personal losses. The adjustment for depreciated business and investment property can be quite significant, probably a much bigger factor than the adjustment for net operating losses and net operating loss carryovers. It is not clear how this rule will apply to passive losses. They would be deductible under § 165 so they would seem to increase the \$1.3 million amount. However, § 469(g)(2) describes how unused passive losses at death are treated, and the §1022 and § 469 treatment is inconsistent. Fortunately, both sections grant full regulatory authority to the IRS, so the IRS will need to provide guidance.

- h. *IRS Guidance is Coming.* The Treasury and IRS have indicated that their highest priority in the transfer tax area is providing guidance for 2010 decedent's estates. (There are indications that guidance will be provided in Publication 4895 for deaths in 2010.)
- i. *Community Property.* Both halves of community property can qualify for receiving basis adjustments and are subject to the modified carryover basis system (i.e., subject to a potential reduction in basis for depreciated assets). If there is substantial appreciation in community property, being able to get both halves of the community property stepped-up may be critically important in the election decision.

## 11. Treasury-IRS Priority Guidance Plan

- a. *Little Action in 2010.* Only one item on the 2009-2010 list was acted upon – repealing §2511(c). The IRS was burdened by the same problems as the rest of us; the uncertainty was paralyzing. They tried to get out guidance for 2010 decedents, and then Congress changed all the rules.
- b. *Highest Priorities.* IRS and Treasury officials have indicated informally that their number one priority is publishing guidance for 2010 decedents. Their number two priority is now giving guidance regarding portability, even though it is not on the 2010-2011 Priority Guidance Plan.
- c. *Carryover Items.* Among the carryover items from the prior year are the following: (1) Charitable lead trust ordering rules and adjustments to charitable lead trust sample forms; (2) effect of substitution powers under §2042 (despite the *Jordahl* case, it is safest to except life insurance from substitution powers until the IRS issues guidance); (3) protective claims for refund guidance; (4) §2053 – effect of guarantees and applying present value concepts; (5) private trust companies guidance; (6) § 67(e) final regulations regarding the 2% “haircut” rule exception for estates and trusts; and (7) § 7477 final regulations regarding declaratory judgment procedures for gift tax valuation issues.
- d. *Private Trust Companies.* This has been on the action plan since 2004. Notice 2008-63 issued a proposed Revenue Ruling dealing with two situations. The IRS received many comments, some of which were inconsistent. The IRS now feels that the conflicts between state partnership laws and provisions that they were going to require for the documents are not consistent in all states. They are going back to the drawing board to outline what would be acceptable where there is no state statute governing private trust companies. This guidance is far from being completed.
- e. *Section 67(e) — Haircut Rule Application to Investment Management Fees and Trustee Fees.* In *Knight v. Commissioner*, 128 S. Ct. 782 (2008), the Supreme Court rejected Judge Sotomayor's reasoning in the Second Circuit case (*Rudkin*) that “would equals could” and that the §67(e) exception for trusts applies only if a particular expense “could not” be incurred by taxpayers other than trusts or estates. (The Supreme Case was unanimous; query whether it would have been an 8-1 decision or at least had an additional concurring opinion had Justice Sotomayor been on the Court?) In light of the Supreme Court's reasoning, it would seem that the §67(e) proposed regulations will need to be substantially changed. The IRS has not yet issued an extension for 2010 returns relieving trustees from having to separate out trustee fees between unique and non-unique categories. We anticipate that the extension will be issued again for 2010 returns unless the IRS issues its final regulations in the near future.

- f. *Declaratory Judgment Procedures for Gift Tax Issues.* We are awaiting final regulations under §7477 (added in 1977), which empowers the Tax Court to issue declaratory judgments regarding the value of gifts (including the use of unified credit) even if no gift tax is owed. This issue is becoming more important with the gift exemption going to \$5 million. Before §7477 was adopted, there was no recourse if an IRS audit revalued a gift, thus requiring more use of the gift tax unified credit, if the audit did not result in the imposition of gift tax. (This procedure is only available in the Tax Court, not district courts.)

## 12. Decanting

- a. *No Ruling Position.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 is the annual “no ruling” revenue procedure. It adds “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. The specific relevant sections of the Revenue Procedure include § 5.09 (whether decanting distributions qualify for a distributions deduction under § 661 or are included in income of the recipient under § 662), 5.16 (whether decanting is a gift under §2501), and 5.17 (whether a decanting distribution results in the loss of GST exempt status or constitutes a taxable termination or taxable distribution under §2612).
- b. *Should Planners Continue Decanting Transactions?* In a private letter ruling pending since the summer of 2010, the IRS is saying that it will not rule because decanting is involved. The Service makes no distinctions whether the decanting is specifically authorized in the trust agreement or not. There is no decanting project on the Priority Guidance Plan, but we will likely see one in the future. Whether to proceed with a decanting transaction at this point depends upon the differences in the trust terms. If mere administrative provisions are being changed, that should not cause a problem, even though it is not possible to get a ruling. If the decanting transaction affects distributions, various adverse tax consequences are possible, and planners should be wary.

## 13. Defined Value Clause Updates

- a. *Petter on Appeal; Another “McCord”-Type Case Pending in Tax Court.* *Petter v. Commissioner*, T.C. Memo. 2009-820 upheld classic defined value clauses that allocated blocks of LLC units in gift and sale transactions between grantor trusts for the family and charities. The court held that the clauses did not violate public policy for various reasons. That case is on appeal to the 9<sup>th</sup> Circuit Court of Appeals. (The 8<sup>th</sup> Circuit Court of Appeals has previously upheld a formula disclaimer that operated much like a defined value clause. *Estate of Christensen v. Commissioner*, 586 F.3d 1061 (8<sup>th</sup> Cir. 2009).)

There is another McCord-type case by John Porter that is pending in the Tax Court. *Hendrix v. Commissioner*, Cause No. 10501-03. In that case, the parents gave (with a net gift) and sold stock in a C corporation to trusts for their children. As indicated by the cause number, the case was first filed in 2003 (and apparently delayed until the *McCord* result was determined). The IRS argued that the McCord-type defined value clause was invalid because it created a condition subsequent and violated public policy. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord*, but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The case was tried before Judge Paris in

December 2008 and the parties are still awaiting decision over two years later. The delay may suggest that this will be a reviewed decision.

- b. *Possible Methods of Reducing Gift Risk Due to Valuation of Hard to Value Assets.* Possible approaches include using (1) a GRAT, (2) net gifts, (3) defined value formula clauses (either defining the transfer or defining the consideration received), or (4) an incomplete gift approach combined with a defined value transfer clause.
- c. *GRATs.* GRATs avoid valuation risk because of the provision in the regulations recognizing that the annuity amount can be described in terms of a percentage of the initial value transferred to the trust. This protects against unforeseen gift risk on the creation of the GRAT. The GRAT is the only “bullet proof” method. (However, John Porter describes a recent audit in which the business was sold for substantially more than the value when it was contributed to the GRAT. The examining agent, who is very knowledgeable about GRATs, stated that the IRS is considering taking the position that the donor or so undervalued the property when contributed that she violated the spirit of § 2702, so the donor’s retained annuity was not a qualified annuity interest under § 2702. The valuation issue was ultimately resolved and the IRS dropped that “spiritual” argument.)

A problem with GRATs is that the cash flow may be insufficient to support the annuity payments without using a very long-term (which increases the actuarial risk of dying during the GRAT term and causing estate inclusion). A shorter term could be used with in-kind distributions, but the valuation of assets used to satisfy the annual annuity payments is not protected by the GRAT “savings clause” feature in the regulations.

The following is a method of protecting against valuation risk and making the annual annuity payments from a GRAT. Make a gift using some of the \$5 million gift exemption amount to a second trust (the “remainder trust”) that is the pourover recipient of the GRAT at the end of the GRAT term. When an annuity payment is due after one year, the GRAT will borrow cash or other investment assets from the remainder trust and pay the annuity with those assets. After two years the GRAT terminates and passes to the remainder trust subject to the debt, and the debt would be extinguished. In this manner, the hard to value asset is moved to the remainder trust without any gift risk at all. (Disadvantages to that approach: (1) estate inclusion if the donor dies during the GRAT term; (2) GST exemption cannot be allocated until the end of the GRAT term; (3) a key advantage of the GRAT is the ability to shift much of the future appreciation/income of the contributed asset without using any gift exemption and this strategy will require using substantial gift exemption; and (4) the GRAT transaction has a built-in interest factor equal to the §7520 rate which is higher than the intrafamily short and midterm loan rates.

- d. *Net Gifts.* If the IRS re-values the gift, the net gift donees will have significantly reduced gift tax and penalties compared to what the donor would have owed without a net gift arrangement.
- e. *Defined Value Clauses.* Clauses defining the amount transferred were used in *McCord* and *Petter*. It should also be possible to use a formula clause defining the consideration based on the value of a fixed property interest as finally determined for federal gift tax purposes. (As an example of a defined consideration approach, the parent might give \$200,000 cash to a trust and loan an additional \$2 million, which the trust would use to acquire a \$2.0 million two-year Treasury Note. Parent might subsequently sell Blackacre to the trust in return for a fraction of the Treasury Note; the numerator of the fraction would be the

value of Blackacre as finally determined for federal gift tax purposes and the denominator would equal \$2.0 million.)

f. *Structuring Defined Value Clauses.*

- (1) *Spillover Arrangement Preferred.* If there is any excess value, does the excess go to the transferor or to someone else? The successful reported cases have involved “spillover” type transactions. A properly structured defined value “transfer” clause should work, because property does not really “return” to the transferor but all that is transferred in the first place is a fraction of a larger piece of property. However, the more conservative approach is to use the “spillover” arrangement.
- (2) *Who to Use as Spillover Recipient.* The excess value would pass to some person or entity that would not have gift tax consequences. Possibilities are a charity, a GRAT, the donor’s spouse, a QTIP trust for the donor’s spouse, or an incomplete gift trust. The reported cases so far have used a charity as the spillover entity. John Porter prefers using the charity approach. Several cases have mentioned a public policy favoring charities. In addition, they are independent parties and owe duties to assure that they are receiving proper value under contractual arrangements. John Porter’s next preferred spillover is a GRAT. Remainder beneficiaries of the GRAT should be different than the beneficiaries of the grantor trust that is the original donee of the defined value transfer. In addition, use an independent trustee who has a fiduciary duty to assure that the GRAT is receiving its appropriate number of units under the formula transferor. Using the spouse or a QTIP trust is not as favorable because the excess “spillover” value will be included in the spouse’s gross estate and there are no independent parties reviewing the appropriate values under the formulas.
- (3) *Some Property Should Pass To Spillover Transferee.* Some significant property should pass to the spillover transferee even if the assets are not revalued by the IRS. The spillover transferee will not meaningfully participate in the negotiations regarding the proper number of units passing under the formula transferor unless it thinks that it will receive significant value. This is not essential but it provides a more comfortable arguing position.
- (4) *Consider Leaving Some Percentage of “Excess Value” to Spillover Transferee.* For example, the formula could be structured to leave 1% or 2% of any excess value upon a revaluation to the trust resulting in additional taxable gift. This would help counter a “mootness” argument under *Procter*. However, there was no additional taxable gift produced by the operation of the formula in the successful *McCord* or *Petter* cases.
- (5) *Method of Valuing Property For Purposes of Applying the Formula.* If the property is valued by an appraiser, that does not eliminate any gift tax risk. One approach would be for the transferees to come to agreement as to the number of units passing under the formula (as in *McCord*). The other approach is to use values as finally determined for federal gift tax purposes. The first approach shifts the gift tax risk to a later time (if a family member agrees upon a value resulting in too few units passing to that person or trust). If a charity and is involved there is no gift tax risk, but the charity runs into potential problems with the state attorney general or there could be self-dealing problems if it is a private foundation. Using

values as finally determined for federal gift tax purposes protects both the transferor and transferee from gift taxes. That was used in *Petter*.

John Porter likes both approaches. The *McCord* approach runs the risk of shifting units away from the family trust based on what the charity does. The *Petter* (as finally determined for federal gift tax purposes) approach runs the risk of shifting additional units away from the family trust based on what the IRS does.

- (6) *Buying Out Charity's Interest.* Is it permissible for the trust to purchase the charities interest before the gift tax audit is completed? John Porter would prefer not. However, it should be permissible if the charity approaches the family rather than vice versa about selling its interest for a fixed sum rather than not knowing for sure what it owns until a gift tax audit is completed years later.
  - (7) *Income Tax Reporting.* If the various transferees are all grantor trusts (for example, if a GRAT is the spillover transferee), income tax reporting is simplified – everything appears on the grantor's income tax return. If the income is reported by separate taxpayers, and one party is later determined to have reported excess income, there may not be the ability to amend a return and get a refund, even if the statute of limitations has not run. The taxpayer appeared to be entitled to the income at the time, and she had an obligation to report income on her return. Perhaps §1341 can help. If an item of income is included in gross income in a prior year because it appeared as if the taxpayer had a right to it but it is determined that she did not, there is a special way to calculate income tax in the subsequent year to provide relief. However, §1341 only applies if in the subsequent year she is entitled to a deduction for the obligation to return the income previously received under the claim of right, and it is not clear what that other section would be in this situation. John Porter said they are facing that issue in *Petter*.
  - (8) *Qualified Appraisal Important.* It is important to obtain a qualified appraisal. It satisfies the adequate disclosure regulations, and helps rebut an IRS argument that the taxpayer is just trying to win the audit lottery with a defined value clause used in conjunction with a “low ball” appraisal.
- g. *Incomplete Gift Trust Approach.* If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. See *Gibbs v. Comm'r*, T.C. Memo 1997-196. A concern with this approach is that the full appreciation in the asset that is “sold/given” to the trust would be included in the grantor's gross estate, less a § 2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth \$1 million, the formula could transfer a fraction of the asset with a numerator of \$1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

## 14. GRATs Planning Creative Strategies

An outstanding presentation full of creative ideas was presented by Stacy Eastland, Carlyn McCaffrey, and Pam Schneider. The following creative ideas come from them.

a. *Reducing Mortality Risk.* If the grantor dies during the initial GRAT term, much if not all of the value in the GRAT will be includable in the grantor's gross estate under § 2036.

(1) *Fund Life Insurance Trust.* One possible strategy to reduce the mortality risk element would be to have the client create and fund an insurance trust that would pay off if the grantor died during the initial GRAT term to offset the estate tax cost.

(2) *Purchase Remainder Interest.* Another possible strategy would be to have the grantor purchase the remainder interest in a profitable GRAT from the remainder beneficiaries before the GRAT terminated. Revenue Ruling 98-8 treated a similar sale of the remainder interest from a QTIP trust as a being the equivalent of a commutation. (The IRS gave so many reasons in that ruling that it was apparent that the IRS was struggling with a reason that worked. The main rationale in the ruling was §2519, which obviously would not apply outside the context of a QTIP trust.) The IRS could assert that this transaction is a prohibited commutation, but it is hard to understand how a commutation can occur without action by the trustee.

If the remainder purchase occurred after the statute of limitations had closed on asserting additional gift taxes with respect to the creation of the GRAT, it may be very difficult for the IRS to attack this transaction. (It would seem that the IRS's only argument would be fraud, on the basis that there was a plan from the initial creation of the GRAT to do something that was not allowed. "There should not be a memo in the file suggesting that the remainder be purchased back after four years.")

(3) *Sell Annuity Interest.* A third possible strategy is for the grantor to sell his or her annuity interest in the GRAT to the remainder beneficiaries. A transfer of a retained interest that would trigger § 2036 if held until death generally is subject to the three-year rule of § 2035(a), but a sale for full consideration is exempt under § 2035(d). Again, the IRS could argue this is a prohibited commutation; a counter argument would be that the trustee is not involved.

(4) *Creation of GRAT For Full Consideration.* If the remainder beneficiary pays full value for its interest, there does not appear to be any transferred that would trigger § 2036. See further discussion of this alternative in paragraph b.(4) below.

(5) *Creation of 99-Year Term GRAT.* Turney Berry has suggested the following transaction, which Carlyn McCaffrey finds very intriguing, but she has not yet used it within any clients. Create a 99-year GRAT. With that longer term, the annual annuity payments will be very small. With a 2.4% §7520 rate, the annual annuity would only be 2.6536% of the initial value. Even though the client will not outlive the GRAT, it is likely that much of the value will not be includable under §2036. First assume the § 7520 rate remains constant. If \$1 million is initially contributed to the GRAT, the most that would be included in the client's estate under § 2036 would be \$1.1 million if the section 7520 rate remains at 2.4% at the client's death. ( $\$1 \text{ million} \times .026536 = \$26,536$  annual annuity and



\$26,536/.024 = \$1,105,664). All appreciation above that would be removed from the gross estate. Alternatively, assume the value stays constant but the § 7520 rate increases from 2.4% to 5.0% at the grantor's death. The amount included in the estate would be about 53% of the initial value contributed to the trust. In the above example, with a \$1.0 million initial contribution and a \$26,536 annual annuity, the maximum amount includable under § 2036 would be \$26,536/.05, or \$530,720. Again, all of the GRAT value in excess of that would have been removed from the gross estate. Indeed, it is likely that both things would happen, resulting in a dramatically decreased maximum amount that could be included in the grantor's gross estate under § 2036.

There are various complicating issues with this strategy. First, realize that provisions must be made for paying the estate tax out of assets other than the GRAT.

Next, how would family members benefit from the GRAT after the grantor dies? Perhaps the GRAT could be collapsed by bequeathing the annuity interest to the same party that holds the remainder interest, so that there would be a merger of interests under state law. Would that be a prohibited commutation? If the GRAT remains in effect for 99 years, this transaction would only be attractive to someone who wants to benefit beneficiaries three or four generations below the grantor, because no one would receive anything out of the trust for 99 years more than the very small annual annuity payments. For that reason, this type of trust might be structured as a "split purchase" type of transaction (described in paragraph b.(4) below) with a GST exempt trust originally contributing the value of the remainder interest. Of course, who can have any idea what the estate and GST laws may look like 99 years from now.

b. *GST Planning With GRATs.*

- (1) *ETIP Issue.* The ETIP rule generally prevents allocating any GST exemption until the end of the initial GRAT term. Some have questioned if there is a 5% exception that would allow grantor's age 70 or younger to create a two-year GRAT that is not subject to the ETIP rule. *See* Treas. Reg. § 26.2632-1(c)(2). However, even if that is the case, there is no certainty about how much GST exemption would have to be allocated to fully cover the transfer to the GRAT. It may well be that GST exemption would have to be allocated to the full value transferred to the GRAT, so as a practical matter this possible exception is not useful.
- (2) *Elect Out of Automatic Allocation Because of Possible 5% Exception to ETIP Rule.* Because of the 5% possible exception, it is possible that there would be automatic allocation of GST exemption equal to the full amount contributed to the GRAT under § 2632(c) when the GRAT is created. As a result, Carlyn McCaffrey routinely sends a memo to clients who are creating GRATs telling them to report the transfer on a gift tax return and to elect out of automatic allocation of the GST exemption on that gift tax return.
- (3) *Indirectly Profiting a GST Trust Where the Remainderman of a GRAT is Not a Skip Person.* Assume a grandmother creates a GRAT with the daughter as remainder beneficiary at the end of the GRAT term. Sometime later, but before the remainder appreciates in value significantly, the daughter creates a grantor trust for her children and gives the remainder interest in the GRAT to that separate trust.

