ACTEC 2013 Annual Meeting Musings

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Important Information Regarding This Summary

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Introduction

Some of my observations from the 2013 ACTEC Annual Meeting Seminars at the Grand Wailea in Maui, Hawaii on March 7-10, 2013 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings at the ACTEC Annual Meeting. The summary generally also does not include issues that I have discussed in prior "Musings.") I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the seminars. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. I often have not identified individual speakers who made each of the comments (primarily in case I have misinterpreted any of their comments).

The summary sometimes references other Musings where there is a more detailed discussion of the issue being discussed. They can be accessed at www.bessemer.com/advisor. (Sign in [and if you are not already registered, the registration process is extremely simple], look under Planning Insights, or to view all prior summaries, click on the Insights link at the top of the webpage.)

Items 1- 6 come from a symposium by Ronald Aucutt, Lauren Detzel and Stephanie Donaho: Planning for 2013 and Beyond. (A number of the issues discussed in this symposium are also summarized in the "Heckerling 2013 Musings," and references to those more detailed summaries are included below.)

1. ATRA Observations

For a summary of the key changes under ATRA, See Item 1 of the Heckerling Musings 2013 Summary available at www.bessemer.com/advisor.

What Congress did in ATRA was a compromise. The 10% income tax bracket was retained. The top income tax rate increased, but the threshold was raised above $250,000. For investment income, the top rate increased to 20%, but the favorable treatment for qualified dividends was retained. Itemized deductions are subject to limitations, but at much higher threshold than under prior law.

The estate tax provisions also resulted from compromise. The major change was the rate, which is the easiest thing to change. (For example, changing exemptions requires concerns about clawback.) The 40% rate is midpoint between 35% and 45% (which was the top rate proposed by the Administration). Compare what was done in 2012 to what was done in 2010. In December 2010, when we had a 45% rate that would increase to a 55% rate, Congress chose 35% as the rate. In December 2010, when we had a $3.5 million exemption that was set to decrease to $1 million, Congress picked $5 million. What was done in 2010 did not seem to be a compromise; what was done in 2012 was a compromise.

Ron Aucutt points out that what Congress did is durable and permanent: "An act of Congress is required to change it. For 12 years we have not been able to say that."

2. Handicapping the Administration's Legislative Proposals

The Administration's legislative proposals are described in Item 2 of the Heckerling Musings 2013 available at www.bessemer.com/advisor. Ron Aucutt braved making predictions of the likelihood of legislative proposals being adopted this year.

a. *Consistency of Values for Transfer and Income Tax Purposes.* Prognosis: Yes, soon probably.

b. *Valuation Discounts.* The proposal to revise §2704 is estimated to raise only $18 billion over 10 years, so does not represent eliminating all valuation discounts. The proposal also

proposes confirming that the valuation rules for gross estate inclusion and deductions would be treated the same. Prognosis: someday, but a long shot this year.

c. *GRATs*. The proposal requires (i) a 10-year minimum term, (ii) the remainder interest must have a value greater than zero, (iii) the annuity amount cannot it decrease in any year during the annuity term, and (iv) a GRAT cannot last longer than the grantor's life expectancy plus 10 years. Prognosis: Likely. Do not dismiss the possibility of a 10% remainder value requirement at some point, but not this year. (Bruce Stone, in a later seminar, suggested that attorneys send notices to clients of the possible changes to the GRAT rules.)

d. *GST Exemption Duration*. The proposal limits the GST exemption to 90 years after a trust is created (applicable to trusts created after the date of enactment and the portion of pre-existing trusts attributable to additions after the date of enactment). Prognosis: probably this year. (There will be 90 years to make technical corrections.)

e. *Extend §6166 Liens*. Prognosis: This year.

f. *Grantor Trusts*. The provision in the Fiscal Year 2013 Greenbook (released February 13, 2012) proposed that grantor trusts (generally only those created after or to the extent of gifts made after date of enactment) would be includable in the grantor's gross estate for federal estate tax purposes. However, the Administration must have had in mind a more targeted concern, because the proposal was estimated to raise only $910 million over 10 years. Ron observes that "we have wasted our energy panicking about this. The new Greenbook will tell us what they really meant — and then we can panic." The new Greenbook will likely focus the proposal on sales to grantor trusts, involving changes to the gift and estate tax rules, not the grantor trust income tax rules. Bruce Stone, in a later seminar, confirmed that he also believes that the new provisions governing grantor trusts, if ever adopted, will not apply to existing trusts or to open installment sales.

3. Further Planning for Clients Who Made Large 2012 Gifts

a. *Donor's Remorse*. Ron Aucutt's summary of planning alternatives: Renouncing, Refocusing, Reversing, Rescinding, Reforming, Refinancing. Disclaimers of trust transfers may not result in assets returning to the donor unless the trust agreement specifically states that a disclaimer by the primary beneficiary or trustee causes the disclaimed assets to return to the donor.

Rescission probably does not apply either – it is problematic at best to think we can rescind the gift because we did not know what the law would be in the future at the time of the gift but now that we know the law we do not like it.

A donor may choose to exercise a substitution power or purchase assets from grantor trusts if the donor would like to reacquire the favored assets that were previously given to the trust.

For gifts to QTIP trusts, the donor can still decide whether to make a QTIP election (making the election would cause the transfer to qualify for the gift tax marital deduction, leaving the donor's gift exemption amount unused).

Terminating grantor trust status may reduce the ongoing income tax cost to the donor (but may reduce future planning flexibilities).

b. *Implementation Mechanics.*

- Recording, obtaining transfer agents' acknowledgments, making book entries, adjusting capital accounts, etc.,
- Educating the family about managing trusts,
- In a UTC state, notifying beneficiaries,
- Preparing appropriate amendments to operating agreements, and obtaining appropriate consents of other partners or owners,
- For gifts of personal use properties that will be used by the donor, preparing leases and arranging for rent payments,
- For transfers of property with insurance, changing the policy to reflect the new owner as the insured,
- Taking steps to designate successor trustees if trusts have provisions permitting such designation, and
- Coordinating with the client's accountant.

c. *Gift Tax Returns.*

- If the client's accountant is preparing the gift tax return, communicate that a reasonable time will be needed for reviewing the return.
- When to file? Some planners have addressed whether it would be better strategically to file the return in April or October. As a practical matter, the prospect of filing returns by April 15 "is not working out." There is probably no particular advantage of waiting to file until close to October 15 (to be one of many thousands of gift tax returns filed about the same time).
- The number of gift tax audits is increasing dramatically. While there will be many more gift tax returns filed in 2013, there is a significant chance of audit.
- GST issues: Just because no prior gift tax returns have been filed does not mean that GST exemption has not previously been allocated automatically. If exemptions have not been allocated appropriately in prior years, clean up the GST exemption allocations.
- For *Wandry* defined dollar-value transfers, provide detailed language to the accountant for reporting the *Wandry* transfer.

d. *Grantor Trust Decision.* The planner should carefully consider whether the trust should continue as a grantor trust in light of the increased income tax rates and the Medicare tax that applies to trusts with income in excess of $11,950. There is an estate tax advantage of having the grantor pay income taxes, but income tax issues may become of paramount significance. This is not a simple analysis. Begin with looking at the purposes of the trust – was it supposed to accumulate funds for multiple generations? Are there outstanding sales for which gain would be recognized if the grantor trust status is terminated before all payments are made? Various factors apply beyond just analyzing the rates. With respect to rates, compare the grantor's income tax rate to the beneficiary's tax rate if the trust will be making distributions to beneficiaries. While that may save significant current income taxes, it may cause increased estate taxes in the future. (Some, perhaps many, clients will opt to save money now rather than later.)

Make the grantor trust decision in conjunction with the accountant. Analyze the Medicare tax implications to the trust with the client's accountant as well.

e. *Distribution Planning*. For non-grantor trusts, distribution decisions may include income tax factors. Making distributions may avoid the top income tax brackets and the 3.8% Medicare tax that applies to undistributed income in excess of $11,950. However, comparing income tax rates is only one factor among many factors considered in making distribution decisions.

f. *Coordinate With Rest of Estate Plan.* The 2012 irrevocable trust may be the most current version of the client's thoughts. Consider whether the rest of the estate plan should be revised to coordinate with the irrevocable trust. Review how formulas in existing plans work in light of the current exemptions. (One panelist indicates that she is doing more of that than anything else in her practice at this point.) For example, a plan with a marital pecuniary gift and a bypass trust residue may have the residuary estate eliminated with the current large indexed estate exemption. Portability must also be considered.

4. Gift Planning Considerations in a Permanent High-Exemption World

a. *Basis*. Basis is becoming a more important consideration. Income tax rates rose relatively more than estate tax rates. (The top estate tax rate increased 14.3% (from 35% to 40%) while the top capital gains rate increased 33% (from 15% to 20%).) Interest in discounted leveraged gifts may wane somewhat, but that will not happen for core clients. The loss of basis step up at the donor's death is a more significant factor for depreciable gifts.

b. *Paying Gift Tax*. Paying gift tax converts a 40% estate tax inclusive rate to a 28.5% tax exclusive rate if the donor survives at least three years. However, if the cash that is used by the gift tax would have been invested, an offset may occur, especially if paying gift tax requires the sale of the "favored asset." Basis is increased by the gift tax paid, but even so, spreadsheets suggest that paying gift tax "is never a good idea." However, that assumes assets are homogeneous, and in specific situations paying gift taxes can be advantageous. For example, if assets will be sold during the client's life, losing the basis step up at the donor's death is not a factor.

c. *Increasing Exemption.* Address each year whether the client wants to make gifts to utilize the increased gift exemption from indexing in each year.

d. *Valuation Discounts*. Some valuation discount techniques may work better in a gift tax setting. Rev. Rul. 93-12.

e. *Disappearing Techniques*. Some techniques may disappear in the future (discounting, short-term GRATs, grantor trusts, etc.).

f. *Annual Exclusion*. The annual exclusion increased to $14,000 in 2013. Similarly, direct payments of tuition and medical expenses are exempt from gift taxes without regard to the annual exclusion.

g. *GST Exemption*. Making use of the GST exemption currently has a dramatic long-term impact on multigenerational planning.

5. Portability

a. *Client Reaction.* Some clients may consider as a baseline that they have a $10 million exemption and can get a double basis step up without planning. They will ask if the attorney can do better than that.

b. *Client Acknowledgements Needed.* There are two areas of significant concern for the planner.

(1) If the planning does not achieve a double basis step up, get something in writing from the client acknowledging that is intended. The concern is that the children, with hindsight, may complain that the planning was improper because it did not permit a second basis step up.

(2) If the portability election is not made, someone (at least the executor, and perhaps other family members as well) should sign off on that decision.

c. *9100 Relief For Late Elections*. There have been informal indications that the IRS is now accepting requests for 9100 relief on late portability elections if no estate tax return was otherwise required. No formal announcement of this policy is expected. Even if 9100 relief is not requested, one panelist suggests filing a return to make the portability election even if the return is late, in light of the evolving nature of guidance from the IRS. That may be helpful in establishing the intent to make the election even if 9100 relief must be requested at a later time.

d. *Portability Decision Is Complex; It Is Not Just For Small Estates*. Although the underlying premise of the portability concept is to facilitate simplicity for clients, from the planner's perspective this is a complex decision involving a variety of factors. The portability election in many cases will make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives.

e. *Major Factors*. In many cases the credit shelter trust vs. portability decision will come down to the following major factors:

Credit Shelter trust — (i) desirability of omitting future appreciation from the estate, (ii) being able to include both the spouse and other persons as trust beneficiaries, and (iii) avoiding (or minimizing) inequities in a blended family situation; vs.

Portability — (i) administrative simplicity factors of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, creditor protection advantages, and generation-skipping advantages), (ii) desirability of a second basis step up at the second spouse's death, and (iii) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules.

f. *Optimal Approach — Leaving Surviving Spouse Flexibility*. Unless a spouse specifically wants to make a definite decision regarding the use of portability (for example, to mandate the use of a credit shelter trust in a blended family situation), an optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to use portability. Alternatives are (1) to rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or (2) to leave assets to a QTIPable trust (relying on portability if the QTIP election is made and with the assets passing into a bypass trust under a "Clayton" provision if the QTIP election is not made). See Item 7.c.(1) and Item 8.g of the Heckerling Musings 2013 summary available at www.bessemer.com/advisor for a more detailed discussion of the advantages of each of these possible alternatives and of the portability decision generally.

g. *GST Exemption Allocation With Portability*. If the QTIPable trust approach is used as a way of leaving the post-mortem flexibility of deciding how to use portability, the first spouse's GST exemption can be used even if the decision is made to make a QTIP election for the entire trust. A double benefit results: (1) the first deceased spouse's estate would

make the reverse QTIP election under §2652(a)(3) to utilize the first spouse's GST exemption; and (2) the assets would get a basis adjustment (hopefully a step up) at the deaths of both spouses. Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of this strategy. It provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." If portability applies, the election is not required to reduce the estate tax liability to zero, so literally, the Rev. Proc. might apply to negate the QTIP election. However, most commentators believe that Rev. Proc. 2001-38 does not preclude making a QTIP election even though the estate is relying on portability. Rev. Proc. 2001-38 was a relief measure to avoid unnecessary estate inclusion where an estate made an unnecessary QTIP election. The Revenue Procedure states: "[t]o establish that an election is within the scope of this Revenue Procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer may produce a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero." Ron Aucutt concludes that "[t]his statement and the 'relief' origin of Rev. Proc. 2001-38 suggest to some that a QTIP election will be respected unless the spouse or executor repudiates it. "Others are concerned that this approach could appear, in effect, to make the consequences of a QTIP election elective on the basis of what could be very long hindsight." Furthermore, Ron points out that if the Revenue Procedure invalidates the QTIP election, it would be null and void for small estates, but would not be voided for larger estates (because the Revenue Procedure does not apply if the QTIP election was needed at least in part in order to avoid estate tax). That has a bad optic, and the IRS will never allow that result because of the political unacceptability of a rule that "takes care of rich folks but not middle class folks."

6. Estate Planning for 2013 and Beyond

ATRA is the "'great stratifier' of our estate planning toolkit." There will be radically different planning approaches for smaller, middle, and higher wealth clients. General approaches to estate planning following ATRA are described for couples in three different wealth ranges in item 7 of the Heckerling Musings 2013 available at www.bessemer.com/advisor.

Estimates are that approximately $11 trillion will pass from the World War II generation in the next 5 to 10 years. Baby boomers who inherit that wealth will feel more economically secure and willing to engage in transfer planning. The best planning will be available if planning for the inheritance occurs before it is received.

Items 7-17 come from a symposium by John Bergner, Turney Barry, and James Lamm: Planning For Large Estates — The Bigger They Are, The Harder They Fall Unless We Work Hard to Make Them Small

7. 10-Page Summary of Estate Planning Strategies for Large Estates

An outstanding panel discussion at the 2012 Heckerling Institute on Estate Planning by Ann Burns (Minneapolis, Minnesota), John Bergner (Dallas, Texas) and David Handler (Chicago, Illinois) addressed planning approaches and alternatives for hypothetical clients with large estates. The discussion addressed not only technical tax issues and best practices tips for various planning alternatives but an analysis of deciding which types of strategies are most appropriate for various different types of assets and family situations. For a summary of a truly outstanding discussion of planning considerations for large estates, see Item 14 of the 2012 Heckerling Musings at

www.bessemer.com/advisors. This 10-page summary of sophisticated estate planning strategies and considerations for large estates is a wonderful resource (no thanks to me — all I did was summarize the excellent pithy panel discussion).

The symposium at the ACTEC 2013 Annual Meeting is based on that prior discussion. Additional items (and very brief highlights of planning issues) are summarized below.

8. Motivating Clients

Point out to the client that the IRS is a 40% silent partner with the client as to all future appreciation. Strategies to freeze the estate can remove the IRS as a silent partner.

Complexity is at the top of the list of things that keeps clients from moving forward and pulling the trigger on advantageous tax planning strategies. The attorney's job is to persuade the client that the complicated strategy can still be very helpful. (It helps if the attorney really believes that.)

"Providing a solution that is not implemented is not a solution."

9. Attorney Bias

An attorney will often say that all of his or her clients want a particular approach. The reason that happens is that the attorney prefers that approach and the attorney sells the clients what the attorney really believes. The attorney should be sensitive to those biases. For example, one attorney by his nature takes things that are complicated and boils them down in his mind to something simple and understandable to clients in a very simple manner. That is fine until something goes wrong. That attorney needs to realize that tendency and not oversimplify the risk for clients. Other attorneys however, by their nature are inclined to discuss every single risk. They should be aware of that bias as well and be balanced in presenting ideas to clients.

10. Reporting Sales as Non-Gift Transactions

Some attorneys suggest that clients make gifts of cash or easy-to-value marketable securities. After a reasonable interval (Turney Barry quips: after the client has paid the bill for the first transaction), swap discounted assets in return for the trust assets.

The gift of cash or marketable securities will be reported on a gift tax return. The client and planner will need to make a decision whether the non-gift transaction will be reported on a gift tax return as well to commence running of the gift tax statute of limitations on the sale transaction.

A survey of the audience indicates that about 50% typically report sales on gift tax returns and about 50% do not.

11. Actuarial Factors

Jim Lamm (who is also a "computer whiz") has prepared software for calculating actuarial factors, life expectancies, etc. The software is available for free at www.epcalc.com. The program involves entering no more than five variables, and provides calculation results for:

- single and joint life expectancy factors,
- probability of living to certain ages,
- term certain factors,
- single and joint life estate, remainder, and annuity factors, and
- various GRAT, CRUT, CLUT and QPRT/GRIT factors.