(That is not a GST transfer because the daughter is creating a trust for one generation below herself.) Before the GRAT terminates, the daughter buys the remainder interest back from the grantor trust. When the GRAT term ends, the daughter receives the remainder proceeds from the GRAT. The daughter is not a skip person, and the payment to her is not subject to the GST tax. Her payment to the grantor trust to buy back the remainder interest is not subject to GST or gift tax – she was just buying the asset for its full value.

A refinement of this approach would be for the daughter to sell her remainder interest to the grantor trust initially instead of giving it. That allows an argument that the daughter is not a “transferor” for GST purposes, because it was not a transfer subject to the estate or gift tax. If there is no “transferor,” under the GST rules there can be no skip person beneficiary and the entire world would be a non-skip person.

This would be difficult for the IRS to attack because the GRAT assets in fact pass to the daughter and do not pass to a skip person. However, the grantor trust for the benefit of the daughter’s children receives the economic benefit of the GRAT value.

- (4) *Creation of GRAT For Full and Adequate Consideration.* Assume a client created a GST exempt grantor trust some years ago and it now has \$2 million. Client and the GST exempt grantor trust together create a GRAT, with the client contributing \$21 million in return for the term annuity interest and the grantor trust contributing \$2 million for the remainder interest. Section 2035 should not apply even if the grantor dies during the trust term, because there was no “transfer” by the grantor to any other person – the GST exempt grantor trust paid full value for its interest. (That is why it is important to use in “old and cold” trust, so that the consideration paid by the grantor trust is not indirectly a gift from the client.) The creation of the GRAT did not result in a transfer from the client to the GST exempt trust, because the trust paid full value for its interest. When the GRAT terminates and passes to the grandchildren’s trust, that might look like a taxable termination. However, it seems that there is no “transferor” with respect to that transaction, because the assets passing to the GST exempt trusts did not result from a transaction subject to the gift or estate tax.

This transaction may seem too good to be true. There is obviously a huge premium on getting the values right. If the values are off by even a penny, the full consideration exception would not apply, and there would be a “transferor” for GST purposes.

A twist that would help with the valuation question would be to have the client and grantor trust contribute interests in the same entity (for example an interest in a family limited partnership or LLC). Values would be proportionate to the units transferred by each party.

A further twist is to structure the grantor trust that is paying for the remainder interest so that there are non-skip beneficiaries of that trust. In that situation, there would be no GST tax due at the end of the initial GRAT term in any event.

In this type of split purchase transaction, the annuity payments should be structured so that the remainder trust pays significant consideration for its interest.

There would be real economic substance to the transaction, so that the rationale of the *D'Ambrosio*, *Magnin*, and *Wheeler* “sale of remainder interest” cases would apply.

Jonathan Blattmachr has written about this type of transaction referring to it as a “SPLAT” (split purchase annuity trust).

- (5) *Exempt Trust as Remainder Beneficiary; Purchase of Trust's Interest Before End of GRAT Term.* Assume a GST exempt grantor trust is the remainder beneficiary of the GRAT, but before the end of the GRAT term, the grantor's spouse purchases the remainder interest from the GST exempt grantor trust. The purchase from the grantor trust would be income tax-free because it is between the grantor's spouse and the grantor trust. At the termination of the GRAT, the assets pass to a non-skip person, so there would seem to be no GST consequences.
  - (6) *Transfer of Economic Equivalent of Remainder Interest Value.* Create a GRAT with a GST non-exempt trust as the remainder beneficiary. An existing GST exempt trust would enter into a contract with the non-exempt trust agreeing to pay \$x dollars today in return for a promise by the nonexempt trust to pay an amount equal to the value of the remainder interest at the end of the GRAT term. The exempt trust never actually receives the remainder interest from the GRAT, but is paid the equivalent value by the non-exempt trust. It would seem that there would not be a taxable distribution or taxable termination at the end of the GRAT term. “That's got a substantial opportunity for working.”
  - (7) *Omit Spendthrift Provision.* A number of these strategies depend on being able to transfer interests in the GRAT by one party or another. In drafting GRATs, do not include spendthrift clauses that prohibit transfers of interests in the GRAT.
- c. *Reverse Freezes.* A client may transfer a preferred interest in a partnership with a coupon rate of say 11% to a GRAT. Because the coupon rate greatly exceeds the §7520 rate, there is a very strong likelihood that substantial value will be transferred at the end of the GRAT term. This would also be advantageous in the event that we eventually have 10 year minimum terms for GRATs. This type of asset would avoid the long-term exposure to depreciation can occur in a ten-year GRAT. Because of potential income tax complications, it would be preferable if all of the parties to the partnership were grantor trusts or disregarded entities.
- d. *Derivatives.*
- (1) *Hedging GRAT Success.* Using hedging transactions may increase the likelihood of some significant value passing at the end of the GRAT term. In return, the client would give up the possibility of passing value in excess of a predetermined amount.
  - (2) *Derivatives That Move In Opposite Directions.* As an example, someone might buy a call option to acquire a stock if it goes above a certain price. That can be a volatile transaction — the potential gain compared to the cost of the call option may be a much larger percentage gain than if the person bought the stock directly and it increased in value by that same amount. By buying and selling call options within a range of future price levels, the person can “collar” the transaction to reduce the risk. To further ameliorate the risk the person might enter into a similar derivative transaction with another stock that correlates closely with the first stock but hedge that second transaction so that it would succeed if the second stock goes

down in value. Sophisticated investors use these types of transactions as investment vehicles. Volatile assets are perfect for GRATs. The individual might contribute the derivatives of one side of that transaction into a GRAT. However, the individual should keep the derivatives of the second transaction — don't get greedy and contribute both sides into separate GRATs so that there is almost a guarantee that one of the two GRATs will be successful. Obviously put the side that the individual thinks has the greatest likelihood of success into the GRAT and keep the other side.

- e. *Leveraged GRAT.* This strategy introduces leverage into a GRAT transaction, so that it has the leveraging characteristics of sale to grantor trust transactions. A simple straightforward of introducing leverage would be for the GRAT to borrow as much possible and invest the borrowed proceeds in assets with appreciation potential. There would be the increased possibility of “hitting a home run” but also a greater risk that the GRAT would implode and that the GRAT would be “underwater.” While that transaction might have a greater likelihood of transferring significant value from the GRAT, it also has high economic risks for the family.

Another way to introduce leverage is use an existing family investment entity, and leverage that vehicle within the family (but not introducing the added economic risk to the family of outside leverage), so that the net equity value contributed to the GRAT is substantially lower, resulting in much lower annuity payments that hopefully can be satisfied out of cash flow if the GRAT has a long enough term.

For example, assume client owns an interest in an FLP.

- a. The client might contribute 10% of the LP units to an LLC in return for units in the LLC, and sell 90% of the LP units to the LLC in return for a 9-year balloon note.
- b. The net equity value of the LLC would be represented by the value of the 10% contributed as a capital contribution. The value of the LLC would be based on the discounted value of the LP units.
- c. The capital interest in the LLC (representing 10% of the value of the total LLC assets) would be contributed to a 10-year GRAT. Because of the discounted value of the LP units and because of the 9-1 leverage of the LLC and because of the ten-year term, the annuity payments may be low enough that the cash flow from the FLP to the LLC and from the LLC to the GRAT may be sufficient to pay the annuity payments in cash.
- d. At the end of the 10-year GRAT term, it would then own all of the capital interests in the LLC.

Carlyn McCaffrey indicated that she thinks this is an excellent idea and she has “used it a lot recently.” It can work particularly well if the client wanted to transfer interests in a private equity fund. The client typically has both a “carry interest” and an “investment interest.” The client would contribute both the carry and investment interest to a single member LLC (that is a disregarded entity), partly as a capital contribution and partly as a sale for a note (9-1 ratio). Transferring both the carry and investment interests avoids the application of section 2701. The capital interest in the LLC would be contributed to the GRAT.

This is somewhat comparable to a gift and sale to grantor trust transaction. The leveraged GRAT is better in that the client does not have to use up any significant amount of gift exemption. If the assets do not perform, nothing is transferred to family members via the

GRAT, but there is also no wastage of gift exemption (which can occur under a sale to grantor trust transaction if the assets in the grantor trust decline below the amount of the note).

## 15. Improvements and Alternatives to Incentive Trusts — Results Oriented Trust Environment and Financial Skills Test

- a. *Novel Approach.* A fascinating and intriguing novel approach to trust drafting and an alternative to incentive trusts was presented by Jon Gallo, Eileen Gallo, Ph.D, and James Grubman, Ph.D. A sample form illustrating their suggested approach is included (with their permission) in Appendix A of this summary.
- b. *Fundamental Flaw of Incentive Trusts.* Incentive trust provisions are those provisions in the trust that the grantor has decided to use to motivate the beneficiaries (some of whom are not yet born) to engage in behaviors and have values of which the grantor approves. The grantor has decided to use the presumed power of money to accomplish that result.

Decades of research, with over 100 published studies, reflect that money is good at *controlling* but not good at *motivating*. Control is external, motivation is internal. Indeed, money is a de-motivator in many situations.

One of the best studies is by the Federal Reserve Bank of Boston. It reaches the following conclusions regarding the effect of money as a motivator in business contexts. (1) Money is a good behavioral incentive, only if the behavior is repetitive and boring, but not for cognitive skills that involve reasoning. In fact, money was found to be counterproductive for those higher-level skills. (2) Money incentives may work too well; they may be a great motivator of behaviors that the employer wants to de-incentivize, leading to unethical behavior to game the system. (3) There is often little correlation between behaviors that are being encouraged and the goals desired. For example, working while going to college does not lead to good money management or a good work ethic.

Another study examined the effects if the money involved were so great that it could alter the person's lifestyle. The study was in India, where enough money could be offered in the study to materially alter the lifestyle of participants. There were 87 participants in a village, divided into three groups. Each group had to accomplish nine goals, six involving cognitive skills and three involving routine activities. Group 1 could earn one day's pay for achieving the goals. Group 2 could earn two weeks' pay. Group 3 could earn six months of income. There was no discernible difference at all between Groups 1 and 2. Group 3 did *worse* in eight of the nine activities, including every one of the activities involving reasoning, judgment, and cognitive skills.

A study in 1908, which resulted in what has come to be known as the "Yerkes-Dodson Law," concluded that if an activity that is supposed to be work is made interesting and challenging and fun, people will do better at it. Vice versa, if an activity is made work by attaching money to it, people will do worse at it. (This is also referred to as the Tom Sawyer Effect, by reference to Tom's getting friends to paint the fence that he was supposed to paint by convincing them that it was a game.)

- c. *Construction of Incentive Trusts.* Three possible approaches are available: (1) Absolute discretion; (2) Listing approach; and (3) Behavioral benchmarking.

The absolute discretion approach can provoke resentment. The relationship with the trustee feels to the beneficiaries like an extension of the parent-child relationship.

The listing approach requires listing very detailed activities and behaviors. It necessitates a high degree of specificity. Resources include Nancy Henderson, *Managing “Carrot and Stick” Provisions: Selected Fiduciary Issues in Drafting and Administering Trusts with “Incentive” Provisions*, ALI-ABA Course of Study, Representing Estate and Trust Beneficiaries and Fiduciaries (2008); Joshua Tate, *Conditional Love: Incentive Trusts and the Inflexibility Problem*, 41 REAL PROP., PROB. & TR. J. 445 (2006) (concluding that incentive trusts pose an inflexibility problem because the settlor cannot foresee all potential eventualities and take them into account).

The behavioral benchmarking approach argues against a rigid listing of activities, but uses principles that are not hard and fast rules but offer guidance to the settlor’s values and principles. David Handler & Alison Lothes, *The Case for Principle Trusts and Against Incentive Trusts*, TR. & EST. (Oct. 2008). The authors find this a welcome contribution, but believe that some of the benchmarks are so subjective that both the trustee and beneficiaries lack guidance as to how the benchmark is to be met. (Is buying a 60 inch TV “wasteful spending” but buying a 42 inch TV is not?)

- d. *Behaviors Are Not Necessarily Related to Goals.* If the client’s goal is to motivate heirs to be responsible and productive, does encouraging graduating from college and obtaining full employment achieve that goal? We all know of college graduates who are compulsive over-spenders who have to be bailed out by their parents repeatedly. The same thing exists for full time workers.
- e. *“ROWE” and “ROTE.”* A classic motivational business approach is known as “Results Oriented Work Environment.” It was invented by the Best Buy HR department and has been implemented by various other businesses. The general approach is that employees can do whatever they want when they want — as long as the work gets done. There are no fixed hours or work times — just look at the results. The authors suggest a new approach to trust drafting for clients that want incentive-type trusts. They call it “ROTE” — Results Oriented Trust Environment. The approach focuses on the beneficiaries obtaining specific results (financial skills), not on behaviors that do not necessarily correlate with those financial skills.
- f. *General Structural Elements of Financial Skills Trust Approach.*
  - (1) *Discretionary Trust.* The trust uses largely discretionary distribution standards. The trust agreement will identify what types of distributions the financial skill element impacts. For example, the trust might provide for making distributions to provide a basic safety net with a minimal amount of income and with provisions for health needs, but additional distributions may be a function of the beneficiary demonstrating growth in acquiring the specified financial skills. Another approach would be to provide mandatory income distributions with discretionary principal distributions based on demonstrating the financial skills.
  - (2) *Mission Statement.* The trust will have a clearly stated outline of the trust mission statement including the settlor’s goals and the general operational pattern. This should articulate what “living within one’s means” means for the family. Professor Ed Halbach, Jr. suggested this approach 50 years ago:

“Too frequently the trust instruments provide no guidance as to the purpose and scope of the power. [The trustee] should be informed of the purposes of the trust, the factors he is to consider, and something of the

general frame of mind in which the settlor wishes him to act.” Edward Halbach, Jr., *Problems of Discretion in Discretionary Trusts*, 61 COL. L. REV. 1425 (1961).

- (3) *Guidelines Focused on Results of Beneficiary’s Demonstrating Financial Skills.* Elaborate the mission statement by delineating guidelines, but not requirements, focused on the results of the beneficiary’s learning and demonstrating money-management skills, results that the trustee takes into consideration when deciding whether to make discretionary distributions.
  - (4) *Transparency.* A key is having open communication of the trust’s provisions so that both the trustee and beneficiary know the guidelines and how trustee discretion may be exercised. “Make it as transparent as possible so the beneficiary does not have to mind read the trustee, and the trustee does not have to mind read the settlor.” The Financial Skills Trust provides much more transparency than an incentive trust, and it helps prepare beneficiaries for handling money.
- g. *Fundamental Paradox.* A fascinating paradox is that the primary aim is not to develop the specific financial skills described in the trust agreement, but to achieve a general goal of a beneficiary keeping out of money problems and living within his or her means. That overall goal will occur as a result of developing the specific skills, but achieving the skills themselves is not the ultimate goal.
- h. *Focus On Skills, Not Values; Avoids Judgmental Decisions Because of Objective Guidelines.* The financial skills (described below) are very objective. This avoids the trustee meddling into the beneficiary’s life choices including choice of career, spouse, employment, education, etc. The emphasis of this approach is about obtaining skills (possibly through training and education with trust resources) and not about values.
- Car analogy: Assume that a trust owns a really nice car. Under an ascertainable standard approach, the beneficiary must address why she needs the car. Under an incentive trust approach, the beneficiary may be entitled to receive the car by getting a college degree or making a certain amount of income. With a financial skills trust approach, there is only one question — “Can you drive?”
- “There are many paths that lead to the top of the mountain. The focus is on results and not controlling the path one takes to the mountaintop.”
- i. *Balance of Autonomy and Accountability.* This approach achieves a balance between a desire for beneficiary autonomy while still developing the ability to be responsible money managers for what the beneficiaries inherit. Clients really like the balance of autonomy and accountability.
  - j. *Shifts “Burden of Proof.”* This arrangement shifts the “burden of proof.” In the classic trust, the burden is on the trustee to establish that the beneficiary’s request is not within an ascertainable standard of support and maintenance. However, in the ROTE approach, the beneficiary has the burden to establish that he or she is demonstrating the financial skills and that the beneficiary is acting prudently. There can be disagreement over whether the beneficiary has done what satisfies a particular skills requirement, but the burden is shifted to the beneficiaries’ establishment of the skills versus a breach of duty lawsuit over an ascertainable standard.

- k. *Financial Skills Guidelines.* The authors suggest using six primary skills fundamental to financial management (the first four of which are primarily budgeting skills), and two additional skills that are commendable but not absolutely necessary.
- (1) *Live Within One's Means.* The trustee must work out with the beneficiary what this means in practice, being transparent and understandable. However, no value judgments are made regarding how the beneficiary spends money as long as expenses do not exceed income. Amazingly, many trust beneficiaries have not learned that, so this is the very first financial skill. Expenses cannot exceed income for any reasonable period of time, but for special situations there could be exceptions (e.g., starting a business, allowing expenses to exceed income by 10% for up to two years, etc.) The beneficiary will have to describe to the trustee what he or she is doing to maintain a budget and match spending with income. (One of the later skills deals with credit behavior, to avoid gaming this guideline by using credit cards or debt.)
  - (2) *Ability to Manage Spending by Being Able to Save a Portion of Income.* The beneficiary would establish this skill by demonstrating the ability to create a reserve, delay immediate gratification, and resisting spending the reserve. The beneficiaries should document situations in which there is deferred spending and a cushion is retained for everyday living expenses and for special expenses. The application of this skill may depend largely on the size of the trust – if a trust is sufficiently large, the trust itself might legitimately be considered to be the beneficiary's retirement fund and savings account.
  - (3) *Ability to Manage Credit and Avoid Excessive Debt.* This skill relates to “closing the back door on an easy way to overspend.” The trustee will examine credit spending by the beneficiary, and determine if the beneficiary is staying out of credit card debt. The trust agreement would include operational language providing that the trustee may ask the beneficiary for copies of credit reports that show how many credit accounts are open at any one time and the amounts. This would provide for strict confidence by the trustee and removal of the trustee if this information were not kept completely confidential.
  - (4) *Ability to Maintain Reasonable Accounting of Financial Resources.* Many beneficiaries lack this skill, and it can lead to drastic financial mistakes. A beneficiary may be ashamed of his or her inability to keep track of assets. Can the beneficiary keep a budget that has any relation to reality and that keeps the beneficiary from constantly coming back to the trustee for extraordinary distributions? This skill relates not to being able to make a budget but being able to follow a budget.
  - (5) *Ability to Manage Assets Using Basic Investment Principles or Delegating Responsibly to Appropriate Advisors.* If the beneficiary is doing a good job with guidelines 1-4, the beneficiary will build a reserve and need to manage it. The beneficiary should understand the basics of sound investment principles. If the beneficiary delegates money-management, the beneficiary will need to demonstrate the ability to oversee responsibly the money manager. This teaches the beneficiary who ultimately will receive a distribution how to manage it. One approach is to make the beneficiary an “apprentice trustee” at some age, and to participate in money management meetings.