This is a terrific very easy to use resource.

12. Residences

a. *Using Traditional Wealth Shifting Strategies*. In the current extremely low-interest rate environment, QPRTs and split purchase transactions are not particularly attractive. Instead, accomplish a wealth transfer with GRATs or sales. The wealth shift can later be swapped out for the vacation home or residence.

b. *Charitable Swap*. Turney Berry discussed the following strategy at a 2006 ACTEC program. Consider giving a remainder interest in the residence to charity, retaining the life estate (the client's spouse may also retain a life estate). The children (or a trust for them) could subsequently purchase the remainder interest if the charity needed/wanted cash before the client's death or if the goal were to keep the residence in the family. Either way, the remainder passes to the charity at the client's death and the client's estate receives a charitable deduction. What the charity has done with this asset is an independent matter. *Blackford v. Commissioner*, 77 T.C. 1246.

13. Family Lending Facility

Parents fund an LLC that would be used as a lending facility to make loans to family members, for acquiring houses or for other purposes. The parents will arrange a large loan at a bank to the LLC. This approach may allow the children to obtain loans with much more favorable terms than they can get on their own (assuming they could obtain the loan at all). The lending entity will be able to make a small spread when it makes loans; there will be a non-tax reason with a reasonable business purpose for having marketable securities or other assets in the LLC, thus providing a better case for discounting.

14. Brief Summary of Favorite Planning Ideas for the Large (Not Mega) Estate

a. *Interspousal Transfers*. Give $5,250,000 to a trust for the other spouse, and allocate GST exemption to it.

b. *Give Business Interests*. Gifts of closely held business interests are ideal because they can be discounted, and the gift leaves the client with liquidity intact.

c. *Defined Value Transfers*. Defined value transfers can minimize the gift risk for large gifts of hard to value assets. If a charitable entity is used, a donor advised fund from the community foundation is ideal. It should act independently in evaluating values and hire an appraiser to review the appraisal secured by the family. The donor advised fund will want an exit strategy for being able to sell any business interest that it acquires. The donor advised fund (unlike a private foundation) is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.

d. *Life Insurance*. Sell the client's life insurance policy to a trust to avoid the three-year rule and to avoid gross estate inclusion of the policy proceeds.

e. *Annual Exclusion*. Make use of the annual exclusion (currently $14,000). Make annual exclusion gifts to §2642(c) trusts or 529 Plans for grandchildren.

f. *Core Planning*. Coordinate testamentary planning with appropriate steps for disability planning and for IRA and life insurance beneficiary designations. Retitle assets so that both spouses have enough assets to make full use of exemption amounts, although portability may limit the need for asset equalization. Transferring one-half of closely held business interests to the non-owning spouse and using QTIP trusts can secure lack of

control discounts. (Even better, transfer 1% to the children so that each spouse owns 49.5%, yielding even greater discounts.)

g. *Trust Planning.* Holding assets in trusts minimizes risks from creditors, including spouses, as well as maximizing transfer tax and income tax planning advantages. Planning to leave the flexibility to achieve income tax basis changes at death is more important with the higher income tax rates that currently apply to capital gains.

15. Installment Sales

a. *Seeding.* The rule of thumb is to have a 10% equity interest in the trust for installment sales to trusts. However, if the trust is funded with assets with low appreciation potential, a higher equity percentage may be appropriate, which also allows more cash flow for making the payments. If personal guarantees are used for the initial seeding, some planners want a 15-20% equity ratio. Pay a going-rate guaranty fee, often about 1%.

b. *Delay.* After funding the initial trust, leave a gap of time before entering into the sale transaction so that the sale and gift transactions will not be treated as a single transaction that does not qualify for the "full consideration" exception to §2036. The panelists like to leave 90 days or even longer before the sale occurs.

c. *Audits.* Only five Fellows in the audience have had lifetime sales audited after reporting sales on gift tax returns.

d. *Note Terms.* Notes are typically structured to be in the mid-term range (using a nine-year note) to take advantage of the interest rate that is dramatically lower than the long-term rate. The transaction could be structured to consist in part of a mid-term note and in part a long-term note.

16. GRATs

a. *More Conservative.* For a very conservative client who wants to avoid audits, GRATs are more attractive than installment sales.

b. *Less Risk of Wasting Gift Exemption.* GRATs are more favorable for volatile assets. For a gift followed by sale of volatile assets, a downturn in the asset value can waste all of the gift exemption and can result in a reverse wealth shift. For a GRAT, the worst case is that the client made a $10 gift.

c. *Multiple GRATs.* One panelist managed a transaction in which a client created 50 GRATs — there was a separate GRAT for each separate financial asset. That is the only time he had a GRAT transaction audited, and it resulted in no changes. In that situation, 55% of the GRATs failed, but the other 45% successful GRATs shifted $700 million to trusts for the client's spouse and children. (All 50 GRATs poured into one trust receptacle, which was initially funded with $10.) The firm has a tickler system for sending notices to clients each month of GRAT payments due the following month. (Turney Berry points out this is a good example of the importance of attorney bias. He could never convince a client to do 50 GRATs, because keeping up with them would drive him crazy.)

d. *Long-Term GRATs.* If the grantor dies during the term of the GRAT, the amount included under §2036 is the amount of the annuity payment divided by the §7520 rate in effect at the individual's death. If the §7520 rate has risen from when the GRAT was funded, there may be a significant decrease in the amount included in the gross estate under §2036. Turney Berry has created various 99-year GRATs. (Why 99 years? Turney replies:

"because 100 years is clearly abusive." As authority for using 99 years, he points to the fact that the United States leased the Panama Canal for 99 years, and Great Britain leased Hong Kong for 99 years.)

The Greenbook proposes limiting the terms of a GRAT to life expectancy plus 10 years. Turney observes that there is nothing better to validate a strategy than that someone wants to outlaw it.

It is likely that the 99-year GRAT would not last the full 99 years. (Turney quips, "despite my prolific consumption of Diet Coke, I am unlikely to survive another 99 years.") If the client's children are entitled to receive the remainder interest and if they are also bequeathed the annuity interest in the GRAT, the annuity and remainder interests merge and the trust ends when the grantor dies.

A possible planning strategy for long-term GRATs is to fund them with notes from installment sales to grantor trust transactions.

17. FLP/LLC Practicalities

John Bergner often convinces clients not to use FLPs. He asks clients why they want to use them, and they respond (based on cocktail party talk) for discounting and asset protection purposes. As to discounting, he asks if they are going to make current gifts or sales of limited partnership interests, and if not, he asks them what they think is the likelihood that we will still have discounts at their deaths in 20 years. With respect to creditor claims, he asks them what they pay for an umbrella policy. They respond almost nothing, and he says that is reflective of the very low likelihood that there will be a claim asserted against the client.

Using FLPs/LLCs can be very helpful if there is a substantial nontax purpose. They can also be helpful if a client is terminally ill and has few if any other planning alternatives (under the theory of what is there to lose?).

Items 18-31 come from a seminar by Carol Harrington, Charles (Skip) Fox, and Bruce Stone: Hot Topics

18. Relief From Retroactive Revocation of PLR Allowing Extension of Time to Make Lifetime QTIP Election

PLR 201025021 allowed 9100 relief to provide an extension for making a QTIP election for a lifetime QTIP trust, contrary to the position in prior letter rulings (such as PLR 9641023). The IRS subsequently retroactively revoked the ruling granting the extension, but invited the taxpayer to submit a request to limit the retroactive effect of that revocation under §7805(b), PLR 201109012. Rev. Proc. 2012-1, § 11.06 states that the revocation or modification of a letter ruling for a reason other than a change of facts will generally not be applied retroactively. There is a history of limiting the retroactive effect of withdrawing a letter ruling if the taxpayer has relied upon it in the meantime to its detriment. In this situation, the taxpayer had released the law firm responsible for preparing the gift tax return from a malpractice action, and retroactive application of the extension denial would cause the taxpayer harm. Accordingly, the Service granted §7805(b) relief from retroactive allocation of the ruling denying an extension of time for making the QTIP election. PLR 201233011. Moral: if a favorable letter ruling is issued that seems questionable, do something to rely on it.

19. Notices Regarding Portability Election

Planners responsible for handling estate administration should mention portability in the engagement letter. If the planner is not responsible for filing the return to make the portability election, that should be clearly stated in the engagement letter – and that the client will get advice from someone else. An explanation about portability must be in the engagement letter because an individual cannot waive something without knowledge of what is being waived.

20. No More Printed Internal Revenue Bulletins or Cumulative Bulletins

Notice 2013-11 states that the IRS will no longer print copies of the Internal Revenue Bulletin; it will only be issued electronically in the future. Furthermore, no Cumulative Bulletins will be printed after the 2008-2 Cumulative Bulletin. (This change is estimated to save $148,000 per year. "Every cent helps.")

21. DING Trust Letter Rulings, PLRs 201310002-201310006

After a five-year hiatus in issuing any DING trust rulings, the IRS issued favorable rulings on March 8, 2013. PLRs 201310002-201310006. "Delaware Incomplete Non-Grantor" Trusts are trusts used to avoid state income tax by having the trust sitused in a jurisdiction that will not tax the accumulated income in a non-grantor trust. (Income of a grantor trust would presumably be subject to tax in the state of the grantor's residence.) Such trusts are merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 40% rate) to have an argument of avoiding state income taxes at a much lower rate.

The DING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor's lifetime. The grantor retains a testamentary limited power of appointment. Various rulings have ruled that the transfer to the trust is an incomplete gift for gift tax purposes, and some have also ruled that the distribution committee members do not have adverse gift tax consequences from serving on the committee. PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005.

No DING Trust rulings have been issued for five years. The status of DING trust rulings has been in doubt for several reasons: (1) *Gift tax consequences for distribution committee members — IR*-2007-127 (July 9, 2007) announced that the IRS is reconsidering its position in these rulings with respect to the gift tax consequences of trust committee members; and (2) *Incomplete gift treatment for grantor* — CCA 201208026 concluded that the retained testamentary powers of appointment over a trust under which the grantors were not beneficiaries cause the remainder interest to be an incomplete gift, but concluded that the testamentary powers of appointment relate only to the remainder interest.

PLRs 201310002-201310006, issued March 8, 2013, address the grantor trust and gift tax issues for what is believed to be a Nevada DING trust (though the ruling does not state explicitly that it is a Nevada trust).

Basic Facts. The rulings all involved identical fact situations. Grantor created an irrevocable trust of which Grantor and his issue were discretionary beneficiaries. There was a corporate trustee, who was required to distribute income or principal at the direction of a distribution committee or principal upon direction from Grantor. The distribution committee consisted of Grantor and each

of his four sons. Three alternative methods were provided for distribution directions: (1) *Grantor consent power*-distribute income or principal upon direction of a majority of the distribution committee members with the written consent of Grantor; (2) *Unanimous member power*-distribute income or principal upon direction by all distribution committee members other than Grantor; and (3) *Grantor's sole power*-distribute principal to any of Grantor's issue (not to Grantor, and not income) upon direction from Grantor as Grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

Two "eligible Individuals" (defined) are required to serve at all times as distribution committee members. "A vacancy on the Distribution Committee" was required to be filled by the eldest of Grantor's adult issue other than then serving members of the committee (with alternate successors if there were no such surviving adult issue). (The rulings do not clarify whether this is interpreted to mean that a vacancy occurs when any member ceases to serve or only when there are less than two members serving. Some commentators interpret the ruling to say that a distribution committee member is not replaced unless there is only one remaining committee member, and that this provision may be important in resolving the IRS's concern that prior DING rulings may be inconsistent with Rev. Ruls. 76-503 and 77-158. Under this reasoning, it is not clear whether the distribution committee members would have a general power of appointment once the committee has been reduced to only two individuals. *See Bill Lipkind on PLR 201310002: DING Redux*, LEIMBERG EST. PL. EMAIL NEWSLETTER #2076 (March 12, 2013).) The distribution committee ceased to exist upon Grantor's death.

There was a decanting power, authorizing the distribution committee to distribute assets to qualified trusts. Grantor had a testamentary power of appointment to appoint the assets to any persons or entities other than Grantor's estate, creditors, or creditors of the estate. In default of exercise of the power appointment, the assets would pass to the issue of Grantor's deceased father.

Rulings. The IRS gave four important rulings: (1) The trust is not a grantor trust; (an apparent assumption in the analysis is that the distribution committee members are adverse to Grantor for income tax purposes; (2) The transfer to the trust is an incomplete gift by Grantor (for various reasons listed in the ruling, one of which reasons that the distribution committee members are *not* adverse to Grantor for gift tax purposes); (3) A direction by distribution committee members to make distributions to Grantor is not a completed gift by the committee members (because it is merely treated as a return of Grantor's property); and (4) A direction by distribution committee members to make distributions to persons other than Grantor is not a completed gift by the committee members because the distribution power is held jointly by persons having interests that are adverse to each other. (Part of the analysis for this issue seems to rely on the fact that distribution committee members are not succeeded in office unless there is only one distribution committee member remaining.)

Miscellaneous Observations in Rulings. The rulings make various miscellaneous observations in addition to the formal rulings described above. (a) The fair market value of the trust assets is includible in Grantor's gross estate for federal estate tax purposes. (b) Any distribution to any beneficiary other than Grantor will be a gift by Grantor for federal gift tax purposes. (c) The rulings specifically decline to express an opinion about the effect of the decanting authority to make distributions to other trusts.

A detailed summary of the IRS's reasoning in PLRs 201310002-201310006 is in the Heckerling Musings 2013 and Other Current Developments summary available at www.bessemer.com/advisor.

22. Constitutionality of DOMA and Availability of Estate Tax Marital Deduction For Same Sex Married Couple, *Windsor v. United States*

Windsor v. United States, 699 F.3d 169 (2d Cir. 2012), is on appeal to the U.S. Supreme Court regarding the constitutionality of the Defense of Marriage Act (DOMA). This case advanced to the Supreme Court on a very quick track. A same-sex couple registered as domestic partners in New York in 1993 and were married in Canada in 2007. Following the decedent's death, the survivor paid federal estate tax and filed a claim for refund on the basis that DOMA is unconstitutional. The IRS denied the marital deduction on the basis of DOMA, but the Justice Department subsequently changed its view and now takes the position that DOMA is unconstitutional. Because of the Justice Department's decision, the Bipartisan Legal Advisory Group of the U.S. House of Representatives moved to intervene in the case to defend the constitutionality of DOMA. The Supreme Court could possibly decide that it does not have jurisdiction in the case because the government is not contesting the taxpayer's position that DOMA is unconstitutional. Eventually, though, this issue will have to be decided by the courts or legislatively. Within the last several weeks a group of 200 large companies filed an amicus brief asking the Supreme Court to hold DOMA unconstitutional.

23. Overcoming Position on Estate Tax Return as Admission, *Estate of Richard*

In *Estate of Richard v. Commissioner*, T.C. Memo. 2012-173, husband and wife had completed a preferred stock recapitalization, with the parents receiving preferred stock and children receiving common stock. At wife's death in 1997, her will was not offered for probate and her estate did not file an estate tax return. On husband's death in 2004, his estate tax return reported 740 preferred shares at $740,000 (par value). The IRS asserted a value of $142 million. (How's that for a difference of opinion?) The estate scrambled and realized that 140 of the preferred shares had actually been owned by wife. Wife's will was probated in 2010, and the court held that the 140 shares that had been owned by wife should not be included in husband's gross estate. (There is ongoing litigation over the valuation of the husband's remaining 600 shares.)

Positions taken on a tax return signed by a taxpayer or return preparer may be treated as admissions, and the taxpayer or return preparer cannot disavow returns without cogent proof that they are incorrect. The court found that the discovery of wife's will in 2010 and its admission to probate provided the cogent proof required.

24. Drafting Powers of Appointment If a Descendant Can Appoint Among Settlor's Issue, PLR 201229005

An irrevocable trust granted the settlor's son a testamentary power of appointment exercisable among a group consisting of the "Settlor's issue." The issue is whether the son could appoint the assets to his estate (since he is an "issue" of the settlor); if so the son would have a taxable general power of appointment. The ruling concludes that the son does not have a general power of appointment. Because the power was a testamentary power, the son was unable to appoint the assets to himself or his creditors during his life. In this circumstance, state law generally provides that a testamentary power of appointment cannot be exercised in favor of the power holder's

estate as an "issue" of the settlor. There are several other rulings consistent with this approach. However, this result only applies for a testamentary power of appointment, for which the common-law rule is that the assets cannot be appointed to the power holder's estate unless the estate is specifically named as a potential appointee. The practical drafting point is that in drafting a testamentary power of appointment authorizing appointment among the settlor's issue, add "but in no event may X exercise the power of appointment in favor of himself, his estate, his creditors, or the creditors of his estate."

25. Planning for Surviving Spouse-Beneficiary of QTIP Trust; Deferred Private Annuity, *Estate of Kite*

Estate of Kite v. Commissioner, T.C. Memo. 2013-43, involved a rather complicated fact situation. QTIP trusts established for the surviving spouse made various investment changes, including investing assets in a limited partnership and selling the limited partnership interests for notes. Under a series of planned transactions, the decedent's children were named as trustees and several days later they distributed all of the QTIP trust assets to the surviving spouse, and she sold the assets to her children for a deferred private annuity. Payments under the private annuity would not begin for 10 years; the surviving spouse had a 12.5 year life expectancy at that point.

The court observed that the IRS had not argued that the investment changes triggered §2519. The court held that the surviving spouse's sale of assets in return for the 10-year deferred private annuity was for full consideration and did not constitute a gift. However, the court held that the series of planned transactions was an integrated transaction that constituted a disposition of the qualified income interest, which triggered §2519. The deemed transfer of the income interest was for full consideration. The court did not address the gift value of the deemed transfer of the remainder interest. Presumably, that will not result in a gift either under the Rule 155 determinations in light of the court's finding that the sale of assets for the deferred private annuity was for full consideration. Carol Harrington asks: "Did the court not understand that the life estate plus remainder interest equals 100%?"

A more detailed analysis of *Kite* is available at Item 43 of the Heckerling Musings 2013 summary at www.bessemer.com/advisor.

26. Settlement Proceeds Paid to Estate Beneficiary Not Deductible as Administration Expense, *Estate of Bates*

Decedent's first will provided that assets would pass to a family trust, which provided for various bequests including a $100,000 bequest to Lopez. A subsequent will (executed after decedent was diagnosed with Alzheimer's disease) provided that Lopez would serve as executor and trustee and that one grandchild and Lopez would be the only beneficiaries of the trust. Following decedent's death, there was litigation over the validity of the subsequent will, and under a settlement Lopez received a fixed sum, with the balance of the property passing pursuant to the terms of the first trust. The estate claimed the settlement payment to Lopez as a §2053 administration expense. The court determined that the settlement payment was not deductible because it lacked adequate consideration. The court reasoned that Lopez was a beneficiary of both the first and second trust and therefore had a legitimate interest as a beneficiary of the estate; settlement payments to beneficiaries are not deductible as administration expenses. (Carol Harrington observes that if the case had been litigated and if the estate won, the litigation expenses would have been deductible. Part of settlements represent avoiding litigation costs, but the "litigation cost" portion is not deductible for settlements with a beneficiary. Consider tax effects in settlement discussions.)

The court imposed a penalty for failing to file the return on time. During the litigation, the court appointed a granddaughter as executor for limited purposes, not including filing the estate tax return. Even though the granddaughter relied on professionals in determining that she lacked the authority to file a return, the court held that was not a valid defense because after being advised that the estate needed to file a return, she did not attempt to seek authority from the court to do so.

27. Special Use Valution Regulation Requiring Election For Real Property Representing at Least 25% of Adjusted Gross Estate Invalid, *Finfrock v. United States*

Regulation §20.2032A-8(a)(2) provides that the special use valuation need not include all the real property included in the estate that is eligible, "but sufficient property to satisfy the threshold requirements of section 2032A(b)(1)(B) must be specially valued under the election." Accordingly, the regulation requires that the special use valuation election be made for real property representing at least 25% of the adjusted gross estate. That regulation was held invalid because there is no such statutory requirement. The regulation is an "interpretive" regulation entitled to less deference than a "legislative" regulation promulgated under a specific grant of rulemaking authority. *Finfrock v. United States*, 109 A.F.T.R.2d 2012-1439 (C.D. Ill. 2012). Another case, also in the Central District of Illinois, has ruled similarly. *Miller v. United States,* 680 F. Supp. 1269 (C.D. Ill. 1988). Query whether the IRS will continue to press this issue outside the Central District of Illinois?

28. Attempt to "Undo" Prior Gifts Rejected, *Estate of Sommers*

An individual made transfers of art to an LLC and made gifts of LLC interests to his nieces and nephews. The individual decided to re-marry his former wife. He changed his estate plan to remove the nieces as estate beneficiaries and commenced a state court action against the nieces claiming there had been no effective transfer or gift of artwork to the LLC or of LLC units to the nieces. An arbitrator in the Indiana action and a subsequent state court in New Jersey held that the prior gift transfers were effective. Following the individual's death, the estate argued that the decedent had retained the power to alter, amend, revoke or terminate the gifts within the meaning of §2038 so that the LLC units were includable in his gross estate (and arguably would pass in a manner that would qualify for the marital deduction). The court denied the estate's request for summary judgment, but granted the government's summary judgment motion that the transfers were completed gifts.

29. Asset Protection

There are various self-settled trust states providing that the creditors of a settlor may not reach the trust assets merely because the settlor is a discretionary beneficiary. Realize that many states have a choice of law doctrine that includes a consideration of rejecting the application of laws of other states that violate a strong policy of the state. Creditor issues could be a strong public policy matter. When selecting governing law in trust documents, realize there is the possibility that an argument can be made that the selected law violates a strong public policy of the resident state and may not be recognized.

30. Qualified Personal Residence Trust Survives Alter Ego Challenge by Bankruptcy Trustee, *In re Yerushalmi*

A creditor in a bankruptcy proceeding made arguments that it should be able to reach assets contributed to a qualified personal residence trust by the debtor. The trustee initially made a

fraudulent conveyance claim, which was later withdrawn because the claims appeared to be time-barred since the transfers occurred more than six years prior to the bankruptcy filing. The trustee then argued that Bankruptcy Code Sections 541 and 542 apply because the qualified personal residence trust was the alter ego of the debtor. The court rejected the alter ego claim, finding that the debtor did not exercise complete domination over the trust or use domination to commit a fraud or wrong. The debtor had retained significant assets and disposable income when the residence was transferred into the trust, and the debtor's use and enjoyment of the residence was consistent with the requirements of a valid qualified personal residence trust.

31. Subsequent Sale Almost Three Years After Valuation Date Considered in Determining Value; Understatement Penalties Avoided By Reliance on Appraisers, *Estate of Giovacchini*

In *Estate of Giovacchini*, T.C. Memo. 2013-27, a unique 2500 acre tract was sold two years and seven months after the date that a 50% interest was sold to an LLC owned by family members and 16 months after the decedent's date of death. The court noted that subsequent events are generally irrelevant and inadmissible in determining the fair market value of property as of a prior valuation date. However, that guideline is inapplicable if the subsequent event is a sale of the property itself within a reasonable time unless there have been "material changes in circumstances … between the valuation date and the date of sale." The court determined that the sale within these time frames was reasonably close and that the sale price was the best evidence of value. The property was sold for $29.5 million. The court determined that the value on the sale date was determined to be $18.5 million, and the value on the date of death was $21.3 million.

The court refused to impose §6662 penalties for valuation understatements. The estate relied upon professional advisors who were provided the information they needed to accurately appraise the property. The estate demonstrated good faith reliance and never directed the appraiser to take any particular tax positions that might have been favorable. The understatement arose from the evaluation of a unique property and in a unique location that was very difficult to value.

Items 32-58 are observations from the Trachtman Lecture, by Max Gutierrez, Jr.: The Life and Death of John J. Stevens, Esq. a Member of the Legal Profession (Reflections on a Legal Career). The entire lecture will be published in an upcoming issue of the *ACTEC Law Journal*. The lecture is full of highlights of interesting reflections on changes in legal practices over Max's legal career. For more than 40 years, Max led the Trust and Estates and Family Law Departments as an attorney with Brobeck, Phleger & Harrison in San Francisco. Max was the chair of the ABA Real Property Probate and Trust Law Section from 1994-1995. He was one of twelve lawyers who established the International Academy of Trust and Estate Law.

32. Estate Planning Very Broad Legal Field

Estate planning is attractive as a legal practice area because it involves the representation of "people" rather than representatives of large corporate entities and many legal fields: corporate, partnership, contracts, real estate, and tax, as well as traditional estate planning matters. When Max began his legal practice, estate planning lawyers were referred to as "probate lawyers."

33. Growth of Large Firms

Upon graduating from law school (number one in his law school class and in his LLM class), Max accepted an offer in 1960 from the second-largest law firm in San Francisco. The firm had about 45 lawyers — all white men. Max was concerned about working for a really large firm. By the time of his retirement, he worked for a firm with over 1,300 lawyers.

34. Dress

Max's preparation for a legal career included acquiring two three-piece suits and a hat – which represented a large expenditure for a first-year associate making $450 per month (less than Max earned from a fellowship and GI stipend as a student for his LLM degree). There was a firm dress code in place for every employee of the firm. Forty years later, Max "regressed" to business casual dress on occasion, but he always wore a suit when meeting with clients.

35. Law Firm Furnishings

Max started his career in a "bullpen" with two other first-year lawyers. The offices in the law firm were carpeted but hallways were linoleum. The managing partner thought that clients would be comforted by knowing that their fees were not going to purchase regal furniture. When the founding partner died, the firm leaders went through an extensive upgrading of the offices in a new office building. The new leaders justified the expense by saying that they spent more than one-third of their lives in the office, so they should have a nice place to work.

36. Library

As part of the move to the new building, one-half of a floor was devoted to the firm's library with beautiful views. Over time, the method of legal research changed from the Key Word system (which required stacks of books) to technology that replaced the library, much to the chagrin of the library staff. The library ultimately moved to a lower floor and half the books disappeared. Eventually, attorneys could do legal research from their personal computers.

37. Addressing the Partners

Associates and staff addressed partners as "Mr. ___." Upon becoming a partner (typically within 7 to 10 years), the new partner addressed everyone in his class and above by their first names. (Max's impression at the time was that was not professional.)

38. Typewriters

The Selectric typewriter was replacing typewriters when Max began his legal career. No professional instrument could have any erasure or sign of an error. Erasable paper was available, but carbon paper was erasure proof.

39. Estate Planning in Tax Departments

When Max began, the "probate attorneys" were led by the head of the corporate and tax departments. At one point, the department head confided that he was uncomfortable being the head of the probate attorneys because he did not know the underlying law.

40. Billing for Estate Planning

Wills were often charged out at $50, even though many hours were sometimes required to get the background information and produce the documents. Billing by the hour was not considered as a measure of value to the client. Max struggled with the realization that estate planning work did not contribute to the firm's profits. He was also concerned with the ethics of delivering a separate invoice for estate planning work for company executives without notice to the Board of Directors.

41. Legal Assistants

Max prepared inventories and estate tax returns with a calculator that had to be cranked every time a number was entered. The work was "physically demanding" and not a good use of his law

school education. Very early in his career, Max persuaded the head of the practice to hire the firm's first paralegal. The paralegal was much less expensive than the attorney and handled more mundane tasks.

42. Statutory Probate Fees

The probate department sometimes produced very high revenues – when a statutory fee was allowed. One estate alone resulted in a very high dividend for every employee of the firm. That was quite disturbing to Max; there should be a reasonable relationship between the work done and the fee. State law eventually changed so that it became a challenge to probate estates within the statutory fee.

43. Role of Partners

Max became a partner after seven years. In his first partnership meeting, he realized very quickly that it was not a place for younger partners to open their mouths at all. Young partners discussed issues with department heads, who would discuss the issues with senior partners.

At one partner meeting, the head of the Labor Law Department said he had read about statutory retirement plans offering tax deferral advantages. To the embarrassment of the Labor Law Department head, the managing partner said that anytime the department head wished to discuss his retirement, he was free to do so in the managing partner's office.

Over time, law firms converted to more democratic governance. Managing partners would serve for about three years. The leadership transferred to partners who were elected by other partners. This was a change in governance, not a change in the profession.

44. Partner Compensation

When the founding partner at Max's firm died, the partners seriously considered the partner compensation system. After much discussion among senior partners, with all partners being under a cloud of risk that some very productive partners might leave the firm, a new management and compensation plan was adopted.

45. Divorce Law Evolution

California originally had about seven grounds for divorce-- extreme cruelty and adultery were the most common grounds. There was an interlocutory waiting period of one year before a divorce could be entered. That tended to encourage settlements. Divorce actions often ended up with an "innocent spouse" and "guilty spouse". The court typically awarded more than one-half of community property to the innocent spouse. Therefore, both parties claimed the other was guilty of extreme cruelty so that the judge would find both parties guilty and divide the community property equally. Eventually, the grounds for divorce were changed to "irreconcilable differences" with no evidence admissible as to what the irreconcilable differences were. (There was one exception; if child custody was involved, extreme cruelty or adultery could be addressed.) In effect, it became a no-fault divorce system, and the interlocutory waiting period was reduced from one year to six months.

46. 1976 Tax Reform Act

The 1976 Tax Reform Act was a profound change in estate planning tax law, with a unified rate schedule and unified credit for gift and estate taxes, an increase of the marital deduction, a new generation-skipping transfer tax, carryover basis (relatively soon repealed, "to the consternation of early book writers"), special use valuation, and liberalization of requirements for obtaining

extensions of time to pay state taxes. The 1976 Act resulted in thousands of hours of work for estate planning attorneys in revising documents. Max was the co-author of a widely used CED treatise about the 1976 Act.

47. Professional Bar Activities

Max's work on committees to reform the divorce laws in California and in educating attorneys about estate planning law changes were extremely important to building his credibility as an expert in estate and family law matters and in building important contacts and professional relationships.

48. Impact of Computers

The development of the personal computer made a huge change in law practices. Personal computers were introduced to Max not from the firm's IT group — which did not exist — but from a gift from his children in the 1980s of a new Macintosh. The only problem in the trial period with computers was that several older partners could not type and they were at the mercy of secretaries.

49. Emphasis on Profit Centers in Firms

One aspect of computers was that all sections of law firms came to be judged as profit centers. There were few large firms in which the estate planning practice was profitable compared to other traditional practice areas. Some large firm shut their estate practices and the partners joined to develop small boutique law firms.

National legal newspapers started to publish the annual financial results of law firms throughout the country. At one time, it was unusual for partners to switch law firms. When the numbers were published, partners could compare their compensation to the average compensation of partners and other firms, and considered moving to firms where they can make more money.

50. Women and Minorities

When Max was in law school, there was one woman in his class. When he began his legal career, there were no women or African-Americans (or other Latinos) in the firm. In his first five years of practice, Max taught an estate planning course in law school, and he observed one woman in class who was extremely bright and would graduate as the number one student in her class. He approached a partner, who was clearly the most liberal partner in the firm, about hiring her. To Max's surprise, the partner would not even discuss hiring the woman with the firm's autocratic leaders. The reason given was that the firm's clients would not want to be represented by a woman. Over time, the ranks of women in the top 20% of law school classes increased dramatically.

There was similar prejudice against hiring African-Americans or Asian students. Eventually, it became more difficult to recruit minorities than women. Whenever a minority graduated from a prestigious law school with the top ranking, the student was very highly recruited. There was fierce competition, but Max was still reluctant to create a second-tier class of attorneys.

One minority student who was being recruited by Max's firm asked Max "Why should I come to work for your firm where there is not a single minority lawyer? Why shouldn't I join a firm where there is equally good work but where there is a majority of minority lawyers?" Max responded that his concerns about practicing in a large law firm are real, "but if you practice with only

fellow African-Americans, no firm would develop diversity that would benefit everyone." That student joined Max's firm.

The fears that clients would not want to be represented by women or minorities proved to be unfounded.

51. Behavior of Lawyers

Max has noticed changes in the behavior of lawyers. When he started his career, lawyers were mostly courteous and professional. That was not always the case with younger lawyers in the family law area, where attorneys felt that they had to establish their macho reputations (both men and women).

52. Advertising

When Max started practice, the worst thing you could call a lawyer was an ambulance chaser. Advertisements and papers, on television, or on the radio were prohibited by state bar guidelines. The U.S. Supreme Court ultimately found that restrictions on advertising were an unconstitutional infringement on free speech. Attorney advertisement, even by prominent firms, has now become commonplace.

53. Technology

Technology advances in the law have been profound, including personal computers, cell phones, teleconferences, etc. As an example, at a recent hearing to show cause, Max was surprised that his opponent spoke from an iPad, with the ability to instantly call up any case the judge might refer to. There was not a single sheet of paper on the table, which was very intimidating.

54. Developing Personal Clientele in Estate Planning and Family Law Practice

Max realized that if he ever left his law firm, he would not be able to take the bank as a client. However, his estate planning and family law clients would be his and his alone.

55. In-House Counsel

One of Max's good friends transferred to the firm's bank client as in-house counsel. His role became that of a liaison with the law firm. The bank increased its legal staff to handle more mundane things that were being handled by second or third year associates at the firm. The in-house counsel's staff increased to the size of mid-size law firms. That resulted in the end of the exclusive representation of the bank, which opened its bidding for legal services among firms by the billable hour.

56. Changing Business Practices

Eventually, branch offices of firms developed. Law firms are run as businesses, with new branches, expensive lease arrangements, etc. (At one time, Max's firm, subsequently disbanded, had to pay $10 million per year for space that was not occupied.)

57. Billing Practices

At the beginning of Max's career, billing practices depended upon the complexity of the matter, the number of key partners and other attorneys committed to the case, etc. Many factors were evaluated in determining the final bill, which was often determined after consultations with clients. Eventually, billable hours brought a new approach to billing and to compensating the firm's associates. Billable hours were an easy measure of an associates' work, and also became an

important factor in the profitability of the firm. This led to an increase in the target hours expected of associates, rising to 1900, then 2,000, then 2,400 hours per year – in addition to pro bono hours, CLE hours, and hours in building a practice. Ultimately, firms became aware that associates were padding their hours.

Companies bid for legal services based on billable hour rates, and demanded that they not be billed for work by first or second year associates. This ultimately resulted in many cases of firms hiring contract attorneys who were not on a partner track or hiring non-lawyer personnel to perform services previously performed by associates.

58. ACTEC and Professionalism

The work of ACTEC is legal profession at its finest. Max's involvement in ACTEC led to collaboration with other Fellows that have been important to Max's career, for example, leading to his work in writing and educating attorneys about the 1976 Tax Reform Act. The ACTEC principles are ones that Max views as the principles of a profession — which is often no longer the case for the principles driving the business of large law firms.