Fifty percent of the population lives paycheck to paycheck. They think of money as *income*. The idea of having skills to manage money as an *asset* requires a different mindset and skills. For a beneficiary who has never had excess distributions, the beneficiary needs to develop skills to manage *assets* rather than managing *income*.

- (6) *Ability to Generate Income If Additional Resources Are Desired Beyond Trust Distributions.* The beneficiary must be able to get and keep a job if the beneficiary wants more money than just the trust distributions. That involves specific skill sets, such as showing up on time, getting along with coworkers, etc. If the beneficiary does not wish to get a job but still lives within his or her means without using credit to do so, that would meet this criteria. “If you want more money, don’t look to the trust but get a job.” The trustee makes no judgment on the kind of job the beneficiary pursues.

The next two skills are commendable but not absolutely required. Many settlors may object that the first six skills are too elementary and don’t have values attached to them. For them, encouraging the last two skills may be very important. These last two skills are very subjective, and it is impossible to come up with specific standards.

- (7) *Using a Portion of Resources to Support Charitable Activities.* This can be use of money, time, and talents for charitable causes. Observe that the potential for gaming the system increases when the guideline is activity-based rather than skills-based.
- (8) *Demonstrate a Purpose Driven Life.* This guideline advocates life with a purpose. It is the hardest to define and evaluate of the behavioral skills. However, it comes up so often in conversations with settlors that it deserves a place on the list.

The most successful beneficiaries are ones who don’t focus on cash. Focusing on cash is focusing on consumption. It is better to focus on a purpose.

- l. *Sample Form.* A sample form illustrating one possible alternative for implementing this type of approach, with additional guidelines about how to apply the trustee’s discretionary distribution authority in light of the financial skills guidelines, is included (with the authors’ permission) in Appendix A of this summary.
- m. *Takes More Time and Introspection; Not for Everyone.* Planning a financial skills trust will take more time and greater commitment by the settlor in introspection and identifying values and appropriate skills, and will involve a higher cost for preparing the agreement and structuring the skills guidelines in light of the settlor’s overall goals. It is not appropriate in all situations.
- n. *Use With Corporate Trustees?* Some corporate trustees who just want to manage money and do not have the resources to spend time working with beneficiaries will not like this approach. Some clients may prefer to have individuals serve as an advisory committee or co-trustees to assist in assessing the skills tests. Others think this will work better with the corporate trustee because this approach involves very objective issues, and family advisors may be reluctant to assess the beneficiaries’ skills objectively.

Several officers with corporate trustees and wealth management firms expressed their views. They see this as a huge improvement over the classic incentive trust. Having the trustee as a mentor takes much of the rancor out of the traditional trust relationship between the trustee and beneficiary. This approach will require a very dedicated and

effective trust officer. The trustee needs to be engaged, and have open communication with the beneficiary, understanding the beneficiary's situation, dreams and goals. Many trustees are not equipped to do that.

This approach can work very well if the corporate trust officer has the skills and open communication and deep relationships with beneficiaries, and if the company has an open book to allow officers to develop these relationships and not be burdened with so many relationships that they don't even remember the names of beneficiaries. If the company actually promotes the type of environment of having deep relationships with beneficiaries, it could be fabulously successful within a corporate trustee environment.

Jon Gallo offered that this concept is being accepted by the smaller trust companies, multifamily offices, and single family offices. Trust companies that basically just want to manage the money would view this as an interesting concept but require an individual trustee or trust committee to manage the financial skills elements. Dr. James Grubman believes there will be trust companies that will see this as a differentiator and a very attractive design.

- o. *An Important Side Effect: Encourage Parents to Use Financial Skills Benchmarks During Their Lifetimes.* Going through the detailed process of thinking through and developing the skills guidelines should encourage the parents to start the process during their lifetimes. The path to education and learning does not start when the trust starts. It should start during the parents' lifetimes if the trust will be successful for the child.
- p. *Involve Capable Adult Beneficiaries in Developing Guidelines.* It will take time and effort to develop the appropriate financial skills guidelines. Having the trustee and capable adult beneficiaries take part with the settlor in developing the guidelines is an excellent idea. That takes time and money, but it can be explained in a way that is beneficial to all the parties involved. In many ways, it is worth the time and money to avoid litigation down the road. The planners and the trustee will need to spend more time working with the beneficiaries, explaining the reasons for the approach and the process. Consider even going so far as having beneficiaries become a signatory to the document and commit to repeat the process with their children and grandchildren.
- q. *Consistent With Viewpoint of Being Stewards of Wealth.* What does it mean to be a responsible owner of wealth? Some view themselves as stewards of wealth – not entitled to the wealth, but with a responsibility to pass it on from generation to generation. Part of being a steward is to provide financial education so that everyone is at the same level. The best approach is for the entire family to work through this instead of just having the settlor dictate the terms. The family will get much more participation by that approach and this also allows the settlor to see how the family reacts to the concept. In addition, beneficiaries will know this approach is coming down the road. The beneficiaries who object are invariably the over spenders. They see what the future holds for them and how this approach will impact them and they will not like it.
- r. *Trust Cannot Be Expected to Develop Values.* Jon Gallo eloquently distinguishes the role of parents and of trust planners:
  - “My job is not to teach values to your kids. Your job is to teach your kids values. My job is to have a mechanism that transfers your wealth so that it will be managed responsibly at the next generation. It is ludicrous to think that if you have failed in your job as a parent that you can delegate the job to a mercenary –

the attorney. My job is to help in moving the assets, but not in parenting your children. We may be financially mentoring them, but not teaching them virtues.”

- s. “*Best Hope for Resurgence of the Trust.*” One trust officer expressed her view of this as an important new paradigm for trusts:

“This paradigm is the best hope for the resurgence of the trust. All parties, clients, attorneys, other advisors, and trustees will come to understand and resurrect the true purposes of the trust, which is to carry out to grantor’s intention, but also to encourage good financial behaviors in beneficiaries. After all, this is about protecting and preserving the wealth that family members have put a lot of work into accumulating. And I think that once we all as members of the same industry are involved in doing what is best for our clients, it will become quite apparent that this type of paradigm is the best alternative to some of the trusts that we have had in the past that frankly beneficiaries have come to resent because they seem controlling. And I think the beneficiaries that are engaged in the process will come to respect the trust and the trust environment as opposed to being resentful of it.”

## 16. Qualified Personal Resident Trust Issues

- a. *Grantor’s Paying Rent at End of QPRT Term.* If the grantor continues to live in the residence at the end of the QPRT term, the IRS will likely allege that there was an implied agreement of retained enjoyment under § 2036(a)(1) and include the residence in the grantor’s estate. However, if the grantor pays fair market rental value, various letter rulings have indicated that §2036 will not apply. Natalie Choate quips: “The biggest problem is that parents have to pay rent to the children. Blattmachr’s clients love to pay rent to children and love to pay income taxes for their children. But there are some people out there who haven’t figured out why that’s such a good deal.”

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

In an actual situation, the lawyer sent letters to the donor near the end of the QPRT term about the necessity of signing a lease and paying rent for continued occupancy of the residence. She died one week after the QPRT term ended without negotiating a lease or paying rent. The IRS asserted there was an implied understanding of retained enjoyment triggering estate inclusion under § 2036.

Natalie Choate suggests stating in the original QPRT trust agreement that the donor has the option to lease the residence on a month-to-month basis at the end of the QPRT term, and that if the donor remains in possession of the residence beyond the end of the QPRT term, “such continued occupancy by the Transferor shall be deemed an exercise of the Transferor’s option to rent...”

- b. “*Upstream QPRTs.*” If the parent does not want to pay rent at the end of the QPRT term, one alternative is for the remainder beneficiaries (e.g., children of the donor) to contribute the residence into a series of one-year (or longer term) QPRTs allowing the parent to live

in the residence. The gift would be the very small actuarial value of the right to use the residence for the one-year (or other) term. Various rulings have approved these types of “reverse” QPRTs. *E.g.*, Letter Rulings 200935004 & 200920033. The rulings express no opinion concerning whether the transfer to the new QPRT would result in the residence being included in parent’s estate under § 2036 (apparently leaving open the possibility of arguing that at the time the parent transferred the residence into the original QPRT there was an express or implied agreement that the children would allow the parent to use the residence at the end of the original QPRT term without paying rent). There are no objective rules for assuring that the “gift-back” to the original donor is a separate and independent act and that there is not an express or implied agreement that would trigger § 2036 to include the residence in the original donor’s estate.

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

- c. *“For Best Result, Do It All Wrong.”* In Letter Ruling 200617002, the residence was to pass outright to the donors’ daughters at the end of the eight-year QPRT term. At that time, the parents decided it was all a mistake, and they deeded the property back to themselves – they stole the property from the daughters. (Natalie wryly notes: “According to the rules, you’re not supposed to do that.”) When the parents later tried to sell the house, the real estate lawyers opined that the daughters were supposed to own the house. The daughters had been unaware of the original QPRT transfer. Upon finding out about the situation, they demanded that the sale proceeds be paid to them. The father had died in the meantime, and his estate and the mother agreed to settle by paying the sale proceeds to the daughters. The IRS ruled that the payment of sale proceeds to the daughters is not a taxable gift by the mother, that the daughters did not make a taxable gift upon the transfer of the residence from the QPRT to the parents, and that the gain on the sale of the residence is taxable income to the daughters. The ruling did not address §2036, but presumably there was no transfer with an implied agreement of retained enjoyment – because the daughters did not know about the original creation of the QPRT gift at all so how could there be an understanding?

## 17. **Avoiding Malpractice Litigation**

- a. *Overview.* Howard Zaritsky says that serving as an expert witness in malpractice actions is what convinced him to retire. “It’s like walking by your filing cabinet and hearing it ticking.” In his experience, a lot of what attorneys get sued for are normal transactions where the attorney did nothing (or very little) wrong. Even so, defendants in malpractice cases end up paying good money for expert witnesses. There are some basic rules of practice to minimize the risk of being a defendant.
- b. *Rule 1: Being Right is Not Nearly Enough.* In one case, the attorney was accused not *convincing* the surviving spouse to disclaim — although the plaintiff acknowledged that the attorney discussed the disclaimer. The case settled for seven figures. In another case, a lawyer drafted QTIPable trusts giving a surviving spouse a testamentary power of appointment to appoint to descendants of the decedent. The surviving spouse brought a lawsuit because he could not appoint the assets to his new spouse. In another case, the

client died three days after the estate planning conference. The attorney was sued for not having the documents ready to be signed by then — and the attorney lost.

Juries don't like lawyers. "Normal everyday good practice is not enough to keep you out of lawsuits. Even though you do nothing wrong, you could lose the lawsuit."

- c. *Rule 2: People Don't Sue Their Friends – They Let Someone Else Do It.* If the client likes the lawyer and lawyer owns up to a mistake and corrects it as best as possible, and if the lawyer treats the client with respect, that seriously undercuts the chance that the lawyer will be sued. Unfortunately, in the estate planning field, the second part of the rule comes into play – let someone else sue. The children/beneficiaries of the estate will be the ones suing.

- d. *Rule 3: State the Client's Intentions Clearly and Simply.* Spend time finding out the client's intentions then memorialize the intentions — the more the better. "Tattoos are not ruled out for this purpose."

Explain the intentions in the documents themselves or in a memorandum to the client. There is a general legal principle that one is presumed to have read and understood documents signed by the person. Judges believe that but no jury does.

As an example, the approach of one well respected law firm is to put a lot of effort toward documenting the client's intent. If the jury can understand what the client intended, and if the document accomplishes that result, the chance of losing is pretty narrow.

From a drafting standpoint, people who receive assets under the will should be firmly fixed by the end of page two. The jury will be asleep by page three. Put formula clauses, definitions, etc. at the back of the document.

- e. *Rule 4: Truth is Rarely a Defense.* Client memories are not to be relied upon. The client is not necessarily intentionally lying – the human brain fills gaps with what the person wants to be the correct answer.

Some clients lie, but not necessarily to the attorney. They may not want to tell the children that they are being cut out of the plan. Children who have been cut out of the plan will think that the attorney made a terrible mistake.

It is important that the attorney be able to document that the client knew and understood the issues, and document the client's intentions.

If the client wants to do something that is a bad idea, part of the attorney's job is to talk the client out of it. Howard has refused to represent clients who wanted to do something that was a really bad idea. As an expert witness, he sees how little effect a release has. "If the lawyer had explained it clearly, the client would never have agreed to it." When in doubt, simply refuse to do the deal. Think of how the matter will come across before the jury. Defendant attorney: "I thought it was a terrible idea." Plaintiff: "Well, why couldn't you talk him out of it?"

- f. *Rule 5: An Ounce of Notes is Worth a Pound of Persuasion.* Howard had a practice of drafting estate planning documents soon after the client left the office. He remembered the meeting well and didn't need to take many notes. That is a bad idea. The more notes the better off you are if sued-- especially for anything that is in the slightest way unusual and particularly for transactions that have unusual tax effects.

In one situation a client wanted each of his children to get \$2 million at his death, even though it would cause taxes to be due at the first spouse's death. Howard sent the client a

letter saying that it would very substantially increase the estate taxes at his death. After the client died, the attorney for the estate called to inquire about the big tax bill that would be due. The first thing he saw was the memo saying that the plan would substantially increase the client's taxes and that was the end of the inquiry.

If there is anything out of the ordinary, put it in a memo, boldfaced and underlined. It cannot be stressed too much. If the memo is more than two pages, the jury will think the client didn't see it. But if the item is boldfaced on the first page, the jury will believe the client saw the discussion.

Be careful with calculations. If you say "this will cost an additional \$10 million, just make sure it does not really cost \$10.5 million, or you may be on the hook for the extra \$500,000. That's why Howard generally does not like detailed numbers for memos, but prefers statements such as "will substantially increase your taxes."

Howard was involved in another case where the firm shredded files after they were five years old. The defendant-lawyer was dead and the law firm was being sued. There was no way to prove anything – and the firm lost.

g. *Rule 6: Show Me the Money.* If the client does anything against his or her economic interest, document it "up the wazoo." "What do you mean dad would not do generation-skipping planning? If he had understood the tax cost, he certainly would have paid for the planning."

h. *Rule 7: The Best Surprise Is No Surprise.* Howard worked for a trust company for a year. They said they had never been sued in 30 years of business. He spent the entire year trying to figure out why. He realized it was because they worked only for families that had family offices. The trust company worked through the family offices, so the generations of beneficiaries were forced to learn about fiduciary relationships, finance, etc. The offices presented seminars with required attendance for the beneficiaries. Beneficiaries were gathered together to be told about changes to the estate plans. No beneficiaries received unpleasant surprises when their parents died.

"When you discuss estate plans with clients, it is okay to have the children there. If the kids have their lawyers there as well, you probably know you are not charging enough."

i. *Rule 8: Learning to Love No-Contest and Arbitration Clauses.* At one time Howard did not use no contest clauses, but he now includes them routinely in forms. They really limit lawsuits, even if they are only enforceable in limited circumstances such as if the lawsuit is not brought in good faith or is brought without reasonable cause. When millions of dollars are on the hook, the beneficiary will think 6, 7, or 8 times before suing. They are very effective at reining in frivolous and "not wholly justified" lawsuits. Even use them in states where they are not enforceable — they will still scare the beneficiaries.

In addition, Howard always includes arbitration clauses. In some ways they are more important than no contest clauses. Howard's experience is that arbitration cases are much more efficient and much less expensive.

j. *Rule 9: The Four Letters You Must Always Send.*

(1) *Letter of Introduction.* The letter should state the general process that will be followed. Include a general discussion about fees, such as "in most cases will we will be able to tell you what the fees will be after the first meeting." Also give advance information about potential conflicts of interest so that the married couple

can think about it before they are in your office. “If you send an 18 page questionnaire, you can expect that the first meeting will be canceled.”

- (2) *Planning Confirmation Letter.* Send a confirmation letter explaining the plan in very simple words before preparing the documents. Explain the fee in the confirmation letter.
  - (3) *Executive Summary.* Summarize an overview of the document, and give a very brief article-by-article description. There may be only one line for each article such as “this article includes those provisions the IRS insists be included in the instrument.” (What else does the client care about that article? It can’t be changed.) Include a list of action items, including things that the client or accountant is responsible for completing.
  - (4) *Goodbye Note.* “We are not your lawyer anymore for this particular transaction. If you have any questions, feel free to call.” Howard told clients to review their estate planning summaries once a year and call him and he would tell them if the law had changed. He told clients he would not charge for the call. Howard felt very comfortable doing that, because he was almost never called.
- k. *Rule 10: Avoid Ethical Problems and a Two-Front War.* If the attorney gives the plaintiff the additional argument of an ethical violation, it makes the lawsuit much harder to defend.

## 18. Modifying Irrevocable Trusts — The Uniform Trust Code Has Made This Harder

- a. “*American Rule*” Approach — *Settlor’s Wishes Are Controlling.* American courts recognize the settlor’s wishes as controlling except where they would be contrary to some definite policy. English courts, on the other hand emphasize that the beneficiaries should control their interests except where the interest of others limit that control.
- b. *Representation*
  - (1) *Holders of General Power of Appointment May Represent Potential Appointees.* UTC § 302 allows the holder of a testamentary *general* power of appointment to represent permissible appointees. This makes little sense. The concept of a general versus limited power of appointment is a tax concept and really has nothing to do with state law representation issues. After all, limited powers of appointment can be extremely broad – to anyone other than the person’s estate or creditors.
  - (2) *Parents and Fiduciaries.* UTC § 303 provides that parents can represent their minor or unborn children, but not more remote descendants. A trustee can bind the beneficiaries of the trust. There are no limitations in the statute, but what trustee wants to take that responsibility? In most cases the trustee’s power to bind beneficiaries is illusory.
  - (3) *Virtual Representation.* UTC § 304 provides that a minor, incapacitated individual, unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable may be represented by another having a substantially identical interest with respect to the particular question or dispute. Observe that virtual representation is not available for adult competent individuals whose identity and location are known.