Items 59-62 are observations from a seminar by Lou Harrison and Nancy Hughes: How to Practice Law and Make it to Your Child's Soccer Game, Make it Home in Time for Dinner, Make it to a Ripe Old Age, Make Your Clients Happy, and Be Happy Yourself.

The discussion about making law practices more efficient, for a better quality of life, addresses four areas: (1) Client selection; (2) Office management; (3) Managing the email monster; and (4) Firing bad clients.

59. Client Selection and Intake

a. *Protocol for Initial Contact With Prospect.*

- Rule 1: "Eat Your Ice Cream Rule." Think of the time between the initial referral and your initial contact as ice cream sitting on the counter. At some point it is not edible. Returning the prospect's phone call immediately demonstrates responsiveness. There is also a "first mover" advantage if the client has called several attorneys. Because our day is packed with important projects, we tend to procrastinate.
- Rule 2: "Less than 15 Minute Rule." It is easier to make the initial call quickly because you know it will be less than 15 minutes, "like a speed dating." The initial contact would proceed as follows: "Good morning. Thanks for calling. I have meetings but I wanted to get back to you immediately. Can we schedule a time to meet later in the day?" That "prevents the ice cream from melting."
- Rule 3: Plan for the Longer Call Back. Have a plan in mind to make the longer call back as efficient as possible.
- Rule 4: "Five Minute Rule." If you can tell the matter is a disaster in the first five minutes, reject the prospect. For example, if there are statements such as "I don't like lawyers or paying legal fees," that is a bad client. Have other referral sources nearby to give that individual.
- Rule 5: Stay Connected. If the prospect survives the five-minute rule, there will either be a short call describing the matter generally and scheduling a meeting or a longer phone call going through the issues. In either case, before hanging up, get the prospect's email address, and schedule a meeting.
- Rule 6: "Minimize the Pain of a Long Call." If the initial call is of the longer variety (which is often the case for litigation prospects) the mantra is "listen, segue, schedule."

The more you listen, the more buy-in there will be from the prospect and the call will be shorter. Segue into scheduling a subsequent in-person meeting, and schedule the meeting.

b. *Due Diligence Post Referral*

- Email the prospect a questionnaire asking the prospect to return it prior to the initial meeting. Send it as a Word document so that the prospect can complete it and send it back easily.
- Do a Google search of the individual.
- Send an article or resume by email prior to the meeting.
- Rule 7: "Dismissal Prior to Meeting." If after doing some due diligence regarding the prospect you determine it will not work out, cancel the meeting. Do not meet just to be a nice guy. However, this must be handled with sensitivity. Possible responses:
  - "I think my rates will be too high for this matter, and I have a great solo guy who can do it cheaper;"
  - "My schedule is really bad for the next month and I want to give my clients excellent service. I can tell that your matter needs immediate attention, so let me suggest that you use___;"
  - "This matter is not an area of strength for me. Let me direct you to___;"
  - "Since our discussion, I've taken on matters that will prevent me from accepting your client representation. We endeavor to provide excellent service to all of our clients, but our plates get full and we must decline work that we would otherwise have enjoyed."

c. *Initial Meeting.*

- Rule 8: "Confucius Rule of Estate Planning: The journey to a successful estate plan begins with a single document." Make recommendations that are understandable with discrete projects, beginning with wills, trusts, and a power of attorney. Spent a lot of time listening to the client. Listen for buzzwords that can be positive or negative.
- Rule 9: "Do not ignore buzzwords that can result in buzz kill." Listen for buzzwords that can be positive or negative. Examples of comments suggesting that the prospect would be a bad client include: the prospect has had too many previous lawyers and may even refuse to name them; the prospect thinks all prior lawyers were idiots; the prospect balks at paying a retainer and asks for a special reduced rate or otherwise indicates an unwillingness to pay legal fees; the prospect wants his or her matter to be the sole and primary priority for the attorney; you do not agree with the prospect's legal position or think the prospect is being truthful; the prospect "knows the law" and what they need to do and just wants the attorney to draft documents — "in other words, the prospect is a medical doctor." If the prospect is angry and resentful, send the prospect to your enemy.
- Rule 10: "The Jim Morrison Rule – When the Music's Over Turn Off the Lights." After some hours have been invested in the prospect, it becomes more difficult to decline the representation. However, for a bad client, it is okay to lose five hours; you will save time in the long run and make your life better.

d. *Do Not Forget Good Clients*. Pay extra attention to your good clients. It is not just the squeaky wheel that gets the grease. Treat your good clients better than you have to treat them. The more work you get from good clients, the more time you'll save.

60. Managing Day to Day Practice in a Way That Achieves Both Client Satisfaction and Practitioner Happiness

a. *Goals; Time Management*. The overall goals are to get quality work completed, be responsive to clients, bill clients and get paid, and enjoy our professional lives. An excellent time management resource for attorneys is Mark Powers & Shawn McNalis, *Time Management for Attorneys: A Lawyers Guide to Decreasing Stress, Eliminating Interruptions & Getting Home on Time* (2008).

b. *Set Boundaries*.

- *Clients*. Set reasonable boundaries with clients. We do not have many real emergencies in our practices. Do not apologize for answering email within a reasonable time.
- *Staff*. Encourage staff to schedule short meetings to discuss issues at one time rather than being peppered with emails throughout the day. Set expectations for an email or other written communication with bullet points. Tell the staff that if there is a long email, it will be deleted. The email should consist of short bullets of issues and the staffs suggested response.
- *Self*. Most important, set reasonable boundaries with yourself. For example, do not set too many back-to-back meetings.

c. *Maximize Productivity*.

- Identify and utilize peak brain time.
- Set reasonable goals each morning. The most successful people have a short to-do list for the day. As a practical matter, a 10 item list will not get completed. If there are three items on the list that get completed, you will feel better and will have accomplished more.
- Have regular "no client meeting" days. For example, do not schedule client meetings on Mondays. Instead of working all weekend to catch up, Mondays can be utilized to complete back-office work.
- Set regular drafting/review days. "This is a big one." It is difficult to find concentrated time to do hard reviews without distractions. Consider working in a conference room or at home periodically, using the time to focus and complete projects.
- Set a regular time for client billing. Schedule a focused time each month to complete bills. This avoids having the billing drudgery hanging over one's head, and improves cash flow.
- Keep time contemporaneously. Do not leave for the day until the time is entered.

d. *Delegate*. Lawyers are horrible delegators. We are confident we can do the project better than anyone else and faster. But the only way to leverage and have more time is to delegate. Thinking that "I should do it because I can do it faster and better" is extremely shortsighted.

- Identify what really requires your attention. Otherwise, delegate.
- Take associates to meetings. This has several advantages. (1) this is a cheap way to train and mentor, the associate learns how to run a meeting, (2) following the meeting, the

associate opens the file and handles administrative details, and (3) following the meeting, the associate summarizes notes and prepares a summary of the plan.

- Assign file preparation to staff. For example, paralegals are assigned on a monthly basis to look at all meeting scheduled and pull the files before the meetings. Have regular work status meetings with the office staff to go through all pending matters.

e. *Use Technology*. The practice does not have to be paperless, but the goal is less paper. If executed documents are scanned, then the document can be pulled up when a client subsequently calls about a matter.

61. Managing Email

a. *Goal: FIRM*. **F**ocus on when to use email. ***Intelligent*** use of email, using shortcut keys and efficient storage. ***R****emove* irrelevant and non-action emails. ***M****anage* client expectations as to when responses will be made and manage our expectations by defining boundaries for use of emails.

b. *Focus on When to Use Email*. Email cannot be in front of us all day; we cannot help ourselves from looking at it. Turn off alerts. (In Outlook, go to Tools, Options, Email Options, Advance Email Options and uncheck the items regarding "when new items arrive in my Inbox.")

Change the default view in Outlook to Calendar instead of Inbox. (To shift from Calendar to Inbox, hit Control+1. To shift from Inbox to Calendar, hit Control+2.)

Used ineffectively, email can be a TSA (time sucking abyss).

Email does not have to be answered immediately. For example, try responding to emails from 3 PM to 5 PM. "Is your practice truly polluted by your nonresponsiveness from 7 AM to 3 PM?"

Use the Delayed Delivery option. For example, if you notice and answer an email immediately, you may set expectations of immediate response with the client. Similarly, if you type an email response at 1:00 AM, do not send it until the morning or the client will think that you are available 24-7. (In Outlook, on the outgoing message, under the Options tab, select "Delay Delivery.")

c. *Intelligent Use of Quick Keys*.

- F1 — Displays the Help Pane
- Control+1 — Shift from Calendar to Inbox
- Control+2 — Shift from Inbox to Calendar
- Control+N — Compose a new message or create a new document
- Control+Shift+G — Display an email in the task pane for follow-up
- Control+B — To add bold
- Control+Shift+L — To add bullets
- Control+I — To add italics
- Control+T — To increase indent (without hitting the tab bar)
- Control+Shift+T — To decrease indent
- Control+X — To cut
- Control+C — To copy
- Control+V —To paste
- Control+U—To underline

- Control+F2 — To open print preview
- Control+P —To print
- Control+Shift+F — To find prior emails (This is extremely helpful. For example, one can search for particular words appearing in the subject field or in the message, and a particular sender can be added to the search.)
- Control and Scroll — To zoom

d. *Remove and Review*. Reviewing a large number of emails a second time takes a great deal of time over a year. We must train ourselves not to do this. Each email must be dealt with. The 4D's: Delete, do, delegate, or defer.

- Delete all noncritical emails. (If there's anything that is interesting, "I'll read it later" — Throw it out.)
- If an email can be done in one minute or less, respond to it.
- If there is time to address slightly longer emails, do them as well. "Aside: do not use LOL, funny pictures, abbreviations, or the like. You are not an employee at a technology company."
- If an email is too long to read and respond currently, turn it into a task or appointment. (Hit Control+Shift+G.)

e. *Manage Client Expectations*. Train clients that emails do not garner immediate replies. A response within two minutes sets an undesirable precedent; consider using the delayed delivery option. Do not apologize for the slowness of email responses.

Bill for email time.

62. Terminating Client Relationships

a. *Ethical Constraints*. There are three circumstances for terminating an attorney-client relationship: (1) the client fires the attorney (unfortunately, that does not happen with bad clients); (2) mandatory withdrawal by attorney (ABA Model Rule 1.16(a)); and (3) permissive withdrawal by attorney (ABA Model Rule 1.16(b)). The permissive withdrawal reasons that most commonly are applicable include: "(1) withdrawal can be accomplished without material adverse effect on the interests of the client;" and "(7) other good cause…."

If the attorney wants to terminate the relationship because the attorney just does not like the client ("they make my head explode"), the situation must fall within the first alternative.

If a matter is in litigation, judges have different approaches as to their willingness to allow an attorney to a draw.

b. *Engagement Letter Provisions*. Build exit language into the engagement letter. Example clauses:

> "a. *Failure to pay fees*. Payment is due upon receipt of our invoice. If you fail to pay an outstanding invoice within __ days, we reserve the right to withdraw from the representation with written notice to you.
>
> b. *Withdrawal without cause*. If, at any time, we desire to withdraw from the representation and we determine that your interest will suffer no material adverse effect, we may do so with written notice to you.

c. *Withdrawal for cause.* If, at any time, we desire to withdraw from the representation because of a fundamental disagreement with you, and we determine that your interest will suffer no material adverse effect, we may do so with written notice to you.

d. *Cooperation after withdrawal.* Upon any withdrawal, we will take necessary steps to protect your interests, including cooperation with your new counsel in transitioning your matter."

c. *How to Withdraw.* In litigation matters, the lawyer must seek permission from the court. In non-litigation matters, give written notice of disengagement, preferably after the withdrawal has been communicated in person with the client. Provide sufficient time to engage a new lawyer. Include a refund of any fees paid in advance. Identify filing deadlines and disclose the status of any work in progress.

d. *Life is Short.* "Life is short. Fire bad clients early so that their interests are not materially affected and to enhance the quality of your life."

Items 63-71 are observations from a seminar by Farhad Aghdami, Susan Bart, and Patricia Culler: Decanting: Refining a Vintage Trust.

63. Underlying Theory for Decanting Authority

The theoretical rationale for decanting is that if a trustee has a discretionary power to distribute property to or for the benefit of beneficiaries, the trustee has, in effect, a special power of appointment that should enable the trustee to distribute property to a second trust for the benefit of one or more of such beneficiaries.

The Restatement (Second) of Property: Donative Transfers (§11.1 Comment d) provides that the trustee's ability to transfer trust property is similar to a special power of appointment. If the trustee is able to transfer full legal title to trust property to a beneficiary, the trustee should be able to transfer less than full legal title by transferring the property in further trust.

The Restatement (Third) of Property: Wills & Donative Transfers recognizes a fiduciary distributive power and a discretionary power of appointment. §17.1, Comment g. The Restatement (Third) of Property defers to the Restatement (Third) of Trusts for the law governing the exercise of fiduciary distributive powers, §17.1, Comment g, but specifically recognizes that subject of fiduciary standards and the terms governing the trustee's power, a trustee or other fiduciary can exercise a fiduciary distributive power to distribute trust property to create another trust. §19.14 Comment f. The established rules governing the exercise of special powers of appointment, including the power to appoint trust property in further trust, should provide guidance to trustees looking to exercise discretionary distributive powers over trust property by appointing the property in further trust.

The first decanting case was *Phipps v. Palm Beach Trust Co.*, 196 So. 229 (Fla. 1940). In that case, the individual trustee had the power in its "sole and absolute discretion" to direct distributions to some, none, or all of the trust property to any or more of the settlor's descendants. The individual trustee directed the corporate trustee to distribute assets to a second trust identical to the first trust, except that it gave one of the settlor's children a special testamentary power of appointment to appoint trust income to that child's wife. The corporate trustee sought court approval, and the Florida Supreme Court determined that the trustee's power to distribute property to trust beneficiaries was a special power of appointment that included the power to appoint property in further trust. The court reasoned that "[t]he power vested in a

trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."

Other cases that appear to support the trustees decanting authority arose before 1976 in Iowa, New Jersey, and Georgia.

Judicial modifications are authorized under the laws of most states (and under sections 411-417 of the Uniform Trust Code). Decanting provides the advantages of being able to make modifications without the necessity and expense of a judicial proceeding.

64. Reasons to Decant

There are four common reasons for decanting.

a. *Change of Administrative Provisions.* Examples include: changing the situs or governing law; providing for resignation, removal and appointment of trustees; expanding powers to engage in more sophisticated financial transactions; dividing trustee roles through the use of advisors or protectors, adjusting trustee compensation, addressing liability for failure to diversify over-concentrated assets, and consolidating trusts for administrative efficiency.

b. *Beneficiary Related Change of Circumstance.* Examples include: limiting distributions to beneficiaries with substance abuse problems or other unproductive behaviors; transferring assets to a special needs trust for a disabled beneficiary; limiting beneficiaries' rights to obtain information; dividing a single "pot" sprinkle trust into separate trusts; eliminating a beneficiary; and transferring a self-settled irrevocable trust to a jurisdiction that recognizes asset protection for the trust.

c. *Changes Related to Federal or State Tax Planning.* Examples include: mitigating state income taxation by moving the trust to a more favorable jurisdiction; converting a grantor trust to a non-grantor trust or vice versa; maximizing GST planning; or dividing a trust for GST or marital deduction planning purposes.

d. *Changes to Correct Errors or Address Ambiguities.* Examples include: correcting a scrivener's error; addressing ambiguities; or adding a spendthrift clause.

65. State Statutes

a. *Overview.* Eighteen states have decanting statutes. In chronological order of enactment, they are New York, Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, Arizona, North Carolina, Nevada, Indiana, Missouri, Ohio, Rhode Island, Virginia, Kentucky, Michigan, and Illinois. Over the last three years, there has been a rapidly growing list of states adopting decanting provisions.

   The state statutes vary significantly with respect to a number of different issues. The written materials contain charts identifying all of the state statutes with respect to 37 different issues. Some of these various issues are addressed below.

b. *Who Can Exercise Decanting Authority?* The trustee generally can exercise decanting authority without court approval. Under some statutes, court approval is required for certain actions, such as changing trustee compensation. Beneficiary consent is typically not required. Even though court approval is typically not required, most statutes allow a trustee to seek court approval if desired.

   Some statutes provide that an interested trustee (i.e., a beneficiary) cannot decant. Under those statutes, a disinterested trustee can decant if the interested trustee does not

participate in the decanting decision. If there are only interested trustees, a court may appoint a special trustee who would have the ability to decant.

c. *What Discretion Must the Trustee Have to be Able to Decant?* Some statutes require that the trustee have absolute discretion in order to have decanting authority. Under some statutes, authority to make distributions for comfort, welfare or best interests would be sufficiently broad but other statutes require absolute discretion. Other statutes allow decanting if the trustee has any discretion, even if limited to an ascertainable standard.