- (4) *Persons Appointed by Court.* UTC § 305 recognizes that a court may appoint a representative to bind a minor, incapacitated individual, unborn individual, or person whose identity or location is unknown if the court determines that the interest of such person is not otherwise represented or that representation might be inadequate.
- c. *Material Purposes.* Some of the rules regarding the ability to modify, reform, or terminate an irrevocable trust depend upon whether a material purpose of the trust is impacted. However, the rules are very subjective as to what constitutes a “material purpose.” The Restatement of Trusts (Third) says that material purposes are not to be readily inferred. (More detail is given in the Restatement, but the speaker says that is merely “a nice-sounding phrase written by a lawyer but means nothing.”)
- d. *Modification, Reformation and Termination of Irrevocable Trusts.*
- (1) *Nonjudicial Settlements.* At common law, beneficiaries could modify or terminate a trust with a nonjudicial settlement predicated on three concepts. (i) The trustee cannot be compelled to comply with the beneficiaries’ desires; (ii) there can be no matter pending before a court regarding the desired changes; and (iii) if the beneficiaries consent and the trustee is willing to accede to their desires then the beneficiaries cannot later complain.
- UTC § 1009 provides similarly that a beneficiary cannot complain about a trustee’s action if the beneficiary consented, gave a release, or ratified the action unless induced by improper conduct of the trustee or if the beneficiary did not know the beneficiary’s rights or material facts relating to the breach. If all beneficiaries cannot consent, the trustee will need to determine whether it is willing to proceed with the consents (and possibly hold harmless agreements) of others.
- UTC § 111, Nonjudicial Settlement Agreements, allows “interested persons” to agree to any matter concerning the trust as long as it does not violate a material purpose of the trust and includes terms and conditions that could properly be approved by a court. Any interested person, regardless how remote his or her interest may be, can prevent the settlement by withholding agreement. UTC 111(d) lists certain matters that can be resolved by nonjudicial settlement agreement. However, the list does not seem to include the *termination* of the trust. Only three of the UTC states (New Hampshire, Oregon, and Pennsylvania) list modifying or terminating a trust as a permitted purpose of a nonjudicial settlement agreement. Alan Acker concludes: “The UTC and the states that have adopted it now raise doubt of a nonjudicial settlement agreement being used to terminate a trust!” The UTC makes it harder to do things privately in a nonjudicial settlement than before.
- (2) *Other Ways Under UTC to Modify, Reform or Terminate Irrevocable Trusts.*
- (a) *UTC § 411(a) Consent of Settlor and All Beneficiaries.* If the settlor is alive, both common law and § 411(a) state that if the settlor and the beneficiaries agree, the parties can force modification or termination of a non-charitable irrevocable trust regardless of whether the action impacts material purposes of the trust. The parties must go to court, but once the court determines that all the parties are before the court and have consented, there is no discretion. The court must approve the consented action.



(b) *UTC § 411(b) Consent of All Beneficiaries.* A noncharitable irrevocable trust may be modified or terminated upon the consent of all of the beneficiaries if the court determines that it would be not be inconsistent with a material purpose of the trust.

(c) *UTC § 412, Unanticipated Circumstances, Impracticability, or Impairment.* This section does not require consent, but the action must further the purposes of the trust, and to the extent practicable, the modification must be in accordance with the settlor's probable intention.

(d) *UTC § 414 Uneconomic Trust.* The *trustee* may terminate a trust having a total value less than \$50,000 (the settlor can set a different amount) if the value of trust property is insufficient to justify the cost of administration. A *court* may modify or terminate a trust if the value is insufficient to justify the cost of administration.

(e) *UTC § 415 Correct Mistakes.* The court may reform a trust, even if unambiguous, to conform to the settlor's intention if it is proved by clear and convincing evidence that the settlor's intent and the terms of the trust were affected by a mistake of fact or law.

(f) *UTC 416, Tax Objectives.* To achieve a settlor's tax objectives, the court may modify the terms of the trust in a manner not contrary to the settlor's probable intention.

e. *Planning to Prevent Unbroken Trusts*

(1) *Allow Trustee to Adjust to Changing Circumstances.* Broaden the trustee's powers or grant broad discretionary authority with respect to distributions to address changing economic circumstances.

(2) *Allow Beneficiaries to Change Trustee; Beneficiary-Trustee "Savings Clause."* If the beneficiary becomes a trustee, the outline (by Alan Acker) provides a very straightforward tax "savings clause" that could be drafted into the trust instrument:

"Beneficiary as Trustee. Whenever a beneficiary is acting as a Trustee, I intend that the rights, powers, duties, discretions, and immunities granted to the Trustee not cause such beneficiary to be treated as having a general power of appointment resulting in such trust being included in such beneficiary's gross estate for estate tax purposes, and all provisions of this Trust Agreement will be construed to carry out this intent and, to the extent needed, such rights, powers, duties, discretions, and immunities will be curtailed.

In furtherance of this goal, notwithstanding other provisions, no Trustee will make or participate in any Trustee decision with respect to the following:

- Distributions of principal or income to himself or herself to the extent not limited by an ascertainable standard relating to support, health or education;
- Distributions of principal or income which satisfy a legal obligation of such Trustee; or
- If such Trustee also is a beneficiary of such trust, an early termination of such trust.

Such discretionary powers will be exercised only by another Trustee, if any."

- (3) *Use Powers of Appointment and Amendment to Gain Flexibility.*
- (4) *Plan for Disclaimers to Provide Alternate Dispositive Schemes.*
- (5) *Allow a Beneficiary to Release an Interest and Accelerate Subsequent Interests.*
- (6) *Allow Trustee to Terminate Trust if Trustee Considers it Appropriate.*

## 19. Trustee's Duty to Inform Beneficiaries

- a. *Restatement (Second) vs. Restatement (Third) of Trusts.* The Restatement (Second) of Trusts generally is a good summary of what we might think of as normal traditional trust law. Its position is that the trustees merely need to furnish information in response to requests, without a proactive duty of disclosing information. § 173. The Restatement (Third) of Trusts generally is more aspirational of what the appropriate law should be. Its position with respect to the duty to inform beneficiaries is that the trustee has an affirmative obligation to inform. The standard is that the trustees must promptly inform “fairly representative beneficiaries” of the existence of the trust, of their status as beneficiaries, their right to obtain further information, basic information concerning the trusteeship, any significant changes in their beneficiary status, and information to keep them reasonably informed of changes involving the trust including material information needed by beneficiaries for the protection of their interests. § 82.  
 What constitutes “fairly representative beneficiaries” is not always obvious, and there is not much authority.
- b. *Uniform Probate Code.* The standard in the Uniform Probate Code (in effect in about 20 states) is similar to the Restatement (Third) position. The trustee must keep the beneficiaries reasonably informed of the trust and its administration. UPC § 7–303. The information must be given to a “reasonable selection of beneficiaries ... so that the interests of the beneficiaries may adequately be protected.” § 7-303 Comment.
- c. *Uniform Trust Code.* 22 states plus the District of Columbia have adopted the UTC. It has brought uniformity in some areas, but not regarding the duty to inform beneficiaries. Generally, the trustee must keep “qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests.” UTC § 813. “Qualified beneficiaries” are current beneficiaries of income or principal, whomever would be distributees if the interests of the current beneficiaries expire without causing the termination of the trust, and the trust remaindermen upon termination.
- d. *Rationale for Duty of Notification.* “Most people, if no one is looking over their shoulders, are tempted to misbehave.” This is a policing rationale, and who better to police the trustee than beneficiaries who have an interest in the trust? The “poster child” example of this rationale is the case of *Anderson v. Marquette National Bank*, 518 N.E.2d 196 (Ill. 1987). In that case, a beneficiary had always been told he would be beneficiary of the estate but he had no documents to prove it. After numerous court battles, he finally received a copy of the trust instrument including the amendment in which he had been removed inappropriately, but the statute of limitations had run on the suing the trustee. The court “enlarged” the statutory period in light of the obvious injustice on the facts.
- e. *Other Fiduciaries Having Duty to Inform.* Trust protectors or advisors may be fiduciaries. That is not always clear, but a court’s inclination is to say that if someone has a role in the trust, the person is a fiduciary. However, there is precious little law as to when persons

other than trustees are treated as fiduciaries. The duty of notification may be extended to advisors who are treated as fiduciaries. In *McNeil v. McNeil*, 798 A.2d 503 (Del. 2002) a corporate fiduciary was one of the “general trustees” who served in a role that would typically be called an advisor. One of the settlor’s children was never informed that he was a beneficiary. The court surcharged the trustees and removed the corporate trustees (including the one serving in the advisor role).

- f. *What Beneficiaries Are Entitled to Be Informed?* The common law rule was that any current or future beneficiaries could request information. The Restatement (Third) imposes the obligation to give notice to “fairly representative beneficiaries.” The UPC in effect takes the position that potential current beneficiaries and the next line of beneficiaries, but no others, are entitled to notification. The UTC adopts the same position but also includes trust remaindermen.
- g. *Revocable Trusts.* Most people view revocable trusts as belonging to the settlor and that no one has rights until the settlor dies. *JP Morgan Chase Bank, N.A. v. Longmeyer*, 275 S.W.3d 697 (Ky. 2009) was a “hard facts” case that reached a different result. A corporate fiduciary, after being removed as the investment advisor, notified charities who had previously been named as beneficiaries of the revocable trust at the settlor’s death, but who had been removed as trust beneficiaries under quite suspicious circumstances. An attorney who prepared the documents removing the charities eventually paid a big settlement payment and sued the bank, alleging a breach of fiduciary duty on the basis that the charities would not have discovered their ouster as beneficiaries if the bank had not informed them. The court could have issued a narrow opinion, that when confronted with terrible facts and gross overreaching, it would not hold a trustee responsible for giving notice in a situation like this even for a revocable trust. However, the Kentucky Supreme Court didn’t do that. It recognized no distinction between an irrevocable and revocable trust, and said that the fiduciary must give notice to all beneficiaries and if the trust is changed, notice must be given to removed beneficiaries. Kentucky subsequently changed that result by statute.

The UTC provides that while a trust is revocable and the settlor has capacity, the duties of the trustee are owed exclusively to the settlor. UTC § 603(a). However, the UTC drafters placed the language relating to the settlor in brackets, inviting states to modify §603(a) to provide that the trustee duties are owed exclusively to the settlor regardless of whether the settlor has capacity. About half of the UTC states have made this change, and in those states the bank in the *Longmeyer* case would have been prohibited from contacting the remainder beneficiaries.

- h. *Modification By Settlor of Notification Requirement.* Under the Restatement (Third) of Trusts, a settlor may modify the notification requirements but may not dispense with them entirely or “to a degree or for a time that would unduly interfere with the underlying purposes of effectiveness of the information requirements.” (§ 82, general comment). The UTC sets forth 14 items that a settlor might not change, and two of those relate to trustee notification:

“[(8) the duty under Section 813(b)(2) and (3) to notify qualified beneficiaries of an irrevocable trust who have attained 25 years of age of the existence of the trust, of the identity of the trustee, and of their right to request trustee’s reports;]

[(9) the duty under Section 813(a) to respond to the request of a [qualified] beneficiary of an irrevocable trust for trustee's reports and other information reasonably related to the administration of the trust;]

The provisions are bracketed to indicate that many jurisdictions have deleted or modified them.

## 20. Life Insurance and Charities

- a. *Charitable Income Tax Deduction.* The charity must have an insurable interest or else the partial interest rule in §170(f)(3) would preclude a deduction for the donor. (Forty-seven states by statute provide that the charity has an insurable interest but check state law to make sure.)

*Amount of Deduction.* The amount of the deduction is the lesser of the donor's basis in the policy or the fair market value of the policy. The basis element applies because §170(e) says that the ordinary income element of a charitable contribution cannot be deducted. The IRS views the cash value build-up in a policy as ordinary income if the policy is surrendered. To determine the basis in a policy, start with aggregate premium payments. The basis is reduced by premiums paid for disability income, double indemnity provisions, and disability waiver premiums. Dividends distributed from the policy reduce the basis, but dividends used to purchase paid up additions or reduce regular premium payments do not reduce basis. A big uncertainty is whether basis must also be reduced by mortality charges. If a policy is sold, the IRS position is that the basis is reduced by the cost of insurance protection or mortality charges before the date of the sale. Rev. Rul. 2009-13, Situations 2 & 3; Rev. Rul. 2009-14, Situation 2. A counter argument-analogy is that one's basis in a residence is not reduced by the rental value of the house. Another possible distinction is that this is a gift of the policy to charity rather than a sale.

Determining the fair market value of a policy also involves considerable uncertainty. The fair market value of a policy may be less than the basis, for example for a term policy near the end of the year when there is little "unearned premium" left.

*Percentage Limitation.* Gifts "to" a public charity generally qualify for the 50% of AGI limitation. However, gifts "for the use of" a public charity are subject to a 30% limitation. If a donor makes a cash contribution to the charity and the charity pays the premium, that is a 50% limit gift. However, if the donor pays the insurance company directly (or if the employer pays the premium on group term policy that has been given to charity) there is no authority as to whether the 30% limitation applies. If possible, pay cash to charity and have the charity pay the premium. A case that provides analogous support for treating payments directly to the insurance company as qualifying for the 50% limitation is *Rockefeller v. Commissioner*, 676 F.2d 35 (2d Cir. 1982) (unreimbursed expenses were treated as 50% limitation gifts, based on legislative history).

- b. *Never Make Gift of Policy to Charity Subject to Loan.* NEVER give a policy to charity subject to an outstanding loan. The tax consequences can be devastating. From the donor's perspective, it is treated as a part sale part gift transaction, with the debt relief being sale proceeds. Basis is allocated between the loan and gift portions. In addition, the policy may be a personal benefit contract under §170(f) and if so the donor would not receive a charitable deduction for the gift of the policy. From the charity's perspective, if the personal benefit contract rules apply, the charity will have to pay a 100% excise tax for any premiums paid by the charity.

- c. *Charity Borrowing From Policy.* If the charity borrows from the policy to pay policy premiums, that presumably is not UBIT, but there is no authority on point. One element that causes “unrelated business taxable income” is debt financed income, but no income is produced by the payment of the premium. However, a possible counterargument is that if an individual were to surrender the policy or withdraw more than basis, that would produce income to the individual.

If the charity uses loan proceeds to make other investments, income from those other investments will be UBIT.

- d. *Using IRA Loan to Charity for Charity’s Purchase of Policy.* An IRA may loan funds to the public charity, which it uses in part to pay premiums and in part to pay annual interest payments on the note. This scenario is trademarked as CHIRA® by CHIRA® USA Financial Services, LLC. An IRA cannot invest in life insurance or it will lose its exempt status. Letter Ruling 200741016 gave a favorable ruling where the policy was owned totally by the charity and the IRA had a “bare bones” collateral assignment. That ruling also determined that the charity was not a disqualified person for purposes of the self-dealing rules applicable to IRAs as long as the taxpayer is not a board member or employee of, or does not have control, ownership or financial interest in, the charity.
- e. *Split Dollar Arrangements With Private Foundations.* A split dollar arrangement between a private foundation and an employee or trustee will not constitute self-dealing, taxable expenditure or private inurement as long as the compensation package is reasonable for services rendered. Letter Rulings 200207031, 200020060, 9539016.
- f. *Pushing the Envelope Arrangements: Charitable Reverse Split Dollar, Investor Owned Life Insurance (IOLI), and Temporary Charity Owned Life Insurance (CHOLI).* Charitable reverse split dollar life insurance was basically outlawed in 1999 by §170 (f)(10). Under this arrangement, the donor made a gift to charity which it used to pay a very high premium for the term portion of the policy. Most of the value policy went to the family under the split dollar arrangement. For these “personal benefit contracts,” the donor gets no charitable income tax deduction, and the charity pays a 100% excise tax on any premiums paid by the charity.

Investor owned life insurance (IOLI) involves situations where an insured allows investors to purchase a policy on the insured’s life, naming his or her favorite charity as beneficiary. However, the investors typically end up with most of the value. These policies raise a variety of issues including insurable interest, personal benefit contract, and private inurement issues.

Temporary charity owned life insurance (CHOLI) involves a charity buying a policy. Promoters lend premiums for the first two years at a high interest rate. If the insured dies in the first two years, the charity pockets the excess of the death benefits over the loan amounts. If the insured lives beyond the first two years, the charity has a choice either to pay off the loan or to sell the policy on the life settlement market (and the promoters would be involved in that sale). If the life settlement market does not buy the policy, the loan is nonrecourse and the charity would walk away from the transaction. These policies also raise a variety of issues. Courts may determine that investors rather than the charity were really buying the policy and that there was no insurable interest. A huge risk to the charity is that if it could not sell the policy at the end of the first two years the debt relief would be UBIT income and the charity would have no money to pay the tax. Proposals were made to apply a 100% excise tax on any money paid into these charitable

arrangements, but they were not included in the Pension Protection Act. That Act required charities to file reports about these arrangements for two years, and after two years fewer than 10 reports were filed. Apparently, charities have been scared away from these arrangements.

## 21. Elder Financial Abuse

- a. *Perfect Storm for Elder Financial Abuse.*
  - (1) *Aging Population.* In 1900, older persons (age 65 and over) were 4.1% of the population and by 2010 that grew to 13%. Persons age 65 now have an average life expectancy of 18.6 years (19.8 for women and 17.1 for men).
  - (2) *Growing Prevalence of Dementia.* Dementia is incurable and barely treatable. 5.3 million Americans (13% of elder persons) now have Alzheimer's. By 2050 this will quadruple to 19 million.
  - (3) *Burden of Dementia Care.* Dementia is a big financial burden, and it gets worse as the disease progresses. The burden becomes providing 24-hour care. Typically one family member ends up with the burden of care. Another family member often lives in another state care-free. Yet the estate plan treats all equally, leading to a growing resentment and building of a sense by the caregiver that he or she should receive more than an equal share. Caregivers often have to dip into their own resources to provide for aging parents. The burden is aggravated by the current economic conditions.
  - (4) *Lack of Basic Estate Planning.* Fifty percent of people have absolutely no estate plan; only 48% of older persons have a financial power of attorney.
- b. *Prevalence of Elder Financial Abuse.* As many as five million senior citizens may already have been victims of elder financial abuse. This is underreported; as few as one in 25 cases may be reported.
- c. *Abuse of Guardianship Litigation and Failure of Probate Courts.* Guardianship proceedings are used defensively to protect against abuse, but are also used offensively to seize control of wealth from persons that the client has named to manage the wealth. Sometimes the goal is to steal assets. For example, guardianship proceedings may be brought by an unhappy child to stop gifts that are being made to another child. The most offensive situation is when proceedings are used to restrict older persons from being able to use assets for their own care in order to preserve the inheritance of children. In some situations there has been a conversion of the guardianship process from protecting older persons to being used as a weapon against them.
- d. *Statutes Similar to "Slayer" Statutes.* Four states (Oregon, Illinois, California, and Maryland) have passed statutes treating persons who commit elder abuse like "slayers" under slayer statutes, so that they are treated as having predeceased the abused person for purposes of receiving assets from the person's estate. Whether assets go to their descendants or others varies from state to state.
- e. *Indicators of Elder Financial Abuse.* (These factors are a terrific listing of "red flags" of potential abuse situations taken from Dana Fitzsimons article, and based on additional information available at [http://www.preventelderabuse.org/elderabuse/fin\\_abuse.html](http://www.preventelderabuse.org/elderabuse/fin_abuse.html) and [www.sbcounty.gov/brochures/docs/105.pdf](http://www.sbcounty.gov/brochures/docs/105.pdf).)

- (1) *Financial Indicators.* Activity inconsistent with physical abilities (such as ATM use), numerous withdrawals especially in round numbers, transfers between bank accounts, increased credit card activity, withdrawals that incur penalties (i.e., from CDs), beneficiary designation changes, addition of signatories to accounts, title changes to property, new mortgages or home equity loans, financial confusion, large gifts inconsistent with established giving patterns, unpaid bills, eviction notices, notices to discontinue utilities, missing financial information (including missing bank statements and canceled checks), ceasing of delivery of financial mail to the home, and suspicious signatures on checks and legal documents.
- (2) *Estate Planning.* Changes to powers of attorney and wills and trusts.
- (3) *Caregivers.* Unwillingness to discuss routine matters, isolation of elder person from visits or calls, increased concern with elder person's finances, purports to speak for the elder person even when the older person is present, no financial means of support other than income from the older person, not hired through a reputable agency, lack of references, lack of criminal background check, lack of employment contract, and lack of regular review of caregiver incurred expenses.
- (4) *Social Indicators.* New "best friends," level of care is inconsistent with financial status and resources, unwillingness to discuss routine matters, fatigue and depression, unwillingness to take visits or calls.

f. *Guardianship Litigation Ethical Issues.*

- (1) *Ethical Concerns with Persons of Diminished Capacity as Prospective Client.* Persons with diminished capacity often want to resist an incompetency determination. An initial ethical red flag is that the person coming for representation has already been accused of being legally incompetent. Legal capacity is the foundation of many ethical obligations, including obtaining informed consent, approval of fees, and signing an engagement letter. All persons are presumed to be competent until declared otherwise, but still the attorney should be wary of ethical issues.
- (2) *Obtain Medical Opinion.* To assist in dealing with the ethical challenges, seek a medical opinion at the outset. However, structure the process so that the opinion cannot be used against the client, doing all that is possible to keep the opinion privileged.
- (3) *Seek Appointment.* It may be appropriate to ask a court to appoint the attorney to represent the elder person. The person will probably have a guardian ad litem, but may also have separate counsel. Request the court to approve the fee arrangement.
- (4) *Existing Client With Diminished Capacity.* An attorney may believe that an existing client has diminished capacity. This is a difficult situation. The ethical rules require maintaining normalcy as much as possible. However, if the attorney believes the person is incapacitated and at risk of harm, the attorney may take action including seeking the appointment of a guardian and conservator. Caution: Even though the ethical rules contemplate a narrow set of situations where that is possible, other ethical rules continue to apply including the duty of confidentiality. Confidential information can be disclosed only to the extent necessary to protect the client's interest. That is a difficult line to define and easy to cross. This is an

extraordinary remedy to seek for your own client, creating a very difficult ethical maze.

- (5) *Representing Fiduciary of Person With Diminished Capacity.* Can the attorney for a person with diminished capacity also represent a fiduciary for that person? There is flexibility under the ethical rules, because that attorney is often the most logical choice. However, there are still continuing duties to the client rather than the fiduciary. See the ACTEC Commentaries on the Model Rules of Professional Conduct (MRPC) for MRPC § 1:14.

- g. *Pre-Litigation Information Gathering and Discovery.* Fact gathering in guardianship litigation is more important than in other areas of the law. The simple petition tells nothing. Guardianship matters end up being really ugly, although they may look normal at the outset. During the course of litigation, abusive giving, theft, etc. may be discovered. The attorney may not know whether he or she represents the “good guy” or the “bad guy” at the outset. For example, a son approaches the attorney and says his dad is incompetent and he needs to be appointed. That seems logical, but until the attorney gets into the facts, the attorney will not know if it is an abusive situation.

Searching the land records is a low-cost mechanism for initial determinations of whether property has been improperly diverted. If you find a big gift, you then know what you’re dealing with.

*Disclosure From Trustees.* Compelling disclosure about revocable trusts is a hotly disputed area. While the trust is revocable and the grantor (with capacity) holds the power to revoke, the trustee owes its fiduciary duties (including the duty to disclose) only to the grantor.

*Scope of Discovery.* Discovery can be used as a weapon to run up costs and can convince parties to settle too early. There must be limits on the scope of discovery, but this is often hotly contested.

*Compelling Production of Will.* This is another hotly disputed issue. Discovery of estate planning documents can be relevant to showing evidence of abuse. It may also be an issue in whether to expand the scope of the conservator’s powers in the areas of estate planning. Arguments against compelling production are (i) the standard of capacity for executing a will is lower than for having a guardian appointed, and (ii) the will is ambulatory and does not speak until the moment of death and therefore arguably is irrelevant.

- h. *Jurisdiction and Forum Shopping.* This may more aptly be called “Kidnapping and Forum Shopping.” If guardianship proceedings start in one state and do not go well, an individual may check the elder person out of the hospital in the dark of the night and take the person to another state and start the proceedings without informing the court in the second state that there is an existing proceeding. It is very hard for a court not to act when there is an incapacitated person before the court. NCCUSL adopted the Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act in 2007, now adopted in 19 states and the District of Columbia, and under consideration in other states. It addresses which state has jurisdiction in these circumstances.

- i. *Customary Remedies.* Customary remedies include the appointment of a fiduciary with detailed consideration of the scope of the fiduciary’s powers and bonding. The revocation of powers of attorney so that there is no conflict with appointed fiduciaries is also a possible remedy. In some states, powers of attorney are automatically suspended while



guardianship proceedings are pending. Under the Uniform Probate Code, the court looks for the least restrictive alternative, and if there is no abuse present, the power of attorney or revocable trust will stay intact; the court is supposed to defer to the estate plan in the absence of abuse.

- j. *Extraordinary Remedies.* Some jurisdictions allow extraordinary remedies to prevent an incapacitated adult from abuse. These include imposition of a constructive trust, awarding of a money judgment for assets wrongfully taken, and invalidation of deeds and contracts (raising due process issues so that affected persons have notice). Courts may sometimes be willing to appoint a fiduciary but unwilling to deal with recovering stolen assets, leaving it up to the conservator to pursue that remedy. This can be inefficient, because proof of the theft may already be present in the incompetency and appointment preceding.

A truly extraordinary remedy is the invalidation of a will or restructuring of the estate plan. This is typically used only in very egregious cases. Some courts recognize the “doctrine of substituted judgment” giving the court the power to reorder the estate plan on behalf of the incapacitated person. A case involving Eli Lilly provides a good roadmap for structuring an estate plan in a guardianship. *American for the Arts v. National City Bank*, 855 N.E.2d 592 (Ind. App. 2006). For other cases that have restructured estate plans in a guardianship, see *In re Guardianship of Lillian Glasser* (2007 WL 867783 (N.J. Super Ct. 2007)) and *Murphy v. Murphy* (Calif. 1<sup>st</sup> Dist. Ct. App. June 26, 2007).

- k. *Pre-Trial Tactics.* Restraining orders and injunctions are a possible remedy to tie the hands of a suspicious actor while proceedings are pending. However, hard learned lesson: when dealing with a truly bad actor who has been liberated from the rule of law, injunctions and restraining orders have no effect, what is needed is actual control of the property. The civil ability of courts to recover funds is frustratingly low.

Practicalities of the effect of the guardianship proceeding on the health of the prospective ward raises a gut wrenching and tactically challenging aspect of defending against offensive guardianship litigation. The guardianship proceeding may be used as ammunition by someone wanting to control the individual’s life or property. However, the litigation itself places extreme strain on the client who is suffering from early stages of dementia. There is no comprehensive study confirming that, but there is anecdotal evidence. An individual may try to drag out litigation to preserve control over the client as long as possible. Does the attorney representing the client take steps to accelerate the litigation to reduce the toll on the client? That may force an early settlement or alternative dispute resolution despite a client’s desire to “fight to the death.”

- l. *Pre-Death Will Contest.* Some states allow pre-death probate of wills, which requires that any will contest be decided while the testator is still alive. This provides greater certainty for the testator and allows the testator to testify and personally defend against challenges. Witness memories are fresh. The biggest advantage in the pending against the contest is the “shame factor;” a contestant may do things in a traditional post-death will contest that he or she would not do “in front of momma.”

Difficulties with pre-death probate include due process difficulties to make sure everyone involved is before the court. What if the individual wants to change the will; is a new pre-death probate proceeding required? It is not clear yet whether pre-death probate leads to more efficiency of the court system or clogs the courts.

- m. *Criminal Allegations.* One of the most difficult decisions to guardianship litigation is when the matter crosses the threshold from a civil to criminal matter. This is only appropriate when dealing with “really bad actors.” CAUTION: Never *threaten* to bring a criminal action. That is extortion and never do that. If the situation is so bad that a criminal proceeding is appropriate, just contact the criminal system authorities — never *threaten* to do so.

## 22. Estate Tax Liens and Impact on Interactions With M&A Attorneys

Ed Manigault addressed surprising ways in which estate tax liens and fiduciary duty principles can impact sale transactions, and how dramatically estate tax and trust issues can impact transactions by M&A attorneys. (The discussion below will likely scare the “bejeebers” out of M&A attorneys.)

- a. *Scary Example of Estate Tax Liens.* A big corporate client bought the assets of an LLC several years ago, following the death of the founder of the LLC. The client recently received a letter from the IRS saying that it will foreclose on all assets purchased from the LLC in order to pay the founder’s estate taxes — because the estate is now insolvent. The client complains to the attorney, “We had your help in this transaction and don’t remember you mentioning a lien. We did a lien search and found nothing. We paid full value. Why aren’t we protected as a bona fide purchaser for value?” Unfortunately, there may be no BFP protection, the IRS may be able to foreclose, and the corporate client may not have recourse against anyone.
- b. *Scope and Elements of Estate Tax Lien.* Section 6324 says that on the death of an individual, the estate tax lien attaches to every asset in the gross estate, and it lasts for ten years. The lien is not recorded, and there is no notice to third parties. Indeed, the IRS Manual says that if the agent is in a jurisdiction where there is a forum for filing the lien, the agent is not supposed to record notice of the lien. The lien lasts for up to 10 years unless taxes are paid or become unenforceable due to the lapse of time. The lien can be foreclosed on, even if other assets of the estate are available; the IRS is not required to pursue other estate assets first.
- c. *Example of Application of Lien.* The *First American Title Insurance Co. v. U.S.* case illustrates that the “scary example” discussed above is realistic. 2005-1 USTC ¶60,501 (W.D. Wash. 2005), *aff’d*, 520 F.3d 1051 (9<sup>th</sup> Cir. 2008). Title insurance companies are sophisticated parties, but this illustrates they can still get caught by this special lien. The decedent died in 1981, owing several major assets, including Frisko Freeze that runs hamburger joints. The decedent’s daughter filed the estate tax return and paid part of the estate tax and received an extension on the excess. The estate distributed three houses to the daughter, which she subsequently sold to three purchasers who each obtained title insurance. The IRS revalued Frisko Freeze and assessed more estate taxes. The daughter and estate filed for bankruptcy. The IRS sent letters to the purchasers of the homes threatening foreclosure, unless the taxes were paid. The title insurance companies paid the increased taxes and sued the government for refund, arguing that the sale proceeds were used to pay taxes so the estate tax lien should be divested. The title insurance companies lost that argument because they could not “trace” the use of the proceeds to the payment of taxes, and even if they could, the court held that the payment had not been approved by the court as required by §6324(a)(1). The title companies were left “holding the bag.”
- d. *Practical Problems and Lessons in Dealing With the Estate Tax Lien.*

- (1) *Last Minute.* Invariably, the estate tax lien issue comes up last minute in deals.
- (2) *Hard to Spot; Transferee As Seller.* The seller may not be a decedent's estate, but the child of decedent, who within the prior 10 years received assets from the estate.
- (3) *Hard to Spot; Disregarded Entity.* If assets were purchased from an LLC that either is or was a disregarded entity previously owned by a decedent, the IRS may take the position that the LLC is disregarded for all tax purposes and that all assets of the LLC are subject to the estate tax lien, even if the LLC *at the time of the sale* was taxed as a partnership.
- (4) *Practical Problem of Obtaining Sensitive Information.* The attorney for a prospective purchaser may approach the estate. "I cannot identify my client, but I need to know information about when the decedent died, the assets of the estate, the amount of the estate taxes, when estate taxes have been paid, etc." What is the likelihood of receiving that information until the transaction has proceeded far down the line? In some situations, sellers may be willing to share sensitive estate tax information with counsel for the purchaser or perhaps just with the corporate attorney handling the sale transaction for the seller.
- (5) *IRS Will Not Accept Wire Transfers.* As discussed below, it may be possible to get a release of lien by payment of the estate taxes from the purchaser (i.e., the purchaser may pay part of the purchase price directly to the IRS in partial payment of the estate taxes), but the IRS only accepts checks. It will not accept a wire transfer. The transaction may have to be delayed several days until the check clears. This is particularly difficult when the lien issue arises, as it often does, at the last minute.
- (6) *Drafting Cannot Solve the Problem.* Just adding representations and warranties in the sale documents does not solve the problems. The documents will say that the seller is getting marketable title, and that estate taxes are paid or provided for. However, if taxes in fact are not paid, the purchaser of the asset may still be responsible.
- (7) *Due Diligence.* The purchaser should ask for a copy of the Form 706 if the asset is being sold by an estate. However, even that will not necessarily highlight problems. In the *First American Title* case, the purchaser was primarily interested in the houses, but the estate tax problem arose over the closely held corporation in the estate. It is hard for the purchaser to know what is going on with all of the other assets of the estate. Even if the advisor is comfortable with assets shown on the estate tax return, what about assets that might have been omitted?
- (8) *Joint and Several Liability.* As a result of the inherent uncertainties, sale agreements generally put all sellers in the position of being jointly and severally liable for the taxes. Therefore, all beneficiaries would be on the hook if there is an estate tax problem
- (9) *Escrow for All Proceeds?* It is not surprising that funds may need to be placed in escrow in order to obtain the release of the estate tax lien. However, the transactional attorneys may be quite surprised to find that the IRS may require all, not just a portion, of the sale proceeds to be placed in escrow before the IRS grants a certificate of discharge of the lien.

- (10) *Consider Owning Assets in Revocable Trust or Entity.* As discussed below, there are fewer restrictions on the lien if assets are held in a revocable trust or entity.
- e. *Release of the Estate Tax Lien.* There are various methods of releasing the lien, but often they take time and may not be helpful in a time-sensitive M&A deal.
- (1) *Release of Lien from IRS.* The IRS may release the lien entirely or as to specific assets. § 6325. The IRS has discretion to issue a certificate of discharge if it is otherwise protected (meaning that other assets subject to the lien are twice the tax liability (§ 6325(b)(1)), or if an amount equal to the IRS interest in the property is paid to the IRS, or if the proceeds are held in escrow. The escrow approach is often required in the context of business transactions, but negotiating the agreement can take considerable time. Ed Manigault was involved in a case where three months was required to negotiate the arrangement with the IRS — and all of the proceeds were placed in escrow, not just 45% (because the lien attaches to the entire asset).
  - (2) *Payment of Estate Expenses.* The lien is released if (i) proceeds of the purchase are used to pay charges against the estate or administration expenses, AND (ii) those expenses are allowed by a court with jurisdiction. (The *First American Title Insurance Company* case discussed above, emphasizes the importance of both the tracing and court order requirements.) This method has limited utility in many corporate deals because of the time requirement of obtaining a court order. (This method applies to both probate property and non-probate property.)
  - (3) *Discharge Under § 2204.* If the executor has been discharged from personal liability under § 2204, a transfer of property to a purchaser for full consideration, or a holder of the security interests will divest the lien from the transferred property. § 6323(h)(6), 6326(h)(1). (Instead, a substitute lien is placed on the consideration received from the sale. § 6324(a)(3).) (This method applies to both probate property and non-probate property.)
  - (4) *Non-Probate Property Exception for Bona Fide Purchasers.* A transfer of non-probate property to a purchaser or holder of the security interest divests the lien from the transferred property. § 6324(a)(2)(first sentence). However, a lien is then placed on all of the property of the transferor (not just the consideration received in the transfer). § 6324(a)(2); Rev. Rul. 56-144.
  - (5) *Exception for Purchasers of a “Security”.* If someone pays full value for a “security”, they receive the security free of the estate tax lien; that sounds like BFP protection. However, an important concern is that this exception only applies to stock or other securities, not to a partnership or LLC interest. Also, it does not apply if the purchaser had “actual knowledge or notice” of the existence of the lien. In light of the uncertainties surrounding the “actual notice or knowledge” requirement, purchasers cannot rely on this exception.
- f. *Mitigating the Lien Using Revocable Trusts or Entities.* If there will be substantial sales after an individual’s death, various steps can be taken to mitigate lien problems that may arise in making sales.
- (1) *Revocable Trusts.* Assets in revocable trusts would be non-probate assets that could be sold to a purchaser for full value divested of the estate tax lien.
  - (2) *Assets in Entities.* In *Beaty v. U.S.*, 937 F.2d 288 (6<sup>th</sup> Cir. 1991), the estate sold its partnership interest to the partnership in return for land owned by the partnership,

and the land was distributed to the beneficiaries. The estate tax lien did not attach to that land. Under the reasoning in this case, the estate tax lien only attaches to property included in the estate, i.e., the partnership interest and not the assets in the entity.