   The trend of the more recent decanting statutes is to apply a bifurcated standard. The changes that can be made through decanting depend upon the degree of discretion in making distributions. If there is absolute discretion, the trustee can make changes to beneficial interests (with some limitations). If there is no absolute discretion, the trustee can decant but cannot change beneficial interests, only administrative provisions.

d. *Are Changes to Beneficial Interests Allowed?*

   - *No New Beneficiaries*. The statues are uniform in not allowing the addition of a new beneficiary. "The trustee cannot hand out new wine glasses to new people."
   - *Changing Remainder Beneficiaries?* Some states allow decanting to a trust that include differing provisions for the current beneficiaries, but do not permit changing the remainder beneficiaries. Other states (such as ill Illinois and Virginia) are more liberal and allow changing the remainder interests. For example, if a trust provides that grandchildren C, D, and E are remainder beneficiaries, a trustee with absolute discretion could decant the assets to a new trust eliminating C, D or E as a remainder beneficiary.
   - *One of More Current Beneficiaries*. Many of these states allow decanting to a trust that would include some but not necessarily all of the current beneficiaries. The theory would be in that if the trustee can make a distribution to a current beneficiary, the trustee should be able to make a distribution to a trust that benefits just that one beneficiary.
   - *Changes to Standards for Distributions*. In some states, the ability to change distribution standards depends upon whether the trustee has absolute discretion in making distributions. If so, the trustee can change the distribution standard in the decanted trust. Many states also have restrictions on eliminating mandatory distribution or withdrawal rights, but may permit a eliminating a withdrawal right if the beneficiary has not already reached the age at which withdrawal is permitted.
   - *Granting Power of Appointment*. Most states allow granting the beneficiary a power of appointment. Some restrict who can be appointees but many states allow wide discretion of permissible appointees, including persons who are not currently beneficiaries. Therefore, this is a backdoor method of adding new beneficiaries. "The trustee can give a beneficiary the power to hand out new wine glasses to new beneficiaries."
   - *Making Remainder Beneficiary a Current Beneficiary*. In some states, someone who is only a remainder beneficiary can be given an interest as a current beneficiary of the decanted trust (for example, Illinois, Missouri, and South Dakota). However, some states explicitly prohibit accelerating remainder interests (such as Virginia, New York, North Carolina, and Rhode Island). Other states are silent as to this issue. (A potential

danger of permitting acceleration is that it may be deemed to be a power to add beneficiaries that would cause a trust to be a grantor trust.).

e. *Restrictions on Decanting Under State Statutes*. Some restrictions on decanting are necessary for tax or other property reasons. Otherwise, decanting could alter vested property rights or could alter interests in a manner that would raise tax problems.

- *Rule Against Perpetuities*. All but three statutes directly or indirectly limit the time on the suspension of alienation or vesting to the time limitation that applies to the original trust. (The three states without this limitation are Mississippi, New Hampshire, and Rhode Island.) Most statutes state that the rule against perpetuities applicable to the original trust applies by deeming the decanting as a power of appointment for this purpose. Presumably, the new trust could adopt a shorter rule against perpetuities term and possibly could select a different class of measuring lives as long as they were in existence at the time the rule against perpetuities period began for the old trust (but not under the Illinois statute).
- *Tax Restrictions*. A number of statutes have restrictions to protect tax benefits of trusts. However, the state statutes vary dramatically with respect to the tax provisions that they address. Most of the states restrict decanting in a manner that would cause the old trust not to qualify for the marital deduction or charitable deduction. Most of the states have restrictions to protect qualification for the gift tax annual exclusion. Some states also protect qualification for eligibility as a S corporation shareholder. Some states also have restrictions so that the trust can qualify to use the life expectancy of the beneficiary for purposes of the minimum distribution rules. Some states have restrictions on the ability to decant by a beneficiary who is the trustee, so that the beneficiary would not be deemed to have a general power of appointment. Some states have provisions that would impact the ability to change the grantor or non-grantor trust status of the trust. A few states have catchall provisions so that the trust would not lose any particular tax benefit (Arizona, Illinois, Michigan, New York, and Ohio).
- *Fiduciary Standards*. The power to decant is subject to all fiduciary standards that apply to the trust. Delaware adds that the same standard of care applies as when making an outright distribution, and New York provides that the intent of the settlor must be considered.
- *No Affirmative Duty to Decant*. All of the state statutes provide that there is no affirmative duty to decant.
- *Special Needs Trusts*. Decanting into a special needs trust is a challenge under bifurcated standards that do not permit changing the distribution standards if the trustee does not have absolute discretion. Converting from an ascertainable standard to a purely discretionary standard practices (as would be desired for a special needs trust) would not be permitted. A few states still allow that for disabled beneficiaries (e.g., New York, Illinois, and Virginia with court approval).
- *After Discovered Assets*. Will after discovered assets pass to the new trust or to the old trust? Under some statues, if the trust has been fully decanted, after discovered assets pass to the new trust, but if only partially decanted, to the old trust. If the state statute is silent, the best practice is to address this issue in the actual decanting instrument.
- *Notice Requirements*. Some states require notice to “qualified beneficiaries,” but many do not. A few states allow the beneficiary to object, to prevent decanting. There are

concerns that if a beneficiary participates or consents to the decanting, there could be gift implications for the beneficiary. The best approach seems to be to put beneficiaries on notice, especially if there are shifting interests, but not to require actual consent. Some planners may have beneficiaries provide a release and indemnification, but other planners are concerned that would constitute consent by the beneficiary (for purposes of whether consent creates gift tax problems for the beneficiary).

- *Application of Decanting Statute*. A few statues provide that decanting may be used when the trust is governed by the laws of the particular state. Delaware's statute is applicable if the trust is *administered in* Delaware. Other statutes provide that they may be used when the trust is *administered under* the law of the particular state regardless of where it is actually administered (Kentucky and Virginia). Other states base the issue of the authority to decant on the principal place of administration.

66. Income Tax Consequences

a. *Trust Level Effects*. If there are only administrative changes in the decanted trust, the new trust is generally treated as the same trust for income tax purposes. However, if there are substantive changes so that the trust is treated as a new trust for income tax purposes, the old trust terminates, and DNI is carried out to the new trust. Any carryover losses would also be passed to the new trust.

b. *Beneficiary Perspective*. Under *Cottage Savings*, if the interests exchanged are materially different, there can be income recognition. Various IRS rulings suggest that the analysis is whether the change is permitted under the terms of state law or the instrument. If so, there is no gain recognition under *Cottage Savings*.

c. *Grantor Perspective*. Will gain be recognized under the *Crain* doctrine if there is debt in excess of basis or a negative capital account of the old trust? (1) For a grantor to grantor trust transfer, no gain is recognized (Rev. Rul. 85-13). (2) For a grantor to non-grantor trust transaction, gain is recognized (Reg. §1.1001-2(c), Ex. 5; *Madorin v. Commissioner*). (3) For a complex trust to complex trust transaction the result is uncertain; if there are just administrative changes, gain may not be recognized, but if there are more substantive changes gain recognition could be an issue. (4) For non-grantor to grantor trust transactions, the effect is also uncertain (Chief Counsel Advice 2000923024 determined that there were no income tax consequences upon the conversion from a non-grantor trust to a grantor trust, but there were no negative basis assets in that situation).

67. Gift Tax Consequences

Certain actions or inactions by a beneficiary may be treated as a transfer even if there is not a direct transfer of property. For example, the release of a power of appointment is treated as a transfer, and the failure to enforce a claim may also be treated as a transfer. If a beneficiary's interest is reduced as a result of decanting and the beneficiary fails to object before the statute of limitations expires is that a gift? Only if the beneficiary has a claim against the trustee because the action is outside the scope of the power under state law or the instrument or the trustee breaches the standard of care. If the decanting decision is in accordance with the state statute and in good faith, the transaction should fall within the ordinary course of business exception and not be a gift by the beneficiary.

If a gift is a deemed to occur, difficult valuation issues would arise in determining the amount of the gift. For example, the special valuation rules under §2702 may apply.

68. Estate Tax Issues

Beneficiary Concerns. The primary issue is that if the beneficiary is deemed to have made a gift to the trust when the decanting occurred, one of the estate tax string provisions could then apply.

Trustee Concerns. The trustees should have no estate inclusion issues unless the trustee may be able to increase his or her own interest in the trust.

Grantor Concerns. Estate inclusion issues could exist for the grantor if the grantor is deemed to have a retained an amendment power by reason of an actual or implied agreement with the trustee regarding decanting decisions.

69. GST Tax Issues

The GST consequences are largely unknown. The primary issue is whether a grandfathered trust or zero inclusion trust will lose its GST exempt status by reason of the decanting transaction. Regulations allow certain safe harbors for the modification of grandfathered trusts. There are no specific regulations addressing zero inclusion ratio trusts, but some rulings have indicated that the inclusion ratio will not change if any of the safe harbors that are applicable for grandfathered trusts apply. From a policy point, the rules should be even more relaxed if GST exemption has been allocated to the trust. In that situation, if there has been no new transfer to the trust, there should be no change in the inclusion ratio.

The regulations describe two possible safe harbor transactions for grandfathered trusts. A "discretionary distributions safe harbor" (Reg. §26.2601-1(b)(4)(i)(A)) and a "trust modification safe harbor" (Reg. §26.2601-1(b)(4)(i)(D)).

The "discretionary distributions safe harbor" has three requirements: (i) when the trust became irrevocable, the terms of the trust or local law must authorize decanting (and there were no decanting statutes in 1985, so the planner would have to rely on common law; two state statutes say they are reflective of common law); (ii) neither beneficiary consent nor court approval is required (the Illinois, Kentucky and Rhode Island statutes are problematic in this regard because they permit a beneficiary to object and block decanting, and that may be perceived as negative consent); and (iii) the modification cannot suspend or delay the vesting or power of alienation of an interest in trust beyond the permissible perpetuities period under federal law when the trust was created (not when it became irrevocable but when it was created).

The "trust modification safe harbor" has two requirements: (i) the decanting cannot shift a beneficial interest to a beneficiary in a lower generation, and (ii) the decanting cannot extend the time for vesting of a beneficial interest in the trust beyond the period described in the original trust agreement. Accordingly, this safe harbor applies only to administrative changes or very narrow changes to beneficial interests.

Even if the requirements of the safe harbors for grandfathered trusts cannot be satisfied, do not be completely afraid to use decanting because of GST concerns. The GST inclusion ratio should not change as long as there is not a new transfer, which should not happen if no one is treated as making a transfer to the trust.

70. Drafting Considerations for New Trusts In Light of Decanting

a. *General Considerations.* State decanting statutes generally provide that they may be overridden by provisions in the trust agreement. If the state has a decanting statute, consider whether the limitations in the state statute are appropriate or whether they should be revised. Consider whether the settlor wants to prohibit decanting, or restrict the

authority available under the state statute. For example, the instrument could permit decanting in only a limited way, for example to permit beneficiaries to act as the sole trustee after a certain time.

b. *Sample Form Provisions*. The written materials contain sample trust decanting provisions submitted by various Fellows. The following is a sample trust provision submitted by Bruce Stone, Coral Gables, Florida.

> "*Distributions to Other Trusts*
>
> 9. At any one or more times the Independent Trustee in its sole and absolute discretion can set aside all or any part of the trust estate of a trust held under this trust instrument in one or more separate trusts for the benefit of any one or more of my descendants for whose benefit the trust is held.
>
> 9.1. A separate trust must contain the conditions and restrictions on distributions to married beneficiaries that are set forth in clause 8, but other than that exception the separate trust may provide for distributions of income and principal on terms that are different from those set forth in this trust instrument. The terms may establish beneficial interests that are limited or fixed in nature, whether in scope of permitted distributions or duration, or that vest upon the occurrence of certain terms and conditions.
>
> 9.2. A separate trust may grant a power of appointment to a beneficiary exercisable [*optional*: during the beneficiary's lifetime and] upon the beneficiary's death.
>
> 9.3. The terms of a separate trust may provide for successive, contingent, or future beneficial interests provided the distributions can only be made at any time to for the benefit of any one or more of my descendants for whose benefit the trust under this trust instrument is held until their beneficial interests have terminated as provided in this trust instrument, or if their beneficial interests have terminated, to any one or more of my descendants.
>
> 9.4. A separate trust may contain provisions for the service of trustees and successor trustees that differ from the provisions set forth in this trust instrument.
>
> 9.5. No separate trust may be established for the benefit of anyone who is not a beneficiary under this trust instrument.
>
> 9.6. If the trustee sets aside some but less than all of the trust estate to be held as a separate trust, the portion of the trust estate not set aside will continue to be administered under the provisions of this trust instrument.
>
> 9.7. It is my intention that this power to distribute all or any part of the trust estate in one or more separate trusts shall be exercised only when and to the least extent necessary to provide for specific needs or special situations that cannot be addressed appropriately or efficiently under the provisions of this trust instrument. If the power to distribute in further trust is exercised, it must be exercised in a manner that is consistent with my intentions as set forth in this trust instrument."

Items 71-80 are observations from a seminar by Steve Akers and Carlyn McCaffrey: Wandry Wonderings: Should You Be Using Defined Value Formula Transfers for Inter Vivos Gifts and Sales?

71. General Description of Defined Value Clauses and "Formula Transfer" vs. "Formula Allocation Approaches

a. *General Description*. The concept of using formula valuation clauses for inter vivos transfers, similar to the use of formula marital deduction clauses in wills, was introduced almost 30 years ago. Carlyn S. McCaffrey and Mildred E. Kalik, *Using Valuation Clauses to Avoid Gift Taxes,* 125 TRUSTS & ESTATES 47 (Oct. 1986). In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The United States tax system is based on self-reporting with penalties to enforce self reporting. Defined value clauses may conceivably encourage abusive low-reporting; even if the return is audited, no penalty would apply if no gift could result as a result of the defined value clause.

There are two general types of traditional defined value clauses, "formula transfer clauses" and "formula allocation clauses."

b. *Formula Transfer Clause*. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example of a *very simple* fractional formula transfer clause, which the IRS approved back in 1986 in Technical Advice Memorandum 8611004 (but would no longer approve), is as follows:

> "such interest in x partnership…as has a fair market value of $_________."

Another example, somewhat more complicated but still simple in concept (designed to produce a small gift if the IRS asserts higher values for gift tax purposes to help counter a *Procter* "mootness" attack) is as follows:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 [i.e., the desired dollar value to be transferred by gift] plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property."
>
> McCaffrey, *Tax Tuning The Estate Plan By Formula*, 33rd ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶ 402.4 (1999).

c. *Formula Allocation Clause*. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate

tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the *McCord* and *Hendrix* cases used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two other cases addressing formula allocation clauses have both involved clauses that were based on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

The formula allocation clause is significantly more complicated and by its nature includes multiple parties other than just the donor and donees. In all of the reported cases so far, these types of cases have involved a charity to receive the "excess value" over the stated dollar amount passing to family members.

72. Commissioner v. Procter

a. *Background*. Planners are quite familiar with the Fourth Circuit opinion of *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944), rejecting a "savings clause," but the broader background of the *Procter* case is interesting. Ron Aucutt provides the following summary of the unusual facts and background of this case.

> "The alleged gift in trust in 1939, as the Tax Court saw it, was the present value of Procter's remainder interests (following his mother's death) in two trusts created by his grandfather, less the amount of certain debts of his to his mother that would be paid from those remainders. The Tax Court found that the indebtedness exceeded the present values of the remainders, and that the gift was therefore zero. 2 T.C.M. (CCH) 429 (1943).
>
> Thus, what we regard as the *Procter* case – *Commissioner v. Procter*, 142 F.2d 824 (1944) – was an appeal by the IRS. The Fourth Circuit held that the Tax Court erred in subtracting the face amount of the debts from the present value of the remainders. Instead, the Fourth Circuit held that the debts should be subtracted from the 1939 value of the assets placed in trust, and the difference adjusted by a present value factor. The court then noted that the taxpayer had argued three additional grounds, dismissed two summarily, and then offered the analysis of the third ground, based on Article Eleventh, that has become the familiar (to us!) basis of the savings clause jurisprudence, including the three-part public policy objections of "discourage[ing] the collection of the tax," "requiring the courts to pass upon a moot case," and violating the statutory prohibition on declaratory judgments in tax cases. The Fourth Circuit does not attribute any part of that analysis to the Government, or state at all whether the Government offered a view. So it is possible that the Fourth Circuit came up with this analysis on its own, but it isn't clear.
>
> Eventually, even the actuarial calculation (4 T.C.M. (CCH) 359 (1945)) was appealed by the taxpayer and affirmed by the Fourth Circuit (151 F.2d 603 (1945)), in an opinion by Judge Dobie. The 1939 gift tax due was a whopping $10,566.07.
>
> And the greatest irony of all was that Procter died in 1947, predeceasing his mother, who then unsuccessfully claimed an income tax deduction with respect to the debts and remainders. There is considerable detail about the dysfunction of the Procter family in the opinion in the mother's income tax case (19 T.C. 387 (1952)) and an opinion prior to any of this in which the trustees' attempt to intervene in the gift tax litigation was rejected (2 T.C.M. (CCH) 13 (1943))."

b. *Analysis of Savings Clause*. The trust indenture that was involved with the gift in *Procter* included the following clause:

> "Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property *hereby transferred* which is decreed by such court to be subject to gift tax, shall automatically be *deemed* not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created." (Emphasis added)

Observe that the literal language of the transfer document in *Procter* contemplates that there is a present transfer that counsel believes is not subject to gift tax, and that any property "*hereby transferred*" that would be subject to gift tax is "*deemed*" not to be included in the conveyance. This is different from the clause in *Wandry* that only purported to transfer a specified dollar value of property and nothing else.

The Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons: (1) the provision discouraged the collection of gift tax because any attempt to collect the tax would defeat the gift; (2) the condition obstructed the administration of justice by requiring a court to pass on a moot case; and (3) the provision would reduce a Federal court's final judgment to a declaratory judgment.

Much of the attention in *Procter* about the effect of this clause was about a procedural defect — that the clause would change what had previously been transferred automatically based on what the court decreed and that the clause was automatically undoing whatever the court decided.

> "The court's holding speaks to a procedural defect with the provision, namely, that the clause created a condition subsequent that could not become operative until a final judgment had been rendered, but once a judgment had been rendered it could not become operative because the matter involved had already been concluded by such final judgment.... '[T]he court in *Procter* [held] that because the adjustment was intended to take effect subsequent to the court's judgment, it cannot avoid the imposition of gift tax, because the tax is imposed on the judgment, and is then final.' Diana S.C. Zeydel and Norman J. Benford, *A Walk Through the Authorities on Formula Clauses*, Estate Planning, December 2010, at 4."
>
> Tiffany Carmona and Tye Klooster, *Wandry v. Commissioner-The 'Secret Sauce' Estate Planners Have Been Waiting For?* 26 PROB. & PROP. 10, 11 (Nov./Dec. 2012).

73. *King v. United States* Price Adjustment Clause Case

The next significant case to consider this issue did not arise for over 30 years. That case distinguished *Procter* and gave effect to a "price-adjustment clause." *King v. United States*, 545 F.2d 700, 703-04 (10th Cir. 1976). That case upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be

different than the sale price. The sale agreements stated that "if the fair market value … as of the date of [the agreement] is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the … manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." The IRS determined that the value of the shares was incorrect and refused to give effect to the price adjustment clause based on *Procter*. The case distinguished *Procter*, reasoning that the result in *Procter* was to rescind the transaction if it was determined to be a taxable gift:

> "Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction." 545 F.2d at 705.

The court distinguished *Procter* by noting that (1) no stock was reconveyed to Mr. King, (2) there was no donative intent and the transaction was in the ordinary course of business at arm's length [presumably because it was a sale transaction], and (3) the main purpose of the gift tax was to prevent avoidance of the estate tax, and such avoidance was not an issue in this case because the stock became worthless after the date of the gift.

74. Subsequent Older Cases and Rulings Following *Procter* Approach

Several lower court cases have relied on *Procter* in refusing to give effect to various types of clauses that reduce the IRS's incentive to audit returns. Indeed, prior to *McCord*, *Christiansen*, *Petter*, *Hendrix*, and *Wandry*, the trend of the cases has been to support the *Procter* result. *E.g., Ward v. Commissioner*, 87 T.C. 78 (1986) (gift with agreement that if finally determined gift tax value was different, the number of shares transferred would be increased or decreased; court construed agreement as power to revoke and expressed concern that if no challenge took place the "excess value" would pass without tax); *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986) (transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"); *Estate of McLendon v. Commissioner*, T.C. Memo. 1993-459, *rev'd*, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause that would adjust purchase price and amount of annuity payments; Tax Court ignored the adjustment clause, based on *Procter* and *Ward*, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot"). A more recent case refused to give effect to a formula clause in a gift transaction because the parties did not respect that transaction as a formula transfer. *Knight v. Commissioner*, 115 T.C. 506 (2000).

Various IRS rulings also followed *Procter*. Rev. Rul. 86-41, 1986-1 C.B. 300; Technical Advice Memoranda 200337012, 200245053 (sale by formula not recognized), 9309001, 9246007, 9133001, 8549005, & 8531003; Field Service Advice 200122011 (addressing *McCord* facts).

Interestingly, one of the arguments made by the IRS in some of these cases was that it was concerned of a whipsaw — if the clause is effective to limit gift taxes because of the formula provision, the other parties to the transaction are not parties to the tax case and are not bound by the judgment and there is no assurance that the excess shares will be returned to the donor (*Ward*)

or that the additional price will ever be paid. (*Harwood*, at n.28; *McLendon*); Technical Advice Memo. 200245053.

75. Cases Approving Formula Allocation Clauses

a. *McCord*. *McCord* involves a gift made by a formula giving specified dollar amounts of limited partnership interests to trusts for children and to charities. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). Under an assignment by parents, children and trusts for children were to receive limited partnership interests having an aggregate fair market value of $6,910,933 and the excess was to pass to various charities. The allocation was to be based on a "confirmation agreement" among the transferees. The Court's reasoning is difficult to follow, but is based on the fact that the formula is not tied to values as finally determined for gift tax purposes, but fair market values as determined by the parties. The Tax Court did not decide whether this type of "defined value clause" would be disregarded on public policy grounds. Instead, the court focused on its interpretation of the clause. The court reasoned that the specific clause was not "self-effectuating." The court specifically said that if the parties had used values "as finally determined for Federal gift tax purposes," the Court "might have reached a different result."

A concurring opinion (joined by 2 of the 12 judges) stated that the clause should also be disregarded because of the "long-standing 'reasonable probability' and 'public policy' doctrines applicable generally to gifts…" Dissents by Judge Chiechi and Judge Foley strongly disagreed with the majority opinion. Judge Foley's dissent opens with this volley: "Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law."

The Fifth Circuit held that the IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The Tax Court erred in using the confirmation agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Fifth Circuit opinion gave no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns.

b. *Christiansen*. The Eighth Circuit rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit (as to a portion of the estate). *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). The court gave three reasons for rejecting the IRS's public policy argument even if the effect is that increasing values in audits would not increase the estate tax collected as a result of the audits: (1) the IRS's role is to enforce the tax laws, not just maximize tax receipts; (2) there is not clear Congressional intent of a policy to maximize the audit incentive but there is a public policy favoring charitable gifts; and (3) other mechanisms exist to ensure that values are accurately reported.

c. *Petter*. *Petter v. Commissioner*, T.C. Memo. 2009-280 (Dec. 7, 2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011) involves classic inter vivos gifts and sales to grantor trusts and to a charity using defined value clauses based on values as finally determined for federal gift tax purposes. The Tax Court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for

gift tax purposes. The Ninth Circuit Court of Appeals affirmed, but the IRS did not make the broad based public policy argument on appeal.

The Tax Court discussed four major reasons that the gift and sale transactions with the trusts and foundations by formula allocation do not violate public policy, noting the Supreme Court's test of whether there is a "severe and immediate" threat to public policy: (1) general public policy encourages charitable gifts; (2) there are other "potential sources of enforcement;" (3) the mootness and declaratory judgment concerns raised in *Procter* do not apply because there will actually be a reallocation based on the court decision; and (4) the existence of other sanctioned formula clauses suggests that there is no general public policy against formula clauses.

d. *Hendrix*. In *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (June 15, 2011), parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund (the "Foundation") using values agreed upon by the trusts and Foundation (i.e., using a "confirmation agreement" approach). This case was appealable to the 5th Circuit, and the court held that *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) controlled. The court addressed two distinctions from that case raised by the IRS — that the transfers were not at arm's length and were contrary to public policy. As to the arm's length argument, the court emphasized facts suggesting that there was no collusion with the charity (it negotiated some elements of the transaction, it was represented by independent counsel and hired an independent appraiser to review the family's appraisal, and it had a fiduciary duty to assure that it received the proper shares). As to the public policy argument, the court concluded that the formula clauses do not immediately or severely frustrate any national or State policy but that a fundamental public policy encourages charitable gifts.

76. *Wandry* Approves Formula Transfer Clause

In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court

determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary. (A further problem with the structure of the transaction, which interestingly was not criticized by the court, was that the donor waited 19 months to obtain an appraisal to know the number of units that were transferred under the formula assignment.)

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter* case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting [which seems dubious under these facts]. As to the second and third policy concerns raised by *Procter,* the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case to result in a reallocation of units between the donors and the donees. The court in particular noted that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

This case is not being appealed by the IRS, but the IRS has filed a nonacquiescence in the case.

77. Planning With Defined Value Clauses (Particularly in Light of *Wandry*)

a. *Defined Value Clause Not Needed if Gift is Significantly Less Than Remaining Gift Exemption Amount.* An approach that many planners and clients use is to make a gift of significantly less than the remaining $5 million indexed gift exemption amount. If enough cushion is left, there may not be concerns of having to pay gift tax, even if the valuation is not exactly correct.

b. *Formula Transfer Based on Appraisal Is Allowed.* As a practical matter, it is impossible to value a hard-to-value asset on the date of the transfer. A formula transfer of a dollar value worth of a particular asset, based upon an appraisal to be acquired within a specified term in the near future is routinely used, and is not viewed by the IRS as abusive. By the time the gift tax return is filed, the appraisal will be at hand, and a specific number of shares that have been transferred pursuant to the formula will be known and listed on the gift tax return. *See* Rev. Rul. 86-41, 1986-1 C.B. 300 ("In both cases, the purpose of the adjustment clause was not to preserve or implement the original bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose"). Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction of the *Wandry*-type transfer is that the formula dollar value being transferred is based upon values as finally determined for federal gift tax purposes.

c. *General Comfort With Formula Allocation Clauses (at Least With Charities).* Planners have a general level of comfort that defined value clauses using the formula allocation

approach will be respected, at least where the excess value passes to charity. Three different circuit courts as well as the Tax Court have approved the formula allocation defined value approach (with the excess value passing the charity in all four cases).

If a client is not willing to involve charity, a formula allocation approach could be used with the excess passing to other alternatives, such as the donor's spouse, a marital trust (some planners prefer a general power of appointment trust rather than a QTIP trust because contingent QTIP elections are not allowed for inter vivos transfers, but if the transaction is structured so that some amount is designed to pass to the marital trust from the outset, a QTIP election would be allowed), an incomplete gift trust, or a zeroed-out GRAT. (A particular concern with using a zeroed-out GRAT is that the present value of the excess value would be transferred back entirely to the donor; that may represent a "taking back" concern under *Procter,* and perhaps a concern could be raised about the GRAT not being funded for the intervening months [or years] before the value is determined and about the failure to make required annuity payments during that time frame.)

That all involves more complexity than a straight gift or sale, or a straight gift or sale of "that number of units equal to $X." Many planners and clients have struggled with whether to make transfer under *Wandry*-type clauses when the clients are not willing to make transfers using formula allocations.

d. *Position of Those Planners Who Are Uncomfortable With Wandry-Type Transfers.*

- *Wandry* is just a Tax Court memorandum decision by one judge (Judge Haines). (Query, why was that? Generally, Tax Court memorandum cases are those where the law is clear and the judge is just applying to law to the facts of the case. This is the first court to address a defined value formula transfer clause. Did the government lawyer not make very clear that this is a case of first impression? Did the Tax Court judges not understand that?)
- Some respected commentators view the *Wandry* opinion as poorly reasoned. (Other respected commentators have found the analysis persuasive and well reasoned.) If *Procter* is still good law, no doubt there are fine semantic lines being drawn between describing what is transferred vs. providing that something returns to the donor if the initial values are incorrect. The assignment in *Procter* is certainly similar in broad effect to the assignment in *Wandry* (though there is language in the *Procter* clause suggesting that the "excess property" was originally transferred but that it is "deemed" not to be in the conveyance).
- One commentator's criticism of the *Wandry* analysis focuses on the opinion's reference in several places to "allocations" and suggests that the opinion failed to recognize the key distinction between of reallocation of units among other takers vs. a reallocation of units back to the donor.
- Another poorly reasoned statement in the opinion is the court's statement that other enforcement mechanisms than just IRS audits exist to ensure accurate valuation reporting. That does not make sense in the context of a transaction that is just between a donor and donee, both of whom may wish to have as many "units" transferred as possible without the imposition of gift taxes. Furthermore, the donee has no input into the value used for reporting the gift and cannot participate in the gift tax audit.
- The IRS position is that *Wandry* just can't be right because "we will always lose."

- The IRS has filed a nonacquiescence.
- Planners practicing in the Fourth Circuit (i.e., Maryland, North Carolina, South Carolina, Virginia, and West Virginia) are particularly wary about using *Wandry* clauses. The *Procter* case is a Fourth Circuit case, and "the Fourth Circuit never met a tax it didn't like."
- Many of the planners who are unwilling to rely on *Wandry* nevertheless think it is properly decided.
- Potential disadvantages are: (i) red flag issue for IRS auditors, (ii) a gift tax return must be filed because valuation will be based upon values as finally determined for gift tax purposes, (iii) that the clause arguably might cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about settlement or pursuing the case to litigation), (iv) the potential whipsaw effect if the courts do not respect the clause but it is still binding for state law purposes, and (v) if the gift asset explodes in value after the transfer, the donor may prefer to pay gift tax on the relatively small value at the time of the gift to keep the huge appreciation from the units that remain with the donor under the *Wandry* clause out of the donor's estate.

e. *Position of Those Planners Who Are Comfortable With Wandry-Type Transfers.*

- Even planners more comfortable with the *Wandry* approach are reluctant to rely on *Wandry* if the client is making the transfer primarily in reliance upon protection against having to pay gift taxes because of *Wandry*. However, if the client is planning to make the transfer in any event and will get good appraisals in any event, many planners are using the *Wandry* formula approach to provide an additional argument in case of a gift tax audit.
- Although this is just a Tax Court memorandum case, these planners find the reasoning of the case persuasive. Even though some of the reasoning could be better (see the discussion above), the gist of the opinion focused on the fact that the assignment just describes what is transferred, albeit using a formula. The opinion applies reasoning of the 9th Circuit in *Petter*.
- *Wandry* reached a favorable result in spite of some terrible facts: (i) the gift tax return had an attachment that in one place inartfully referred to a particular percentage interest that was transferred rather than a dollar value, (ii) the donor waited 19 months to get an appraisal to know how many units of the LLC were transferred (which may have suggested that the parties were not really serious about the transfer being just a dollar value of units), and (iii) adjustments in capital accounts did not reflect reality in light of the formula clause.
- *Procter* can be distinguished. Much of the attention in *Procter* was that the clause would change what had previously been transferred automatically based on what the court decreed and that the clause was undoing whatever the court decided. The focus was not that an adjustment was made after the transfer, but that the adjustment occurred after the court decree had already determined that a gift tax was due. Furthermore, some planners believe that even the Fourth Circuit would not decide *Procter* the same as it did 69 years ago because (i) formula clauses have become very routinely used in the meantime (marital deduction formula clauses, charitable remainder trusts, GRATs, disclaimers, GST allocations, etc.), and (ii) the U.S. Supreme Court in the meantime has ruled that public policy concerns should override

traditional tax principles only if the policy frustrations are "severe and immediate" (*Tellier)* and some of the formula allocation cases have referred to that Supreme Court pronouncement in finding that the clause did not rise to the level of a "severe and immediate" frustration of public policy.

- Formula clauses are used every day in testamentary instruments, and there should be no reason why they cannot be used in inter vivos documents either. A distinction is that testamentary formula clauses are, in effect, formula allocation clauses. By definition there are always two parties involved other than the testator. However, if the parties are a surviving spouse and children, all of the parties may want as much value as possible transferred to the children, so there may not be an "adverse" party to negotiate about the proper valuation in many testamentary formula marital deduction clauses.
- The clause can have a favorable impact on settlement discussions (and there is anecdotal evidence that has already happened in audits).
- Prof. Jeff Pennell takes the position that the formula transfer approach (using the *Wandry*-type clause) is less abusive than the formula allocation approach with the excess assets passing to charity because the units that remain with the donor will be subject to a future gift or estate tax to the donor. With the formula allocation/charity approach, the excess units are forever removed from the transfer tax base of the donor.
- Some of the planners using a *Wandry* transfer combine that with a formula disclaimer, with the beneficiaries or trustee disclaiming any property in excess of the dollar amount described in the *Wandry* transfer.

f. *Basic Advantages/ Disadvantages of Using Defined Value Clauses*. The basic *advantage* of using the defined value transfer clause is creating the ability to make lifetime transfers without the risk of having to pay current gift taxes (if the clauses work as intended).

Disadvantages include:

(1) Whether the defined value clause is a red flag that triggers or intensifies a gift tax audit (for formula transfer or formula allocation-type clauses) [response: with the IRS's consistent losses, using defined value clauses should no longer be perceived as a red flag of an abusive transaction];

(2) Complexities of administering the defined value clause (but a "formula transfer" type of clause approved in *Wandry* is easier to administer than a formula allocation among transferees);

(3) A gift tax return must be filed if the clause is based on values as finally determined for federal gift tax purposes (and if the defined value clause is used in the sale transaction, the seller may have preferred not to report the transaction on a gift tax return);

(4) Will a *Wandry* clause cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about value issues and by urging or at least refusing to fight an unreasonably high valuation position by an agent, the donor can cause more of the asset to remain with the donor than should be appropriate); and

(5) If the IRS does not respect the clause, an adjustment of the amount of assets passing to the family trust may still occur (with more assets passing to a charity or

other "pourover" party or remaining with the donor under a Wandry-type of clause) even though no tax benefits result from the adjustment.

As to the incomplete gift argument, the wording of the IRS's nonacquiescence could be interpreted to hint that the IRS might raise an incomplete gift issue. The nonacquiescence stated: "nonacquiescence relating to the court's holding that taxpayers made a *completed transfer* of only a 1.98 percent membership interest in Norseman Capital, LLC" (emphasis added). The extent of the donor's control in a gift tax audit seems to be rather remote insofar as retaining dominion and control over the asset to result in an incomplete gift. It is the agent's decisions that cause more of the property to remain with the donor by urging that the property has been undervalued; all the donor can do is decide what to do in response to the agent's decisions. The donor keeps no control whatsoever the keep more of the units than originally anticipated if the agent does not argue that the units were undervalued.)