- g. *Transactions With Fiduciaries; Third Party Duty To Inquire Into Trustee's Powers.* If a fiduciary is a party to a transaction, most transactional attorneys know to coordinate with the T&E attorney because there are different rules for fiduciaries.

Under traditional common-law principles, if the trustee did not have the power to sell, a transfer by the trustee would be invalid; there was no “bona fide purchaser” rule. This created considerable problems, particularly because at common law, a trustee did not have the power to deal with assets unless specifically authorized in the trust instrument or necessary and appropriate to carry out the terms of the trust. Many statutes have both broadened the authority of trustees to transact with trust assets, as well as reducing the duty of third parties to acquire into the authority of trustees.

Many states have statutes providing that the duty of inquiry arises only if the third party has *actual knowledge* of the breach of trust (Uniform Trustees' Powers Act, §7), or that third persons (not beneficiaries) are protected from liability if the third person *acts in good faith and provides valuable consideration* to the trustee (UTC, §7).

- h. *Scope of Trustees' Powers.* State laws now typically give trustees the power to sell assets, even if the trust instrument is silent. Furthermore, trust instruments typically include an express power to sell.

The law might not be as clear about other more unusual situations that may arise in the sale transaction. Ed Manigault states:

“Consider, as examples, a buyer that wants a trustee to agree to indemnify it, to guarantee the debts or other obligations of other sellers or third parties, or to agree to be jointly and severally liable with other sellers. Would it matter if those third parties are not beneficiaries of the trust? Should a trustee attempt to negotiate so as to not undertake these obligations, with the possible result that the trustee is paid less than those sellers who do agree to the buyer's terms, or that the deal is not consummated?”

Delegation issues may also arise if the transaction is being completed by agents (such as under a power of attorney or shareholder's agreement). Furthermore, the fiduciary will face a prudence question: even if the sale is authorized, is entering into the sale, with all the various terms involved, a prudent transaction for the trust?

The materials include a *terrific* chart of all 50 states, listing state statutes dealing with third-party protection, certification of trusts, and broad trustee powers.

- i. *Certification of Trust.* For obvious reasons, parties dealing with a fiduciary will want to review the trust agreement to confirm the trustee's powers to enter into the transaction. Various states have statutes authorizing a third-party to rely upon a certification by the trustee that the trustee has the power to enter into the transaction. *E.g.*, UTC §1013. However, there may be limits to the benefits provided to third parties by certifications of trust. For example, a party dealing with the trustee may request a certification that the trustee has certain powers *and* can exercise them without consent from other parties, such as advisory committee. Furthermore, if a party is relying upon representations and warranties, or indemnification is given by the trustee, the party may want to review the distribution and termination provisions of the trust. Otherwise, the trust may no longer be

in existence when a third party tries to enforce the breach of a continuing obligation of the trust.

j. *Summary of Approach to Dealing with Trusts Involved in Deals.*

(1) *What Law Applies to Administration of the Trust.* The attorney for a purchaser often asks the attorney representing the fiduciary to give an opinion on what law applies to the administration of the trust. (That should just be a short opinion.) The attorney can then review the statutes of that state regarding the protection for third parties, trust certification, and broad trustee powers.

(2) *Review Terms of Trust.* The attorney should consider reviewing the terms of the trust even if there are favorable statutes protecting third parties or allowing trust certifications. For example, the attorney may want to determine whether the trust will likely continue to exist during periods of post-closing obligations of the trust. Merely relying on a certification does not give information regarding whether assets should be held in escrow and how much. When the terms of the trust are reviewed, the party dealing with the trust will often end up requiring joint and several liability of all of the trust beneficiaries in case the trust does not have sufficient assets to satisfy post-closing obligations at a future time.

(3) *Escrow Arrangements.* As discussed above, escrow arrangements may be helpful for assuring that post-closing obligations are satisfied. However, sellers do not like the solution and the transactional attorney may have already negotiated away an escrow requirement before the T&E attorney becomes involved. An escrow may be even more important, if the trust is the sole seller of the asset, and there are not other sellers to look to for satisfying post-closing obligations.

k. *Transactions With Individuals.* The advice of T&E attorneys may be important even in transactions involving sales by individuals. Following the death of an individual, questions will arise as to whether obligations under the sales agreement survive. State laws will provide for priorities among creditors, and may limit the time to make claims.

In addition, issues may arise regarding the capacity of the party. Dealing with an individual for whom there are some questions about capacity is difficult. Requiring medical examinations or conservatorships may seem quite insensitive, but realize that capacity problems cannot be solved by drafting to include representations or warranties.

## 23. Radically Different Future of Estate Planning Practices

Jonathan Blattmachr presented a fascinating and very creative discussion of the future of law practice generally and of estate planning practices in particular. For an extended discussion see Blattmachr, *Looking Back and Looking Ahead: Preparing Your Practice for the Future: Do Not Get Behind the Change Curve*, 36 ACTEC J. 1 (2010).

a. *Accelerating Changes.* For 15 years, computer capacity has doubled about every 18 months. However, the time to double knowledge has been shortening. Ray Kurzweil, author of *Age of Spiritual Machines* says that the rate of change is increasing rapidly. (KurzweilAI.net has a great deal of information about technological rate of change and predictions for the future.) In some respects we are reaching not only exponential growth [Ex.,  $3^1$ ,  $3^2$ ,  $3^3$ ,  $3^4$ ,  $3^5$  etc.] but growth by an exponent to the exponent [Ex.,  $3^1$ ,  $3^2$ ,  $3^4$ ,  $3^8$ ,  $3^{16}$  etc.]. Kurzweil says that in this century there will be 20,000 times more changes than in the last century.

b. *Planning; Law as a Business*

- (1) *Case for Long-Term Planning.* Reasons for long-term planning include (1) financial, (2) consistency in practice and life, (3) intellectual satisfaction, (4) emotional satisfaction, and (5) standing in the community.
- (2) *Why Lawyers and Law Firms Don't Plan.*
  - “It’s Not Another Money Getting Trade.” When Jonathan became a partner at Milbank in 1979, he asked when there would be a meeting for new partners. The managing partner laughed. Jonathan, as I suspect only he could, was quite persistent and finally convinced the managing partner to have an orientation meeting for the new partners. At that meeting, the managing partner expressed that he thought having lawyers plan might be unethical, proudly bragging that “we’re not another money getting trade.”
  - “Nature of Lawyers: No Three Musketeers.” Lawyers can leave their firms at any time and take their book of business with them. If an employee leaves General Motors, the employee cannot take business with him.
  - No Traditional Ownership of the Enterprise, Contrasted With Australia. As a practical matter, lawyers now own 100% of their book of clients. From a legal standpoint, ethical rules prevent non-lawyer owners of firms. Some day that will change. In Australia, there are now publicly-traded law firms.
  - “I Decided Not to Go to Business School; Lack of Training in Business Matters”
- (3) *Law As a Business.* Gross revenue minus expenses equals profits. That is true for all businesses including law firms. Jonathan’s great epiphany, as he thought about this topic, is that the cost of everything, including legal services, is governed by the law of supply and demand (unless there are government controls).
- (4) *Supply is Increasing.* The supply of lawyers and legal service providers is increasing dramatically. The number of lawyers from 1972 to today has increased from about 300,000 to 1.2 million. The number of paralegals in that time has increased from zero to about 300,000. The number of individuals rendering legal services has increased by four or five times. Furthermore, many other providers of legal services are emerging. California now allows paralegals to form their own “Legal Document Assistance” firms (or “LDAs”). They are not under the supervision of a lawyer, and in theory they do not supply legal advice. LegalZoom prepares legal documents but claims that it does not practice law. LegalZoom has had over 1 million customers to date, and over 99.5% of the customers say they are satisfied. (A will on LegalZoom costs \$71. Jonathan ordered a will, which is based on interactive questions. However, the system would not allow him to choose to leave assets in trust for his son for life. He called to ask why not, and was told that the system could not accommodate a lifetime trust. He was told he had to choose an age, so he chose age 100.)
- (5) *Price Is Increasing Also.* Although there has been at least a five-fold increase in the supply of legal services, the price of legal services has increased dramatically. From 1972 to today, hourly rates have gone up by 8 to 10 times. The supply has increased five-fold and the price has increased 8 to 10 times. Why? Demand is increasing dramatically.

- (6) *Demand.* The demand for legal services has increased by an almost exponential factor. Why? (Jonathan cautions that very little is written about this so take all this with a grain of salt.)
- (a) *Accelerated Increase in Laws and Regulations: Federal, State and Local.* One of George W. Bush's campaign planks was the overabundance of regulations. However, during his term, the number of new regulations increased by more than twice as much as any other president in history. Clients are interested in addressing either compliance with or financial opportunities under new regulations.
  - (b) *Globalization.* If the company does business only in the state of Washington, it has only one set of laws to deal with. Global companies have dramatically increased legal needs.
  - (c) *Increased Litigation.* 24 million lawsuits are brought in the United States each year, and that number is growing.
  - (d) *Advertising.* A subtle kind of advertising is "one-on-one." The client comes to get a will, and the attorney advises that the client needs a GRAT, QPRT, FLP, etc. The attorney becomes an advertiser by explaining additional opportunities, which increases the demand for the attorney's legal services.  
In addition, traditional advertising has a double effect. It does more than just say, "Hire me." It also increases the demand for legal services generally.
  - (e) *Patents.* Legal strategies have been patented in recent years. Marketing of the strategies may lead to increased demand. (Jonathan said that he submitted the first patent application for a tax idea, regarding reverse split dollar life insurance. He withdrew the application because the IRS wasn't happy with it.)
  - (f) *Change in Demographics.* As the population grays, the demand for estate planning increases. The more educated people are, the more likely they are to consume legal services.
  - (g) *Changes in Science.* Changes in science lead to new legal complexities (such as the issue of posthumously conceived children under existing trusts).
- (7) *Summary Regarding Supply and Demand.* There will be more demand for legal services, but the services may be different and delivered in a different way in the future.

c. *Changes to Legal Profession Caused by Technology*

- (1) *Document Preparation.* The IBM Selectric Typewriter was the state-of-the-art when Jonathan got out of law school. About that time, Fran Musselman, managing partner of Milbank, asked IBM to put sentences on punch cards, rather than numbers, so that sentences and paragraphs could be built from the cards. IBM told him he was out of his mind; there was no need for it and no demand for it. Later, he went back to IBM and asked again. Finally IBM relented, but said it would charge Milbank its full expense for creating the system. IBM asked Fran to sign a document saying that it would own the process if it had any commercial



appeal. Fred always said signing that document was “the biggest mistake of my career.”

A huge change came with the development of WYSIWYG (for us non-techies, that stands for “what you see is what you get”) systems, which allowed lawyers to type their own documents.

- (2) *Tax Return and Other Report Preparation.*
- (3) *Written Communication.* Written communications used to be delivered by the post office. In 1985 came the fax machine, and email now dominates written communication.
- (4) *Voice Communication.* Traditional telephone conversations have now developed into conference calls with inexpensive international capability.
- (5) *Calendaring Events and Appointments.* Remember when we used printed calendar books?
- (6) *Research and Law Libraries; Word Search Capability.* In 1972, Jonathan was the seventh person in the country to learn how to use Lexis. He could not understand why it was so extraordinary. It is extraordinary for two reasons: finding laws more efficiently, and finding facts. When Jonathan started law practice, Milbank had 35 staff members in its library. It now has five. Many law libraries have no books but just internal disks or online capabilities.
- (7) *Calculations.* CRT calculations by hand used to take hours. Economical software packages now do the calculations instantly.
- (8) *In Person Meetings.* This is one area where there has not been much change. Technology has not propelled us forward yet, but Jonathan thinks this will change.
- (9) *Education/Learning.* Educational sources are available on line for all topics. Webinars are everywhere.
- (10) *Billing Practices.* When Jonathan started practicing, it was “guess and by golly” to piece together monthly billing statements.
- (11) *Litigation and Dispute Resolution.* Litigation support is changing dramatically as a result of computer capabilities. Dispute resolution is now being handled by computer in some situations. Richard Susskind in his book “The End of Lawyers” says that 40,000 claims in New York City (claims by or against the city) have been closed by a computer program. The program analyzes the facts, makes a reasonable determination of the outcome, and makes an offer.
- (12) *Information Sharing (The American Lawyer).* When Milbank partners found out that other firms were making much more money, it had an enormous impact on the firm. The most important statistic published in *The American Lawyer* became profits per partner. Steven Brill has had an enormous impact on the American practice of law.
- (13) *Technology and Erosion of the “Monopoly” of Lawyers.* LegalZoom has prepared 1 million wills on their system, with amazingly high customer satisfaction. That means lawyers in private practice did not get that business. When Fran Musselman told Milbank lawyers in 1987 they must either learn to do word processing or become extinct, many lawyers were outraged. There was

tremendous resistance. Now, no one wants to give up Lexis, word processing, Tiger tables, etc. Technology has eliminated many of the rudimentary tasks that we previously did. We used to have to read document drafts word for word.

- (14) *Looking Forward: Smart Computers.* Smart computers now begin to mimic human thought. That will become more profound over time.

d. Richard Susskind, *The End of Lawyers*

- (1) *Overview; Evolution of Legal Services.* Technology reduces the cost of rendering legal services. More information produces more “informed” clients. Susskind says the result is a different evolution of legal services: beginning with Tailored, to Standardized, to Systemized, to Packaged (the ability to offer and deliver a package of documents; document assembly programs are close to that now), and finally to Commoditized services.

Jonathan says that legal advice is commoditized now to a degree that some lawyers give away their legal advice for free. Go on YouTube and type in “revocable trusts” or “irrevocable life insurance trusts” and you will find dozens of videos available for free.

- (2) *Exaggeration of Uniqueness of Services.* Susskind says: “[M]any lawyers exaggerate the extent to which their performance depends on deep expertise. We should subject it to scrutiny and analysis... knowledge is being paraded as expertise and yet analysis shows it to be capable of being reduced to routine tasks in whole or in part...”

“Lawyers often overstate the extent to which the content of their work is creative, strategic and novel. If [Thomas] Edison allowed that [only one percent] of his work was inspiration, I wonder about the possibility of lawyers’ claims that most corporate work (to take an example) involves a higher level of creativity.”

“[O]n analysis, many tax problems can be reduced, actively, to a large decision tree of a structured body of rules, so that a computer system would be especially well suited to solving what otherwise might seem to be an insoluble challenge for the non-expert.”

- (3) *Decomposition and Multi-Sourcing.* Susskind says there must be a decomposition of legal services into the separate real elements of the tasks, and then there will be an outsourcing of those tasks. Jonathan calls this the “legal assembly line:” human judgment with outsourcing of tasks to computers.

e. *Disruptive Legal Technologies*

- (1) *Description.* “Applications of technology to challenge the old ways and, in doing so, bring great cost savings and new imaginative ways of managing risk.”

- (2) *Examples.*

- Automated document assembly.
- Relentless connectivity. (Jonathan’s Blackberry works in the Alaska wilderness.)
- Electronic marketplace. Amazon has reviews of anything. EBay has auctions. That is now happening for legal services and will be increasing. (We may see wealthy people sending e-mails with RFPs to all ACTEC attorneys in NYC.)

Then the prospect may go back to selected attorneys asking for a capped or fixed price. Companies are already doing this. Companies can be hired to bid out legal work.)

- E-learning; Legal Wikipedia. Encyclopedia Britannica is out of business; it has been replaced by Wikipedia. Jonathan thinks ACTEC should prepare its own proprietary Wikipedia.
- Closed legal communities. The ACTEC listserv is an example of this. Selected law firms may join to form a similar close legal community for information sharing purposes. (Some law firms in Britain have combined to do this in a formal manner.)
- Embedded legal knowledge in assembly systems. Document assembly systems have embedded legal knowledge. For example, the planner cannot go forward in drafting a will until answering whether the spouse is a U.S. citizen, which automatically triggers certain elements.
- Workflow and project management with automated checklists or procedural manuals. Jonathan gave an example of a 29 item workflow and project management template for implementing a sale to grantor trust transaction.

f. *Preparing For the Future of Your Practice*

- (1) *Willingness to Plan?* Many will say, “Forget it; I practice law my way.”
- (2) *Determine Goals.* Example: Make \$500,000 a year, get intellectual satisfaction; associate with best lawyers, etc. Advisors can assist with this process.
- (3) *Can Your Practice Achieve the Goals?* Be realistic.
- (4) *How to Change Practice to Achieve Goals; Services and Market.* If changes are needed, consider the types of services offered and the marketplace for those services.
- (5) *Marketing.* Keep vigilant.
- (6) *Education.* Ensure consistent and up to date education.
- (7) *Website.* Develop an interactive website that drives prospects to your practice. This is beyond just a website listing lawyers.
- (8) *Outsourcing.* Microsoft outsources legal work to India. English is a common language in India, and India uses the common law. Companies can have the equivalent of a Harvard lawyer for \$25,000 a year in India. CPA Global provides “legal process outsourcing.” Microsoft has entered into an agreement with CPA Global for offshore legal work from lawyers in India. There is an ongoing erosion of American lawyers. Outsourcing can also apply on a more local level.
- (9) *Develop Document Assembly and Greater Standardization.* Standardize everything, including correspondence.
- (10) *Office Space Needs.* Carefully consider realistic needs for future actual office space. There will be an increase in working from home and a decrease of need for office space. The Brobeck law firm was more profitable than any firm west of the Mississippi, but it went out of business because it overcommitted to office space. “A very cheap 50-year lease may put you out of business.” That is also true for trust companies. Having to impress wealthy clients with big offices will change.

- (11) *Dealing With Defection.* Defection is the main reason law firms fail. If the most lucrative areas of the practice leave, the firm still is stuck with a long-term lease and expenses, etc. The economics look bad so other sections leave as well. This is the case whether dealing with a three-person firm or a 3,000 person firm. Come up with a plan to discourage defection. That is the scariest thing for any law practice.
  - (12) *Develop Data Sharing Deal Flow.* A data sharing deal flow system allows all lawyers *and clients* to know the ongoing status of each element of a transaction. That is done routinely in England for banking deals. The clients insist on it.
  - (13) *Develop Business Model.* Some attorneys like solo or very small practices, and others like big firms and like to leverage. The most lucrative law firm in the United States is Cravath Swain and Moore — and they have the highest leverage. “If you want to make more money, figure out a way to leverage.” Leverage can be inside the firm or outside. Many law firms have young mothers working at home on a contract basis.
- g. *Future of Billing Methods*
- (1) *Billable Hour.* “The billable hour is dead.” Richard Susskind in “The End of Lawyers.”
  - (2) *Be Flexible.* The trend will be using a fixed or capped fee, with no success fee. There are ethical considerations. For example, Circular 230 addresses contingent fees.
- h. *Blattmachr’s Ten Year Predictions*
- (1) *Development of Legal Wikipedia.* ACTEC should develop this, with word searchability.
  - (2) *In Person Meetings Will Diminish.* There will be a trend toward video meetings, eventually replaced by “virtual” meetings. A partner left Milbank several years ago to join a project for the development of technology for projecting people and things in three dimensions with holograms. Twenty-five years from now we will meet with people long-distance and it will appear as though you are with each other. Kids use Skype all the time. That is another reason that the need for office space will diminish. New young consumers will have a bias toward long-distance communication.
  - (3) *Need for Office Space Will Diminish.* The decrease in in-person meetings and the increase of alternative work arrangements will decrease the need for office space.
  - (4) *Supercomputers.* Supercomputers this year will have the capacity of the human mind. They will begin to mimic human thought. A computer learns from past mistakes, something we humans don't always do.  
  
Computers will become smaller and increasingly integrated into everyday life, from driving an automobile to preparing meals. More and more computer devices will be used as miniature Web servers, and more will have their resources pooled for computation and data processing including analysis.
  - (5) *Increased Retirements.* Planning for retirement is increasingly important.

- (6) *Typing Will Disappear.* iPhones now allow dictating e-mails. Typing will nearly disappear and be substituted with verbal and eventually with thought input. (Christopher Reeves used a rudimentary thought input system.)
  - (7) *Paper Books, Newspapers and Magazines Will Disappear.* Paper periodicals (including legal periodicals) will essentially disappear, in part driven by the need for word search capabilities.
  - (8) *Internet Broadband.* High-quality broadband Internet access will become available almost everywhere for free.
  - (9) *Virtual Assistants.* For example, free real-time language translation will become available that would appear as subtitles to a user wearing special glasses. Computers will automatically do rudimentary research for free.
  - (11) *Increased Government Benefits and Wealth Shift; Increased Life Expectancies.* Within 10 to 15 years, life expectancies will be significantly extended. Jonathan indicates that the life expectancies of people living in developed countries, both on average and maximum age (now essentially 100 years for most) will increase (in part by nanotechnology) producing an increase in demand for legal services. The demand for legal services will be met, in an ever-growing measure, by computer software.
  - (12) *Expansion of Services Offered to Law Firms.* Examples include emotional counseling services, financial services, Monte Carlo simulation analyses, etc. For example, whether to make Roth IRA conversions depend in large part on what happens with the investment assets in the future.
- i. *Fundamental Disagreement With Susskind: Not the End of Lawyers*

Jonathan's fundamental disagreement with Richard Susskind is that there will be a fundamental increase of new laws and regulations. That means there will not be a reducing demand for lawyers, at least until computers can mimic human thought. Jonathan anticipates that there will be greater government regulation of industry, relationships and lawyers.

## 24. Division of Trust Into Separate Shares vs. Separate Trusts

- a. *How the Issue Arises.* If a trust is being created for multiple beneficiaries, the trust could be a single "pot" trust with all of the beneficiaries as discretionary distributees. Alternatively, the trust agreement could specify that there would be either separate shares or separate trusts created for each of the respective beneficiaries. Another approach is to have a single trust initially, but provide that at some point the trustee would have the discretion or would be required to split the trust into either separate shares or separate trusts for the respective beneficiaries. When this is done, the classic approach by most planners is to use separate trusts. If the desire is to have total autonomy of the family members with respect to their respective assets in the trust, separate trusts will be needed. There could be different trustees of each trust that would carry out the investment philosophies of the respective family members. However, in other situations, separate shares might have advantages.
- b. *Advantages of Separate Share Approach.* (1) Separate shares of the trust can own different assets than others shares. However, the separate shares are still part of the same trust, and are therefore the same taxpayer. The separate shares can transfer assets among the shares

without being an income recognition event. (2) For generation-skipping transfer tax purposes, a taxable termination occurs when a person's interest terminates and there are only skip persons left as beneficiaries. If a trust is split into separate trusts, each trust is treated separately for GST tax purposes, and when one child dies, it is likely that a taxable termination would occur. However, separate shares of the single trust are treated as part of the same trust for generation-skipping transfer tax purposes. A taxable termination would not occur for GST purposes until the death of the last non-skip person beneficiary of all of the separate shares.

## 25. Family Limited Partnership Annual Exclusion Gifts

- a. *Avoid FLP Interests for Annual Exclusion Gifts.* To the extent possible, avoid questions about annual exclusion qualification by making gifts of cash rather than family limited partnership or LLC interests.
- b. *Avoiding the Fisher Price Cases.* *Price v. Commissioner*, T.C. Memo 2010-2 denied the annual exclusion for gifts of limited partnership interests because the donees had neither the right to income nor substantial present enjoyment of the property, primarily because income was not paid each year, and a partner had to obtain the unanimous consent of all of the partners to sell its partnership interest. *Fisher v. U.S.*, 105 AFTR 2d 2010-1347 (S.D. Ind. 2010) denied the annual exclusion where the donees could transfer their interest at any time, merely subject to a right of first refusal. The court did not explain its reasoning, but it was probably correct in reaching the result because the LLC could pay with *non-negotiable* notes. Possible alternatives that may permit the annual exclusion include (1) do not include a prohibition on transfers or the requirement of unanimous consent, (2) "regularize" distributions, (3) specify that the general parent/manager owes fiduciary duties, (4) give donee-partners a Crummey withdrawal power to withdraw the fair market value of the limited partnership interest for a limited period of time after each gift, and (5) give donee-partners a limited period of time to sell the interest to the donor or for its fair market value, determined without regard to the existence of the put right.
- c. *Embrace Rationale of Fisher Price Cases.* We should embrace the rationale in the Fisher Price cases rather than fighting them (and use assets other than family limited partnership interests for annual exclusion gifts). The Fisher Price cases emphasize that limited partnership interests have no substantive present economic benefit. These represent judicial cases acknowledging that FLP interests are not very marketable. These cases are ultimately helpful.

## 26. Shark-Fin CLATs

The IRS sample forms for charitable lead annuity trusts indicate that they can have an initial fixed dollar amount that increases during the annuity term. Some planners have suggested taking this concept to the extreme of having extremely low annuity payments throughout the term of a CLAT, and having a single very large payment at the end. For example, \$1 million may be contributed to a CLAT for the life of an individual. The trust would pay approximately \$4,000 per year to a donor advised fund until the individual's death, then make a balloon payment of \$1.5 million to charity. The taxable gift of the remainder interest is about \$50,000. The trust would purchase a single premium \$4 million face value life insurance policy with \$900,000 of the \$1 million dollars contributed to the trust. The remaining \$100,000 would remain in the trust to make the \$4,000 annual payments. At the individual's death, \$1.5 million would pass to charity, and \$2.5 million could pass to the donor's children. A risk is that the IRS might view this as

abusive, and state that it meant “nominally” increasing payments in the sample form, and that this arrangement would result in a \$1 million upfront gift (even though there is no technical reason in the statute why the annuity payments in a CLAT cannot vary over time as long as the payments are set in the trust agreement). The economics of “shark-fin” CLATs are compelling in light of the extremely low current applicable federal rate, but make sure that the client understands the risk.

**27. Life Insurance Owned by and Payable to Partnership Not in Insured-Partner’s Estate Under § 2042**

Letter Ruling 2009409004 involved a rather complicated fact situation, but the IRS held that an insurance policy owned by a partnership and payable to the partnership is not includable in the insured’s estate under §2042, even though the insured is a partner and is the sole owner of the corporation that serves as general partner of the partnership. The letter ruling is consistent with *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff’d on another issue*, 244 F.2d 436 (4<sup>th</sup> Cir.), *cert. denied*, 355 U.S. 827 (1957). The significance of this ruling is that the insurance policy was the only asset of the partnership, thus suggesting that there is no requirement of a business purpose under the *Estate of Knipp* analysis.

**28. No Extension of Time to Elect QTIP Treatment For Inter Vivos QTIP Trusts**

The IRS position is that the time prescribed for making a lifetime QTIP election is prescribed by statute (§ 2523(f)(4)), so discretionary “9100 relief” for an extension of time to make the election is not available. Reg. § 9100-3(a) indeed limits extensions of time to “regulatory elections.” The IRS granted a letter ruling extending a discretionary extension of time for a lifetime QTIP election (Letter Ruling 201025012), but subsequently realized its mistake and revoked the ruling. The AICPA has filed a letter with various legislative staffers requesting 9100-type relief for inter vivos QTIP elections. They were hopeful that such a provision would be included in the 2010 Tax Act, but it proceeded too fast.

**29. Trustee’s Creation of FLP or LLC Held to be Breach of Trust**

In *Schumacher v. Schumacher*, 303 S.W.3d 170 (Mo. Ct. App. 2010), the trustee invested trust assets in FLP or LLC interests. Beneficiaries successfully asserted that it was “outside the trustees’ authority” to convert trust assets into FLP or LLC interests, because “the overall effect ... was to delay” the beneficiaries’ enjoyment of the trust property. The lower court found this to be a violation of the fiduciaries’ duty “to adhere to the trust purposes, to be loyal, and to prudently administer the trust.” The transfers of trust assets to the FLP and LLC “were avoidable transfers” that the beneficiaries were entitled to set aside. The court remanded to permit trustees to present unspecified affirmative defenses. An intriguing question (not addressed by the court) is whether the IRS could ignore FLP or LLC investments by trustees (for example if a marital trust invests in an FLP, resulting in discounted values at the surviving spouse’s subsequent death), or whether they could assert that the beneficiary’s failure to object to the trustee’s action is a gift.

**30. Practical Advice Regarding Expedited Letter Ruling Requests**

There is a procedure for obtaining expedited ruling requests when there is a hard deadline. Carol Harrington once received an expedited ruling within four months, but that is very difficult to get one issued that quickly. The IRS officials do their best to meet hard deadlines. Call the IRS and get some idea if they have addressed the particular issue before. You can also get some indication of whether they may be able to issue the ruling in time. At a minimum, you may find out there is no way to get the ruling in time, and so you don’t waste time and expense preparing the ruling

request. (The filing fee alone for a letter ruling request is \$14,000. Rev. Proc. 2011-1, Appendix A.)

### 31. Interesting Quotations

- a. *Game Changer.* No one predicted a \$5 million exemption in 2011. This is a game changer.” – Dennis Belcher
- b. *Going Back.* Some clients pulled the trigger and made gifts in 2010 to take advantage of a 35% gift tax rate, because of a fear that the rate would increase. Indeed, the Baucus bill in early December would have increased the rate effective in early December to 45%. If they had waited until 2011, they could take advantage of the \$5 million gift exemption. “Can you cure those and snatch them from the jaws of justice?” – Dennis Belcher
- c. *More Going Back.* “We have had phone calls asking if they could unmake those gifts.” – Dennis Belcher
- d. *Monte Carlo and Estate Tax Predictions.* There could be large exemptions, there could be small exemptions, or there could be no estate tax. It is hard to handicap which of those three is right. It doesn’t matter to an individual client. When you are dealing with a sample of one, probabilities don’t matter.” – Dennis Belcher
- e. *Congress and the Legislative Process.* Despair.com makes fun of motivational topics. One poster shows a grizzly bear getting ready to eat salmon with the caption — “Not every long journey ends well.” Another poster on Government: “If you think the problems we create are bad, just wait until you see our solutions.” Another poster of skydivers in a circle: “Never underestimate the power of stupid people in large groups.” (Of course, Dennis Belcher cynically notes, those have nothing to do with Congress.) – Dennis Belcher
- f. *Dysfunctional Relief.* “The estate tax relief worked this time-but we had a dysfunctional Congress.” – Dennis
- g. *Revenue and Numbers of Returns at \$5 Million.* “Between 5000-6000 taxable estate tax returns will be filed each year with a \$5 million exemption, raising about \$15 million per year. – Beth Kaufman
- h. *1% of What?* Question from Audience: “Why is it that no speaker ever discusses the percentage of federal revenue raised by the federal estate and gift tax as being 1% to 1 ½% of total revenues? This needs to be stated.”

Answer: “Well I just violated the speaker’s creed that we are all asked to sign not to mention this as part of the great conspiracy. Okay, Mr. Oscar the Grouch, is your point that 1 to 1 ½ percent is too small or that it’s pretty darn big? One to 1 ½ percent of anything may sound small but 1 to 1 ½ percent of the revenues [may be sizable]. The Congressional Budget Office estimate s that if we have had the 2009 legislation stay in effect with a \$3.5 million exemption, the 10 year revenue from having a federal estate tax at a \$3.5 million exemption over the next 10 years would have been \$186.1 billion – a mere 1.2% of all federal revenues for that time so said the Congressional Budget Office. According to other information available at the Congressional Budget Office, that would completely fund for 10 years the entire United States Department of the Interior, it would completely pay the Bureau of Land Management, US Geological Survey, the Fish and Wildlife Service, the National Parks Service and the Bureau of Indian Affairs. If you like any or all of these things, what we’re doing is contributing directly toward that. It could also by the way entirely fund the IRS — but that may not be the best sympathetic



- example. One to 1 1/2 percent of our total revenues is a pretty healthy chunk of change. These estimates are based on a \$3.5 million exemption. If we have a \$5 million exemption we may be able to fund fish but not wildlife.” – Sam Donaldson
- i. *Congressional Outlook*. “The odds of now passing sound tax policy because they’ve seen the error their ways seems rather silly. When this comes up in the next Lame Duck session, Obama will not be worried about getting reelected. The economy, makeup of Congress, etc. will be different. After they’re finished torturing us — something they enjoy doing--they’ll straighten it out.” – Carol Harrington
  - j. *Twain on Predictions*. The art of prophecy is very difficult, especially with respect to the future. -Mark Twain, as quoted by Michael Graetz
  - k. *Estate Tax Prediction*. Professor Michael Graetz thinks \$5 million is here to stay as well as portability. But the rate structure is much more vulnerable to future changes. Rates have gone up and down over the years. Some may push to shift to a tax on recipients or to an income tax on recipients. Whatever is done it may be done on temporary basis. It is a mistake to believe repeal proponents have given up. – Michael Graetz
  - l. *Prediction in Stone*. “I’ll bet you the exemption will be \$1 million at the beginning of 2013. I’ll also bet you it will be larger than \$1 million at the end of 2013.” – Bruce Stone
  - m. *Bolder Prediction*. “I predict there will be much increasing unpredictability.” – Carol Harrington
  - n. *Using the Estate Tax Savings*. “The Steinbrenner family could use the saved money to acquire Cliff Lee — or waste it on Derek Jeter.” – Sam Donaldson
  - o. *Serenity*. “The estate, gift and GST exemptions are all unified — and it feels so good.” – Sam Donaldson
  - p. *Estate Planning and Divorce*. “If I had an estate, with a \$5 million exemption I would be out gifting right now. Right now, my ex-wife gets to do all of that.” – Sam Donaldson
  - q. *Larry King Effect*. “Regarding portability, Congress was cognizant of people like Larry King, so you don’t get to use the unused exclusion amounts on all prior spouses — a black widow effect.” – Sam Donaldson
  - r. *Portability Planning Mantra*. “Always marry poor going forward.” – Sam Donaldson
  - s. *New Opportunities to Get Rich*. “If there are any rich ladies out in the room, I’m happy to parlay my unused exemption amount. I’m even happy to arrange for my death for the right price.” – Sam Donaldson
  - t. *Boredom of Consistency*. “We can’t have consistent rules from year to year. What’s the fun in that?” – Sam Donaldson
  - u. *What Calendar?* “We’re tax lawyers so we can still do planning for 2010 even though 2010 is over.” – Beth Kaufman
  - v. *Play it Again, Sam*. On the importance of Opting Out of Automatic GST Allocation for 2010 Direct Skips: You can’t say it enough times.” –Beth Kaufman —“You can’t say it enough times.” – Dennis Belcher; —“You can’t say it enough times.” – Sam Donaldson
  - w. *West Coast Estate Planning*. “Free-basing” — the ability to step up the basis under carryover basis by \$1.3 or \$3.0 million. – Sam Donaldson (“That must be a West coast thing.” – Beth Kaufman)

- x. *Spousal Basis Adjustment.* The \$3 million spousal basis adjustment applies “if you are lucky enough to have a client who died of being nagged to death.” – Sam Donaldson
- y. *Great to Be a Lawyer in America.* Client’s perspective: “I pay you to give me advice about whether to make a gift. Then you charge me to make the gift. Then you charge me for advising it would be best not to have made the gift. Then you charge me for how to undo the gift. Then you charge me to do the gift again.”  
Dennis’s perspective: “Isn’t it great to be a lawyer in America?” – Dennis Belcher
- z. *Another Reason America’s So Great.* The United States has 3% of the world’s population and 80% of the lawyers. Isn’t America great?” – Jonathan Blattmachr
- aa. *The Rich Live Longer.* “Clients are living longer and longer — especially the rich, mean ones seem to live longer and longer.” – Dennis Belcher
- bb. *Social Workers.* “Many times we are just social workers for the wealthy.” – Dennis Belcher
- cc. *Supreme Court Ticket.* Judge Sotomayor in Rudkin said “would equaled could.” That was enough to get her a ticket to the Supreme Court.” – Sam Donaldson
- dd. *Income Tax Focus.* “Our practice will focus more on income tax planning than in the past. The §67(e) imbroglio is an example. – Dennis Belcher
- ee. *Going Rogue.* “The Jensen Tax Court goes rogue — if I can borrow a term from a former Alaska governor” – Sam Donaldson
- ff. *Conservation Easements.* “Conservation easements are a great deal. They affect all subsequent owners — but you get all the income tax deduction. It’s just awesome. Unfortunately, I couldn’t find a charity that wanted any of my backyard.” – Sam Donaldson
- gg. *They’re Never Happy.* “Two years ago, clients were wringing hands because they couldn’t do more transfer planning. Now clients are saying — ‘you want us to give away \$5 million????’” – Mil Hatcher
- hh. *Perfection and Paralysis; Opportunity of a Lifetime.* Don’t be paralyzed. This may be the opportunity of a lifetime. Don’t let the perfect get in the way of the good if the only way to get anything done is a leaky freeze.” – Mil Hatcher
- ii. *Too Much of a Good Thing.* On discussing the volatility exposure of equity in a sale to grantor trust transaction: “The problem in the past was not coming up with enough seed money for sale to grantor trust transactions. In the future, the problem may be having too much seed money.” – Mil Hatcher
- jj. *Clients Rule.* Clients tell us where they want their estates to go, not Congress, tax lawyers, or estate planners. Neither do state legislatures when they draft statutes to say what formulas mean. – Bruce Stone
- kk. *Eating Cake.* “I’ve had my cake and I’ve already eaten it.” – Alan Acker, discussing the beneficiary who consents to a trust distribution then squanders the distribution
- ll. *Tax Disclosures and Direct Skips.* The client signed a “memo of distribution” on December 31 but actually sent out checks on January 3, 2011. “What if I file a taxable distribution return for 2010? Would that start the statute of limitations to return?” No, it just means the IRS can’t assess a tax in 2010, but we know the GST tax rate is zero in 2010. You would have to file a 2011 return to start the statute of limitations on not