The last potential disadvantage seems to be the most dangerous in using a *Wandry* defined value transfer of a dollar value. If the IRS does not respect the clause and imposes a gift tax on the number of units that the donor thought was transferred, for state law purposes the formula would still seem to apply (although perhaps that would be grounds for a reformation) and some of the units may remain with the donor to be included in the donor's estate for estate tax purposes. If that happens, it seems there would not be double inclusion because under §2001(b)(last sentence; any gifts that are included in the gross estate are not treated as adjusted taxable gifts in the estate tax calculation). The units that remain with the donor are obviously included in grantor's gross estate if the donor still owns them at death. The gift tax was calculated as if those units had been transferred. Therefore, under §2001(b) the portion of the adjusted taxable gift attributable to those units that remain with the donor should not be brought back into the estate as adjusted taxable gifts for calculation of the estate tax. (Query what occurs if the donor subsequently makes a gift of those remaining units rather than retaining them until death? Would the transfer be subject to a second gift tax even though the units have already been subjected to a gift tax? Perhaps only the additional value at the time of the second gift would be subjected to gift tax at that time.) If the IRS position is upheld, is the increase in basis under §1015(d) for gift tax paid allocated to all of the shares deemed gifted by the donor even though some of those shares remain with the donor? Also, if the *Wandry* clause is used in connection with a formula disclaimer, the IRS would have to overcome two issues for this disadvantage to arise.

One situation in which a formula transfer clause could be disadvantageous is if the asset may explode in value in the near future. If that were to happen and if the IRS prevailed in asserting that the value is somewhat higher than reported on the gift tax return, the client might prefer to pay gift tax on the relatively small amount in excess of the gift exemption rather than having some of the units remain in the donor's estate, with the subsequent huge appreciation on those units being added to the donor's gross estate.

g. *Formula Disclaimer Combined With Wandry Transfer*. Some practitioners using the formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the trustee or donee(s) immediately following the transfer execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. (A statute in Florida specifically authorizes the validity of such a provision allowing the trustee to disclaim.) The rationale is that the regulations

have always recognized formula disclaimers as being valid, so even if the formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. Until further case law develops approving formula transfer clauses, this is a strategy that may provide additional comfort when using formula transfer rather than formula allocation clauses.

If the formula disclaimer approach is used and the disclaimer provision is included in the trust agreement, consider adding a provision in the trust agreement expressing the settlor's wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor's family, and perhaps make the transfer to the trust as a net gift so that if gift tax consequences arise they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, the formula transfer to the trust in the first place may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor's intent as much as possible in making the formula transfer to the trust.

One planner suggests that the formula disclaimer by the trustee be combined with provisions in the trust document stating (i) that if an excess value is inadvertently transferred compared to the specified dollar value, the trustee holds the excess as agent for the donor, and (ii) that the trustee may commingle the excess assets that are held as agent with the trust assets.

h. *Practical Structuring Tips With Wandry Formula Dollar Transfers.*

- The formula language in *Wandry* may be favorable as a form template. This avoids giving an agent the excuse to reject a clause with different language. (However, a desirable change is to use values "as finally determined for federal gift tax purposes" because that phrase is clearly defined in §2001(f).
- The gift tax return should properly described the gift. The gift tax return properly listed the value of the gifts as the stated dollar values, but the gift description should also make clear that the gift is of the number of units of the LLC having the specified value. The description could state that based on the attached appraisal, the number of units under the formula would be x, but that ultimately the number of units is based on their value as finally determined for federal gift tax purposes.
- A contemporaneous appraisal of the transferred units should be made (rather than waiting 19 months, as was done in *Wandry).*
- Use a professional appraiser. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in *Petter*) "shady dealing" by a "tax-dodging donor."
- Use grantor trusts as the donees, so that if there is a later adjustment of the number of shares transferred, at least the income tax reporting in the interim will be accurate.

i. *Extent of Utilization of Wandry Clauses.* At the seminar, an informal survey of attendees reflect that about 75-80% of the attendees have structured at least one *Wandry* transfer. However, relatively few have combined the *Wandry* transfer with a formula disclaimer provision as well.

78. Incomplete Gift Strategy — Sale to Grantor Trust Created for Client by Spouse

a. *General Description.* The following is an alternative strategy that could be used to limit gift tax exposure. A trust agreement provides for the creation of two trusts. H funds Trust A with, say, $200,000. W funds Trust B with $10. W has a testamentary power of appointment over both trusts. The trust agreement provides that transfers to the trustee will generally be allocated to Trust A, but any gifts from W will be allocated to Trust B. W sells Blackacre (which she thinks is worth $1 million) to the trusts in return for note from Trust A for $1 million.

b. *Effects.*

- Seed Gift Required. A significant seed gift to the trust will be necessary before the spouse makes the sale.
- W is Discretionary Beneficiary and Has Power of Appointment. W is a discretionary beneficiary and has a power of appointment over the trust, which means that W will be more comfortable selling favorable assets to the trust without fear of losing control and having no beneficial interest in the assets. Even so, all of the appreciation will be excluded from her estate (but if Blackacre is worth more than $1 million, the fractional portion of the excess value will be included in her estate).
- Income Tax. There is no gain recognition on W's sale to H's grantor trust. §1041. However, the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments (although the spouse would likely receive an offsetting investment interest deduction). Gibbs v. Commissioner, T.C. Memo 1997-196.
- Gift Tax. W will not make a gift even if Blackacre ends up being worth more than $1 million (because she has a testamentary power of appointment).
- Estate Tax Effect for H. The trusts are designed so that the trusts are not included in H's estate.
- Estate Tax Effect for W. W could be a potential beneficiary of the trusts. However, even if she is a beneficiary, Trust A should not be included in her estate because she never made a gift transfer to Trust A. The advantage of using the separate Trust B is that if there is a gift element in the transfer of Blackacre the fractional portion of Blackacre represented by the gift would pass to Trust B, so that none of the appreciation in the portion equal to $1 million that passed to Trust A will be included in W's gross estate. (If a single trust had been used, and if a portion of the transfer was deemed to be a gift, the entire appreciation in Blackacre might be included in W's estate less a §2043 consideration offset for the $1 million note.)
- Creditors. To the extent that Blackacre is worth $1 million, W has not made a gift to a trust of which she is a discretionary beneficiary, so W's creditors should not be able to reach the trust. To the extent that Blackacre is worth more than $1 million, the excess portion would be a gift from W to a self-settled trust that could be reached by her creditors (unless the trust is established in a "self-settled trust state").

79. Inter Vivos QTIPable Trust

A spouse could make a gift to a "QTIPable" trust for the other spouse. Advantages of this planning approach include: (1) the decision of whether to make a taxable gift can be deferred until the gift tax return is filed (when the decision of whether to make the QTIP election must be

made); (2) a QTIP election may be made by a formula to limit gift tax exposure to a desired specified amount (*see* Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8); Tech Adv. Memo. 9116003); and (3) there is flexibility to allocate the grantor's GST exemption (by making a "reverse QTIP" election under §2652(a)(3)). However, it is not possible to use a "Clayton" provision for inter vivos QTIPs (to provide for more flexible trust terms to the extent that the QTIP election is not made).

80. Formula Consideration Transfer Approach

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.) For a detailed discussion of this approach see Carlyn McCaffrey, *Formulaic Planning to Reduce Transfer Tax Risks,* 45th Univ. of Miami Heckerling Inst. On Est. Pl. ¶701 (2011); Carlyn McCaffrey, *Formula Valuation—Shield Against Gift Tax Risk or Invitation to Audit*, 42nd Univ. of Miami Heckerling Inst. On Est. Pl. ¶1103.3.A.2 (2008).

Items 81-86 are observations from a seminar by Marc Chorney, Kim Kamin and Barry Nelson: John T. Rogers, Jr. and Hugh Kendall: Counseling the 50%: Selected Divorce Issues for the Estate Planner

81. Divisible Property on Divorce

At common law, in a divorce the property was awarded to the spouse who had title to the property. That changed in the 1960s-1970s, when marriage was considered a shared enterprise. Equitable distribution statutes do not alter a state's property law by creating new classes of property, but recognized equitable claims that arise as a consequence of marriage. Equitable distribution statutes now adopt three approaches. (1) Approach 1 — all property owned by the spouses is included in the pool of divisible assets, including property acquired before the marriage and property acquired during the marriage by gift, inheritance, devise and descent. (2) Approach 2 — property is classified as either "separate" (sometimes referred to as "nonmarital") or "marital." Marital property is typically defined as property acquired subsequent to marriage, except by gift, bequest, devise and descent. (3) Approach 3 — various states have adopted hybrid approaches (for example, Arkansas requires as a general rule that the court award separate property to its owner, unless the court makes some other division deemed equitable taking into consideration facts enumerated in the statute).

Community property jurisdictions vary significantly as well with respect to their definitions of community property and the division of property on divorce.

82. Treatment of Interests in Third Party-Settled Trusts as Divisible Property

The types of property that are considered in the pool of divisible property has been expanding, including assets such as retirement benefits, intellectual property, employment perks, professional degrees, goodwill, etc. Interests in trusts have been swept into the expanding pool of divisible assets in several states (in particular Colorado and Massachusetts). "Whether or not Colorado is winning a race to the top, a race to the bottom, or just struggling to come up with a stable framework is a matter of opinion. Colorado practitioners agree that the number of property divisions involving third-party trusts has increased dramatically."

a. *Statutes That Preclude Considering Trust Assets.* Some states preclude considering trust assets in the pool of divisible property. For example, California precludes awarding one party's separate property to the other, and appreciation other than as a result of marital labor is considered separate property. Accordingly, a spouse's entire interest in a third-party settled trust constitutes separate property. There are similar provisions in Arizona, Nevada and New Mexico.

b. *States Where Unlikely That Trust Assets Will Be Considered.* In other states, there is case law making unlikely the consideration of trust assets in dividing marital property. For example, in New York, New Jersey and Florida, separate property includes both income and appreciation from separate property. Unless marital labor is contributed to the trust, the trust interest will not be considered.

c. *Possessory Interest in Trust.* Some cases (from Pennsylvania, Wyoming, Indiana, and Delaware) provide that trust assets are not subject to division on divorce until they become a possessory or a beneficiary has a right to reduce the asset to possession (such as having a presently exercisable general power of appointment or right of withdrawal). For example, in *Solomon v. Solomon* (a 1992 Pennsylvania case) the beneficiary could withdraw one-half of the assets at age 35. Until age 35, the trust interest was considered a mere expectancy. However, the wife-beneficiary did not exercise the right to a withdraw one-half of the assets at age 35, and the court determined that the appreciation in the value of the one-half interest subsequent to age 35 was deemed to be marital property.

d. *Remainder Interests Fully Distributable.* Courts in several states ruled that a remainder interest that will be fully distributable to a spouse at some point in time is subject to division on divorce even though the remainder interest may be subject to a survivorship provision or may be reduced or eliminated by a preceding beneficial interest in the trust.

    (1) *Colorado and Massachusetts.* In *In Re Marriage of Balanson* (a Colorado case) wife's parents created a joint revocable trust, which at the death of wife's mother divided into Trust A (a general power of appointment marital trust) and Trust B (a credit shelter trust). Both trusts provided the wife's father with a mandatory income interest and the power as trustee to distribute principal to himself for his support, care and maintenance. At father's death, he had a testamentary general power of appointment over Trust A but not Trust B. The divorce occurred while father was still living. The Colorado Supreme Court determined that Trust B was included in the pool of divisible property, because wife had a "future, vested interest not within the discretion of the trustee to withhold." The court acknowledged that the father had an income interest and the right to invade principal, but stated that those factors merely render the value of wife's remainder interest uncertain but do not convert her interest into a mere expectancy. The Colorado court arguably applied a vesting test in *Balanson*. However, that does not seem to be a workable rationale, as discussed in subparagraphs (4-5) below. The Supreme Court did not address whether the wife held a property interest in Trust A (over which wife's father held a general power of appointment); apparently husband did not claim that it was divisible property.

    A Massachusetts case ruled similarly (*S.L. v. R.L.*). A trust over which wife's mother held a testamentary general power of appointment was not marital property, because it was "susceptible of complete divestment upon the wife's mother's exercise of the power." However, the credit shelter trust for wife's mother

was considered marital property because wife's interest "[was] subject only to her surviving her [then living] mother, a condition [that Massachusetts precedent] considered not to bar inclusion within the marital estate."

(2) *Trust Property Subject to General Power of Appointment.* The Colorado and Massachusetts cases held that property subject to some person's general power of appointment is not considered divisible marital property.

(3) *Trust Property Subject to Special Power of Appointment.* Whether a special power of appointment causes the same result is less certain. A Montana case (*In Re Marriage of Beadle*) and Massachusetts case (*D.L. v. G.L.*) held the property subject to a parent's special power of appointment is not marital property to be considered in the division of property on divorce.

(4) *Facts and Circumstances Approach.* The best way to construe *Balanson* is not to apply a strict vesting test but a facts and circumstances approach (which is what is done in Massachusetts).

(5) *Legal Inconsistency With "Vesting" Test.* UPC § 2-707(b) provides that unless a trust agreement provides to the contrary, remainder interests in trust are unvested. (This changes the common-law rule, which provided that they remainderman generally was not required to survive in order to receive the interest. The problem was that sent trust estates to dead people, so the UPC changed the rule.) That is contradictory with a divorce "vesting" test for marital property.

e. *Multi-Generational Trust With Discretionary Interest Not Fully Distributable.* If a discretionary multi-generational trust does not require an outright distribution to a child or give a child a presently exercisable general power of appointment, the child's interest in the trust is generally not property considered in the division of assets on divorce. The lead case is *In Re Marriage of Jones* (a Colorado case), in which the trustee had a spray power among the wife and other family members in the trustee's uncontrolled discretion. The trust will terminate upon the death of the wife's father and the wife, at which time the assets would be distributed to the wife's descendants. The wife's rights in the trust were merely an expectancy that did not rise to the level of property. The court gave three rationales. (1) The trust was completely discretionary and the wife could not compel a distribution absent fraud or abuse. (That is not a good rationale; it would suggest that if the trustee was required to make distributions under a standard that was enforceable, the interest necessarily would have been a property right.) (2) The interest was not assignable and could not be reached by the beneficiary's creditors. (That is not a good rationale either; if the result turns on whether a trust instrument contains a spendthrift clause, few trusts would be includable in the pool of divisible assets.) (3) The court distinguished "a discretionary trust from those trusts that grant the beneficiary some future, vested benefit not within the discretion of the trustee to withhold, but whose value may be uncertain at the dissolution of the marriage." Because the wife could not compel a distribution absent fraud or abuse, it was not considered property.

Cases have reached varying results in this type of situation. Another case in Colorado, as well as cases in Vermont, North Dakota and Massachusetts have ruled, similar to *Jones*, that the trust instrument was not property to be considered on divorce. Other cases in Massachusetts have considered the beneficiary's interest in the trust to be divisible property (although it is not clear in any of those cases that distributions were subject to the absolute discretion of the trustee). Cases in Mississippi (*Moore*) and Oregon (*Taylor*)

have determined that interests in such a multigenerational trust were property. The courts did not say how to value the property or how the award would be made.

The result of these cases may depend upon whether there is a absolute discretion in making distributions or whether there is a standard that can be enforced. In addition, there may be a difference based on whether the trustee "may" or "shall" make distributions pursuant to the standard. One Colorado case (*United States v. Delano*) reasoned that if a "pure discretionary trust" had been intended, the settlor would have used the word "may" instead of "shall."

f. *Mandatory Income Interest.* As a general rule, a beneficiary's income interest is not considered property for divorce purposes. *See In Re Marriage of Guinn* (Colo. Ct. App. 2004)("when the beneficiary has no interest in the corpus, and no right to control how the corpus is invested, … the income is a mere gratuity deriving from the beneficence of the settlors"). That could be extended to annuity and unitrust interests. However, income interests are considered in some states (Oregon, New Hampshire, and North Dakota).

g. *Third Party Revocable Trusts.* It is logical and courts have held that a beneficiary's interest in a third-party settled revocable trust of a living settlor is not includable in the pool of divisible assets. A Colorado case (*Gorman*) held that a remainder interest in the parent's revocable trust is a property interest because it is vested (subject to complete divestment). However, the Colorado legislature overruled that decision, so that an interest in a trust subject to a power of amendment or revocation is not a property interest.

h. *Self-Settled Trusts.* It would seem that if a beneficiary's creditor could reach trust assets that the spouse should be able to reach the assets as well. However, a Colorado decision (*In Re Marriage of Pooley*) said the source of funds was not relevant; the dispositional terms of the trust control. However, an earlier case (*In Re Marriage of Kaladic*) had provided that a self-settled trust was illusory and awarded the spouse 26% of the value of the trust.

Trust Subject to "5 or 5" Power or Crummey Trust. There is uncertainty as to whether a creditor can compel the exercise of a "5 or 5" power or a *Crummey* power by beneficiary. There is also uncertainty as to whether the lapse of a "5 or 5" power or *Crummey* power turns a beneficiary-power holder into a settlor. (Under the Uniform Trust Code, it does not to the extent that the withdrawal power does not exceed the annual exclusion or the "5 or 5" amount.) By analogy, that would seem to apply for divorce purposes as well.

i. *Person Who Holds Non-General Power of Appointment Exercisable In Favor of Spouse.* If a person holds a non-general power of appointment exercisable in favor of the person's spouse, can a divorce court order the person to appoint the property to the spouse? A Connecticut case (*Cooley*) says no, but a Massachusetts case (*Ruml*) says yes. *Ruml* is an interesting case in which a wealthy man refused to participate in a divorce proceeding or follow the orders of the court. Eventually, he was ordered by the court to exercise his power of appointment in favor of his wife. He did not do so, and the court awarded the property of the trust (not just the value of the trust) to the wife. This was an unusual decision in which it appeared the judge was emotionally invested in the case. This is illustrative of divorce cases. Divorce courts make decisions in equity on the basis of the facts, and sometimes bend the rules to get to what the judge determines to be an appropriate result. Results can be unpredictable and are very fact driven.

j. *Valuing Trust Interest and Making Property Award*. Courts typically value and award trust interests to the other spouse based on a present value determination. The courts typically look to the estate and gift tax life expectancy tables and calculations for determining the present value. If there is other property owned by the trust beneficiary, the court will award that other property up to the value of the trust interest that it determines should be allocated for the spouse. If there is not enough offsetting property, the court might use a note, or defer the award until the distribution is actually made. For that purpose, a court may retain jurisdiction and make a property division with respect to trust when the trust term ends.