- owing GST tax for 2011. “But that would raise your head to be shot at.”  
– Carol Harrington
- mm. *Carryover Basis Election That Changes Formula Bequests*. One Wall Street Journal commentator said: “There’s another word for an executor who gets to choose which beneficiaries get how much money — defendant.” – Carol Cantrell
- nn. *Future of Estate Planning*. When concerned about the future of estate planning as a career, Dennis Belcher told the young associate: “Wealthy people will always need solutions; all families are dysfunctional; and Congress cannot repeal greed.” – Dana Fitzsimons
- oo. *A Great Country*. “A Time CNN poll said 39% of Americans believed they are already in the top 1% or soon will be. This is truly a great country.” – Michael Graetz
- pp. *Economic Good News*. Alan Greenspan cautioned Congress that the surplus was so large that the government would have to start buying private assets. The good news is that problem has been solved. – Michael Graetz
- qq. *Conrad or Paris?* “You have never seen a hearse with a luggage rack...The estate tax is a tax on Paris Hilton, not Conrad Hilton.” Michael Graetz
- rr. *2010 Window of Opportunity*. “2010 became the year to throw momma from the train, or at least from her private jet.” – Paul Krugman, as quoted by Michael Graetz
- ss. *It Depends on Your Perspective*. From the Movie “The Tourist”.  
Police Inspector: “Now you wish to report a murder.”  
Johnny Depp: “No, some people tried to kill me.”  
Inspector: “I was told you were reporting a murder.”  
Depp: “Attempted murder.”  
Inspector: “Ah, that is not so serious.”  
Depp: “No not when you downgrade it from murder. When you upgrade it from room service it is quite serious.” – quoted by Michael Graetz
- tt. *Money is the Mother’s Milk of Politics*. Comments concerning the Retirement of George Leffco from the Los Angeles County Regional Planning Committee. “A mistake may have been made that I retired before and not after Christmas. I really missed the cards from engineers I never met, the wine and cheese from development companies I never heard on the Commission, and especially the honey baked ham from of all places Forest Lawn (a mortuary and cemetery in Los Angeles) even though the company was never an applicant before the Commission when I was there. But because I missed them is why I think it is a good idea I resigned. I do not think it is wise to stay in public office too long. I use the ham from Forest Lawn as an illustration.  
– My first Christmas as a Commissioner, when I received the ham, I tried to return it at once, although for the record I did not because no one at Forest Lawn seemed authorized to accept hams, not even for burial. My guess is that not one of the many public servants who have received the hams had ever tried to return them.  
– When I received another ham the next Christmas; I gave it to some worthy charity.  
– The next year, some worthy friends were having a party so I gave it to them.  
– The next year I had a party and we enjoyed the ham.

– In the fifth year, around the 10<sup>th</sup> of December I began wondering ‘Where is my ham? Why is it so late?’

So much for the corruption of public officials. It was then I thought it was time to retire, though it took me two more hams and three years to finally do it.”

Michael Graetz observed about this story: “Now there is an example more members of Congress should follow.”

- uu. *Blattmachr’s Clients*. The biggest problem with QPRTs, is that parents have to pay rent to children [to continue using the residence after the QPRT term]. Blattmachr’s clients love to pay rent to children and love to pay income taxes for their children. But there are some people out there who haven’t figured out why that’s such a good deal.” – Natalie Choate
- vv. *Noisy Filing Cabinets*. “Serving as an expert witness is what convinced me to retire. It’s like walking by your filing cabinet and hearing it ticking.” – Howard Zaritsky
- ww. *Expert Witnesses*. “No matter how preposterous their position, they will find an expert to back them up.” – Howard Zaritsky
- xx. *Expert Witness Payday*. “I’ve been an expert witness in seven malpractice cases and have only been in court once. Virtually all of the cases settle. As the time gets close for trial, I think may pay day is here. I can go sit for four days and read a book while waiting to be called as a witness. It never happens.” – Howard Zaritsky
- yy. *You Know Your Not Charging Enough*. If there’s anything unusual in the estate plan, it is a good idea to call everyone in. When you discuss the plan with the client, it is ok to have the kids there. If the kids have their lawyers there as well, you probably know you’re not charging enough.” – Howard Zaritsky
- zz. *Estate Planning Questionnaires*. “If you send an 18 page questionnaire, you can expect that the first meeting will be cancelled.” – Howard Zaritsky
- aaa. *Magnanimous Offer*. “I would tell clients to call me to review their plans once a year. I tell them: ‘Look at the summary; call me and I’ll tell you if the law has changed. I will not charge you for the call.’ I felt comfortable doing that — because no one ever called.” – Howard Zaritsky
- bbb. *No Crying Allowed*. “Only the luckiest of my clients have to worry about the federal estate tax — and I don’t allow them to complain. You are the fortunate 3/10ths of 1% in this country.” – Alan Acker
- ccc. *Your Job and My Job*. “My job is not to teach values to your kids. Your job is to teach your kids values. My job is to have a mechanism that transfers your wealth so that it will be managed responsibly at the next generation. It is ludicrous to think that if you have failed in your job as a parent that you can delegate the job to a mercenary – the attorney. My job is to help in moving the assets, but not in parenting your children. We may be financially mentoring them, but not teaching them virtues.” –Jon Gallo
- ddd. *What Goes Around Comes Around*. The Restatements and the trust law treatises expound on trust law. “A little bit of this, of course, is an echo chamber effect. The professors write the Restatement; the professors write the Comments; the Restatement cites the Comments; the Comments cite the Restatement; and lo and behold it’s perfectly clear that we all agree. We can be sort of sanctimonious about that but if you want to think about something similar, cogitate on why it is you believe that if you’re going to do a sale to a grantor trust you have to put 10% in the trust. I think you’ll discover it’s in large measure because

- we've all told one another that for so long that we now know that is true.”  
– Turney Berry
- eee. *It's All In the Timing.* “Rich people are rich because they can choose when to buy and sell. Poor people are poor because they cannot choose when they buy and sell. Rich people go to banks and get five-year loans. Poor people go to pawn shops and get pay-day loans.”  
– Dennis Belcher
- fff. *Getting Rich and Staying Rich.* Rich people get rich because of lack of diversification. Rich people stay rich because of diversification. – Dennis Belcher
- ggg. *The Neediest of All.* “I want to give rest to charity — endowing the offensive coordinator position at the University of Texas. That's the neediest charity I know of right now.  
– Stacy Eastland
- hhh. *Legal Research.* “If I steal from one person it is plagiarism. If I steal from lots of people, it is legal research.” – Stacy Eastland
- iii. *Freezes.* “Estate freezes — that's not some weird thing you do to Ted Williams.”  
– Stacy Eastland
- jjj. *Investment Sophistication.* “When I was practicing we called these “junk preferreds.” Now at Goldman, we call them “mezzanine preferreds.” – Stacy Eastland
- kkk. *Emergency.* “I once asked a client what he defines as an emergency. He responded, ‘It's when my wife wants to buy a house in Aspen.’” – Stacy Eastland
- lll. *Dementia.* Dementia is incurable and barely treatable. 5.3 million Americans (13% of elder persons) now have Alzheimer's. By 2050 this will quadruple to 19 million.  
– Dana Fitzsimons
- mmm. *But It Sounded So Good.* The Restatement of Trusts (Third) says that material purposes are not to be readily inferred. More detail is given in the Restatement, but the speaker says that is merely “a nice-sounding phrase written by a lawyer but means nothing.”  
– Alan Acker
- nnn. *Political Correctness Only Goes So Far.* The United Daughters of the Confederacy made a gift to construct a dormitory at Peabody College to provide housing for Confederate descendants seeking an education. The donation required that the dormitory be named “Confederate Memorial Hall.” Peabody College merged with Vanderbilt University years later. In 2002, the trustees of Vanderbilt wanted to remove the word “Confederate” from the dormitory's name, but the Daughters sued. The court said that Vanderbilt could remove the name, but they would have to repay the full indexed present day value of the gift plus interest. Vanderbilt decided “Confederate” in the name was just fine.  
– Kathryn Miree
- ooo. *Wonders of Television.* In the *Fisher* case, the parents put their Michigan lake front property in an LLC and made gifts to their SEVEN children. “They need to get a television at that cabin so they have other activities.” – Sam Donaldson
- ppp. *Grain of Salt.* “You must take what speakers say from the podium with a grain of salt. We call that ‘podium chloride.’” – Ron Aucutt

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## Appendix A

### “Results Oriented Trust Environment” Financial Skills Trust Sample Form Provisions (Discussed in Item 15)

Jon J. Gallo, Eileen Gallo, Ph.D, James Grubman, Ph.D (Reprinted with permission)

*[This particular form contemplates that the Trustor desires that the beneficiary becomes sole Trustee at some appropriate time, although that is not essential to the financial skills trust concept. The Trustee is directed to take into consideration the beneficiary’s growth in developing financial skills described in determining whether to make discretionary distributions and in whether to accelerate the time at which the beneficiary may become sole Trustee. The form should be customized to reflect the Trustor’s specific feelings about factors that should be considered and to reflect what particular discretionary decisions will be impacted by those considerations.]*

To my descendants and their Trustees, both living and those to be conceived and born in the future:

On the most basic level, the purpose of this trust is to further the pursuit of happiness by my descendants. I use the phrase the pursuit of happiness in the same way as our Founding Dollars use it in the Declaration of Independence. Neither they nor I were or are talking about acquiring more material goods or taking longer vacations but rather the sense of self-sufficiency that is derived from becoming self-reliant and financially sound, having a sense of emotional, social, and mental competence and giving back to the community.

The money in this trust will help make things more convenient for my descendants but it cannot make them happy. I believe that the family’s money, including the money in this trust, should be viewed as a tool to support the growth of the family’s real capital, which consists of the family members and their knowledge achieved through life experience and education. This is why I believe that travel, involvement in philanthropy and education to one’s maximum potential are so important.

The trust is designed to provide my descendants with the opportunity for a paced introduction to and education in the complete and responsible ownership of wealth.

Until a beneficiary attains age twenty-five (25), the Trustee shall pay to the beneficiary, by distributing such sums to the Guardian of his Person, any fit person with whom the beneficiary resides, or to the beneficiary, or apply for his benefit, as much of the net income and principal of the trust estate as the Trustees consider reasonable and necessary to provide for his education, support, and his medical, dental, hospital and nursing expenses and expenses of invalidism. Any income not so distributed shall become principal.

Once the beneficiary attains age twenty-five (25), the trustees shall pay to the beneficiary here a unitrust amount from the beneficiary’s trust equal to three percent (3%) of the net fair market value of the assets of such trust valued as of the applicable Valuation Date (the “Unitrust Amount”). The Unitrust Amount shall be paid in four (4) equal installments, payable at the end of each calendar quarter, from the net income of the trust and, to the extent such income is not sufficient, from principal. And a net income of the trust estate for a taxable year in excess of the Unitrust Amount shall be added to principal. “Valuation Date” means the first business day of the applicable taxable year of the beneficiary’s trust. The taxable year of the trust shall be the calendar year.

The Independent Trustee may distribute to the beneficiary, in addition to the Unitrust Amount, such sums from the beneficiary’s trust as the Independent Trustee determines, in the Independent Trustee’s sole and absolute discretion, to be reasonably appropriate and consistent with the purposes of the beneficiary’s trust, as explained in this Article.

In determining the unitrust amount payable to the beneficiary, the Trustee shall prorate the same on a daily basis for a short taxable year and for the taxable year ending with the beneficiary's death. Notwithstanding the foregoing, in the year in which the beneficiary's death occurs, the Trustee's obligation to pay the unitrust amount shall terminate with the payment immediately preceding his or her death.

If any unitrust payment is incorrectly determined, then the Trustee shall pay to the beneficiary, in the case of an undervaluation, or the beneficiary shall repay to the trust, in the case of an overvaluation, and amount equal to the difference between the amount actually paid and the amount which should have been paid. Such payments shall be made within a reasonable period after the final determination of the correct unitrust amount.

As used herein, the term "medical, dental, hospital and nursing expenses and expenses of invalidism" include distributions for physical, mental, emotional, and health needs. Health needs include health insurance and therapy, both physical and psychological/emotional, as well as expenses of cosmetic surgery.

As used herein, the term "education" means elementary and secondary schooling, vocational training and trade schools, college and postgraduate study, whether at a public or private institution whether in the United States or abroad, and supplemental education programs and recreational and enrichment activities, whether as part of or in addition to the regular school curriculum. Education also includes all forms of life long learning whether such programs focus on career and business education (including career changes or beneficiaries resuming their education after dropping out of school for a period of time) for the personal curiosity and passions of the beneficiaries. Directions for education shall include tuition, books, supplies, tutors, travel and related living expenses. I believe it is important for the Trustee to facilitate educational experiences that will enhance a beneficiary's well-being and help him develop a global view and appreciation of diverse cultures. Accordingly, the term "education" also includes reasonable world travel.

When the beneficiary attains age thirty (30), the beneficiary shall become sole Trustee of twenty-five percent (25%) of the beneficiary's trust as then constituted.

When the beneficiary attains age thirty-five (35), the beneficiary shall become sole Trustee of fifty percent (50%) of the remaining balance of the beneficiary's trust as then constituted.

When the beneficiary attains age forty (40), the beneficiary shall become sole Trustee of the remaining balance of the beneficiary's trust.

In exercising the discretion whether to distribute income or principal to or for the benefit of the beneficiary, I wish the Independent Trustees to take into consideration, in addition to such other factors as they deem reasonable, the extent to which the beneficiary demonstrates growth of the following skills, recognized and explained in the written literature about financial literacy:

1. The ability to live within one's means, i.e., managing spending consistent with one's level of income;
2. The ability to manage spending relative to income in a manner that would be consistent with being able to save a portion of income, as needed;
3. The ability to understand and manage credit and debt processes, leading to avoidance of excessive debt;
4. The ability to maintain reasonable accounting of one's financial resources;



5. The ability to understand and manage one's personal assets, either using basic investment procedures and principles oneself or to delegate these actions responsibly to appropriate advisors; and
6. The ability to generate income for spending needs if additional resources are required or desired beyond trust distributions.

In addition, the following two skills are advisable though not crucial:

7. The ability to use a portion of one's income and/or financial resources to support charitable activities of one's choosing; and
8. The ability to show initiative, engage in entrepreneurship, and demonstrate purpose in paid or unpaid work.

It is important for the Independent Trustee to recognize that these skills are commonly developed to varying degrees for most people, with few people possessing all of the skills at a proficient level. These are offered here as a useful basis for evaluating a beneficiary's development of maturity, judgment and ability to handle wisely the funds to be distributed by the Trust.

After taking into consideration the extent to which the beneficiary demonstrates the financial literacy skills described above, the Independent Trustees may accelerate by not more than two years the ages at which the beneficiary become sole trustee of some or all of the principal of the trust estate if, at such earlier date, the Independent Trustees determine that the beneficiary has the maturity, judgment and ability to handle wisely such earlier distribution and that such earlier distribution is in his best interests. The Independent Trustees may postpone the beneficiary becoming sole trustee of some or all of the principal of the trust estate if, at the time the beneficiary would otherwise become sole trustee, the Independent Trustees determined that the beneficiary does not have the legal competence or the maturity, judgment and ability wisely to administer such principles or becoming sole trustee would not otherwise be in his best interests.

Making mistakes with money is an important tool in learning to manage money. The beneficiary should be allowed to take reasonable risks with money he receives as income or distributions. A goal is for the beneficiary to develop skills and risk assessment, risk capacity, and risk tolerance as well as to learn from both success and failure. The Independent Trustees may best help the beneficiary by acting as experienced mentors offering advice, support, and practical assistance, e.g., developing and managing business plans for new ventures.

The Independent Trustees should allow the beneficiary to encounter the consequences of his decisions because the Independent Trustees are instructed to allow flexibility in administration of the beneficiary's trust, they may neither be held liable for decisions on the beneficiary's part nor responsible for not having foreseen unanticipated consequences of their decisions.

Disagreements on the part of the beneficiary and the Trustees, including the Independent Trustees, should be seen as normal and an opportunity for learning by the beneficiary. Both the beneficiary and all Trustees should approach conflicts with a desire for collaboration, mutual understanding, negotiation, and a demonstration of mutual respect so that conflicts are accepted and resolved the using the highest principles of human relationships.

Many conflicts between beneficiaries and trustees arise because the beneficiaries have never read and do not understand the trust, including the rights and responsibilities of both the trustees and the beneficiaries. The Trustees should seek to educate the beneficiaries and the beneficiaries are urged to learn about the terms of the trust and the respective rights and responsibilities of the beneficiaries and the trustees. The Trustees are encouraged to retain consultants to assist beneficiaries in understanding the

trust and in developing the financial literacy skills described above. Such consultants may be retained to work directly with the beneficiaries, to provide advice and counsel for all Trustees, as well as for the Guardians of any minor beneficiaries, or both.

Among the issues that such education should include are the following:

- (i) Understanding the mission statement contained in this Section and any related letters from the Settlers and/or videos.
- (ii) Understanding the respective rights and responsibilities of income beneficiaries and remainder beneficiaries.
- (iii) The Trustees' responsibilities with respect to both distributions and investment of assets, including the Trustees' duty to treat both income beneficiaries and remainder beneficiaries impartially, as well as the duty to maintain the purchasing power of the principal while providing a reasonable distribution rate to the income beneficiaries.
- (iv) The basics of modern financial theories of investment and the asset allocation of the trust.
- (v) The basics of trust accounting, so that the beneficiaries will be able to read and have a reasonable basis to evaluate the accounting was prepared by the trustees.
- (vi) Basic principles of trustee compensation, as well as compensation to all other regular advisors and consultants.
- (vii) The importance of participating in educational sessions and becoming financially literate.

When providing educational programs for the beneficiaries, the Trustees are to keep in mind that people learn in different ways and at different speeds. Various assessment programs exist which will help the Trustees identify how my descendants learn and to make certain that information is provided to them in a manner tailored to their individual learning styles. Such assessment tools include those which help to identify how we receive, process, assimilate, store and use information, and career or vocational testing which help to identify the beneficiaries' unique individual talents and interests. The costs of all such assessment tools shall be charged against the trust estate and prorated ratably against the various trusts created hereunder.