83. Forum Shopping

Forum shopping may be possible if there are multiple residences. For example, Marc Chorney has been involved in cases where the divorce could have been brought in either Colorado or Maryland in one case or California in another case. If brought outside of Colorado, the trust interest would not be considered. Tens of millions of dollars of difference could rest on the forum shopping decision.

84. Drafting Considerations For Trusts Taking Into Consideration Possibility of Divorce

a. *Do Not Be Paranoid*. There is no need to be overly paranoid in planning. While the general rule of thumb is that there may be a 50% likelihood of spouses getting a divorce, for affluent and more educated clients the likelihood of divorce may be closer to 10-20%, depending on how long the couple has been married. Keep perspective and plan for flexibility.

b. *State Law Default Provisions*.

UPC. Section 2.804 of the Uniform Probate Code presumes that unless otherwise specified by a governing instrument, court order, or marital settlement agreement, the spouse of the testator or settlor is considered deceased upon divorce. This applies to interests under wills, will substitutes (revocable trusts, beneficiary designations for life insurance or retirement plans), powers of appointment, fiduciary appointments, and agencies under a power of attorney for health care and for property. (However, be aware that *Eggelhoff* provides that ERISA can preempt state law default rules.)

Varying Approaches. Almost every state treats a divorced spouse as deceased under a will that predates the divorce. (The only exception is Mississippi.) The states vary greatly as to will substitutes, but the trend is to add will substitute divorce provisions.

Irrevocable Trusts. The speaker does not know of any state that treats a divorced spouse as having predeceased for purposes of an irrevocable trust. However, under common law principles, a trust may be interpreted that way based on the settlor's intention. If the actual intention is to treat the spouse as deceased even though the express language does not say that, a court may construe the trust in that manner.

c. *Summary of Planning In Light of State Law Default Provisions on Divorce*.

Timing. The person is presumed to be deceased at the actual time of divorce, not the time of separation or of filing the divorce petition.

Mere Presumption. The state law presumption is merely a presumption that the parties can change. In the divorce negotiations, the parties can work with the trust to do what makes

the most sense. (For example, a spouse may prefer to leave the ex-spouse as a beneficiary of the trust rather than distributing other property outright to the spouse.)

Revocable Trusts Can Be Changed. The presumptions apply to a revocable trust, which by its nature can be changed after the divorce if there is a desire for the ex-spouse to be a beneficiary or be involved in the trust in some way in the future.

Relatives of Ex-Spouse. The UPC version applies not just to an ex-spouse but also to relatives of the ex-spouse. That can be important; for example, an individual may not want the ex-spouse's sibling to be the trustee or to allow continued distributions to the children of the ex-spouse.

Revival if Remarriage. UPC §2-804(e) revives the revoked provisions if the parties remarry.

d. *Drafting Approaches in Response to Defaults.* Drafting options in light of the statutory defaults include the following.

- The term "spouse" could be defined to include a divorced spouse. That is typically not done for the settlor's own spouse but may be desired for a beneficiary's spouse. (The settlor may like the descendant's spouse better than the descendant.)
- Declare that a divorced spouse is not treated as a spouse for all purposes (replicating the presumptions under the state default rules and this could be done for irrevocable trusts as well).
- Should the divorce provisions be applied upon mere separation or filing of a divorce petition? That can cause chaos. If a client wants to do that, a more restrained approach would be to address what is of particular concern. For example, perhaps the spouse no longer has the ability to control the removal and appointment of fiduciaries, or in other situations to make distribution decisions, or in still other situations to exercise powers of appointment.

85. Drafting Considerations for "Divorce Trusts"

a. *Gift Tax Considerations.* Section 2516 provides that if spouses enter into a written agreement "relative to their marital and property rights" and divorce occurs within one year prior or two years subsequent to the agreement, transfers made pursuant to the agreement are not treated as gifts. Waiving the right to collect alimony or enforce other marital rights or providing transfers for children that are in satisfaction of the grantor's legal support obligation are treated as having been made for a full and adequate consideration.

b. *Alimony Trusts.* A trust established to make alimony payments can be helpful if the payor's future income stream is questionable (for example, a professional athlete) or if the individual has spendthrift problems. However, alimony payments made directly by the individual are deductible under §71, so these trusts are often not used.

A special income tax provision (§682(a)) provides that even if the trust would otherwise be treated as a grantor trust, the recipient spouse is still responsible for the income tax on the trust income. *See* PLR 200408015. This effectively mimics the income tax treatment of ordinary alimony payments, since alimony is deductible by the provider and includable in the income of the recipient, under §§71 and 215. Furthermore, §1041 provides that there is a true carryover basis; even if the property has depreciated, the higher basis will still be available when the property is later sold.

86. Spendthrift Trusts and Exception Creditors.

a. *Significance; Examples of Concerning Client Situations.* A client may have a child whose marriage the client thinks is somewhat questionable. Alternatively, the child may already be divorced and have limited ability to make payments that are required under the divorce decree. When the client is creating a trust for that child, the client may want to do everything possible to assure that the assets will be used only for the benefit of the child, and not for an ex-spouse of the child.

b. *Uniform Trust Code Provisions.*

§ 501. If a beneficiary's interest in a trust is not subject to a spendthrift provision, a court may authorize a creditor or the assignees of the beneficiary to reach the beneficiary's interest in the trust by attachment of present or future distributions for the benefit of the beneficiary.

§ 502(c). When a trust includes a valid spendthrift provision, a beneficiary may not transfer his interest in the trust and a creditor or assignees of the beneficiary may not reach any interest or distribution from the trust until the beneficiary receives the interest. A Comment to §502 states that unless one of the exceptions applies (as discussed below) a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made from the trust.

§503 — Spouse, Former Spouse or Child as Exception Creditors. Section 503 provides various exception creditors who can reach interests in spendthrift trusts. Section 503(b) provides that "[a] spendthrift provision is unenforceable against: (1) a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance …" Section 503(a) defines a "child" as including "any person for whom an order or judgment for child support has been entered in this or another State.) Section 503(c) states that "a claimant against which a spendthrift provision cannot be enforced may obtain from a court an order attaching present or future distribution to or for the benefit of the beneficiary…" That is very strong authorization for attaching present or future distributions from the trust. The Comments to §503 state that "[t]he exception for judgments or orders to support a beneficiary's child or current or former spouse is in accord with Restatement (Third) of Trusts… and numerous state statutes. It is also consistent with federal bankruptcy law, which exempts such support orders from discharge."

§504 — Discretionary Trusts. Section 504(b) provides that other than as provided in §504 (c) (discussed immediately below) whether or not a trust has a spendthrift provision, a creditor of the beneficiary may not compel a distribution that is subject to the trustee's discretion even if the discretion is expressed in the form of a standard or the trustee has abused the discretion. Section 504(c) contains an exception dealing with a beneficiary's child, spouse, or former spouse. It provides:

> "To the extent a trustee has not complied with a standard of distribution or has abused a discretion:
>
> (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and

(2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."

Strong Provisions. These UTC provisions provide strong protection for children, spouses, or former spouses of beneficiaries, even despite the existence of spendthrift provisions in the trust.

c. *Issues.* Issues that may arise include:

- whether former spouses or children who have a support judgment are exception creditors;
- whether exception creditors can reach spendthrift trust assets;
- whether exception creditors can mandate a distribution from a discretionary trust;
- whether exception creditors can reach or attach distributions after they are made from a discretionary trust or garnish them;
- whether a trustee of a discretionary trust, knowing there is a judgment outstanding against the beneficiary for alimony or child support, can make a distribution to the beneficiary without first getting court approval; and
- whether a trustee of a discretionary trust, where the beneficiary has a judgment outstanding for alimony or child support, may make a distribution *for the benefit of* the beneficiary and thereby avoid potential attachment that might apply if assets are distributed *to* the beneficiary.

d. *South Dakota and Nevada Are Most Protective of Beneficiary's Interest.* Barry Nelson believes that the laws of South Dakota and Nevada are the most protective of beneficiaries' interests against attacks by a spouse or former spouse or child of the beneficiary.

South Dakota Codified Laws §55-1-35 states: "Regardless of whether a beneficiary has any outstanding creditor, a trustee of a spendthrift trust may directly pay any expense on behalf of such beneficiary and may exhaust the income and principal of the trust for the benefit of such beneficiary. No trustee is liable to any creditor for paying the expenses of the beneficiary of a spendthrift trust." In providing that a creditor cannot reach assets in a discretionary trust, the term "reach" is defined as including by garnishment or attachment. § 55-1-24(6). A beneficiary's support interest does not rise to the level of a property interest. §55-1-42. "If the trust contains a spendthrift provision, notwithstanding the beneficiary's right to force a distribution with regard to a mandatory or support interest, no creditor may force a distribution [nor reach a present or future support distribution] with respect to a mandatory or support interest." *Id.* Further, a discretionary interest is explicitly defined as a "mere expectancy," and "[n]o creditor may force a distribution with regard to a discretionary interest. No creditor may require the trustee to exercise the trustee's discretion to make a distribution with regard to a discretionary interest." § 55-1-43(1)-(2).

Nevada has no statutory allowance for exception creditors, and Nevada specifically disallows claims of spouses, former spouses, children, or dependents. Nevada Revised Statutes §166.090 provides that a "[p]rovision for the beneficiary will be for the support, education, maintenance and benefit of the beneficiary alone, and without reference to or

limitation by the beneficiary's needs, station in life, or mode of life, or the needs of any other person, whether dependent upon the beneficiary or not." Section 166.080 adds that "[t]he beneficiary or beneficiaries of such trust shall be named or clearly referred to in the writing. No spouse, former spouse, child or dependent shall be a beneficiary unless named or clearly referred to as a beneficiary in the writing." The trustee's exercise of discretion in a Nevada discretionary trust can only be reviewed if the trustee acts "dishonestly, with improper motive or fails to act." §163.419(1). "Regardless of whether a beneficiary has an outstanding creditor, a trustee of a discretionary interest may directly pay any expense on the beneficiary's behalf and may exhaust the income and principal of the trust for the benefit of such beneficiary. §163.419(4). Section 163.417 provides that a creditor may not exercise and a court may not order the exercise of a power of appointment, any power held by a trust protector, or a trustee's discretion to make distributions or take any other authorized action in a specific way.

Items 87-98 are observations from a seminar by Mickey Davis and Clary Redd: *Warning!* Your Annual Exclusion May be an Illusion.

87. Annual Exclusion Significance and Basic Tax Effects

a. *Significance*. The annual exclusion provides a de minimis exception so that "small" gifts can be ignored for transfer tax purposes. The annual exclusion is also important for large estates, however, because substantial values can be transferred out of the estate over time. (Mickey Davis gives the example of parents who give $14,000 per year to their three children and seven grandchildren. The gifts are $280,000 per year, or $5.6 million over 20 years, which if invested at 6% would effectively shift nearly $10.3 million out of their estates.) We do not know the Congress will always leave the estate exemption at the large amount provided under ATRA.

b. *Amount; Non-Citizen Spouses*. The annual exclusion is $10,000 per donee per year (§2503(b)(1)), but the $10,000 amount is indexed (§2503(b)(2)). For gifts to non-citizen spouses, there is no unlimited marital deduction, but the annual exclusion is changed to $100,000 indexed ($143,000 in 2013). §2523(i).

c. *Estate Tax Impact*. Annual exclusion gifts are not treated as adjusted taxable gifts for estate tax purposes. Therefore, the entire value of the gift is removed from the transfer tax base rather than just the appreciation. The amount of annual exclusions improperly taken by the donor, even for a tax year closed by the statute of limitations, can be added to the donor's adjusted taxable gifts. (*Robinson Estate*, 101 T.C. 499 (1993).)

88. Gifts to Unborn Child Can Qualify For Annual Exclusion

Gifts to an unborn child can qualify for the annual exclusion, as long as the child is subsequently born alive. *Faulkner,* 41 B.T.A. 875 (1940).

89. Indirect Gifts

The IRS has successfully argued substance over form principles to disallow the annual exclusion where gifts are made to strawmen with the understanding that they will be re-gifted. For example, in Cidulka (T.C. Memo 1996-149) annual exclusions were denied for gifts to the donor's daughter-in-law and grandchildren who then immediately made gifts to the donor's son. (For similar cases, see the *Schuler, Sather, Heyen,* and *Bies* cases.)

90. Present Interest Requirements

Reg. §25.2503-3(b) states that "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property." Most but not all outright gifts are present interest gifts. Most life estates are present interests, valued actuarially to a sum certain.

The Supreme Court went beyond the regulatory standard in *Fondren* (324 U.S. 18 (1945)) stating that the donee must have a substantial present economic benefit. A present interest does not exist merely because title is transferred; it is not just a vesting test.

A transfer to a trust in which the beneficiary has a mandatory income interest would seem to qualify as a present interest under the regulation. However, the transfer may not qualify for the annual exclusion if the property is not income producing. In *Calder* (85 T.C. 713 (1985)), art transferred to a trust giving the beneficiary a mandatory income interest did not qualify for the annual exclusion because it was non-income producing and the beneficiaries had no right to force the trustees to sell the art and to purchase assets that would produce income.

Unitrust interests will qualify for the annual exclusion, even if the trust consists of non-income producing property. Unlike a mandatory income interest, a unitrust formula cannot be manipulated; the trustee has an obligation to distribute the unitrust amount each year.

91. Impact of Annual Exclusion on Gift Tax Return Filing Requirements

A gift tax return need not be filed if all gifts during the year are covered by §2503(b) (annual exclusion gifts) or §2503(d)(medical or tuition gifts) or if gifts have been made to the donor spouse that qualify for the marital deduction without a QTIP election. If a return must be filed, all gifts made during the year must be reported, including annual exclusion gifts.

If spouses make the split gift election, both spouses generally must file returns. There are two exceptions; if the exceptions apply, only the donor files a return and the other spouse signs that return as the consenting spouse. The exceptions are: (1) only one spouse made gift, none of them exceeds double the annual exclusion amount, and they are all gifts of present interests; and (2) the spouses made gifts of only present interests, only one spouse (the donor spouse) made gifts of more than the annual exclusion amount but not more than double the annual exclusion amount to any donee, and the only gifts made by the other spouse (the consenting spouse) did not exceed the annual exclusion amount.

92. End of Year/End of Life Issues

The annual exclusion must be used in each year, and any unused exclusion amount for that year vanishes following December 31. Therefore, knowing whether a gift was completed by December 31 rather than being completed in the following year is important. This can present difficulty for intangible assets, such as a gift of a check. If the check is given in year 1 but not cashed until year 2, when is the gift complete? The concern is that the donor may stop payment on the check. Taxpayers argue for the application of a "relation back" doctrine to say that if the check is ultimately paid, the payment would relate back to the date the check was given.

For charitable gifts, the relation back doctrine generally applies. (*Gagliardi, Spiegel, Belcher*). However, for noncharitable gifts, its application is more limited. For example, what if a check is delivered and deposited by the donee in year 1, but does not actually clear the donor's bank until year 2? Based on the *Metzger* case, Rev. Rul. 96-56 provides that a gift by check is complete on the date that is the earlier of:

(1) the date on which the donor has so parted with dominion and control as to leave the donor no power to change its disposition, or

(2) the date on which the donee deposits the check (or cashes the check against available funds of the donee) or presents the check for payment, if it is established that

> (a) the check was paid by the drawee bank when first presented for payment;
>
> (b) the donor was alive when the check was paid by the drawee bank;
>
> (c) the donor intended to make a gift;
>
> (d) delivery of the check by the donor was unconditional; and
>
> (e) the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance.

For end-of-life gifts, the rules are even more strictly construed. In *Newman* (111 T.C. 81 (1998), *aff'd* (D.C. Cir. 1999)), the decedent died before the check cleared, and the court did not apply the relation-back doctrine.

For gifts of stock, endorsing a certificate and delivering it to the donee or the donee's agent completes the gift. If the certificate is delivered to the company or the transfer agent, the gift is complete only when the transfer has been recorded (on the theory that the donor could call the company or transfer agent to stop the transfer before it has been recorded). Reg. §25.2511-2(h).

Self-declaration of trust. If a person delivers property to himself as trustee (or to himself and some other non-adverse person as trustees) and retains no beneficial interest in the trust property and no power except fiduciary powers governed by fixed or ascertainable standard, the donor has made a completed gift of the transferred property. Reg. §25.2511-2(g).

93. Uniform Transfer to Minors Act Gifts

a. *Creation.* A custodianship is created by transferring title to property in the name " ___ as custodian for ___ under the [state name] Uniform Transfers to Minors Act." As contrasted with the treatment of a trust, title to the custodial property is indefeasibly vested in the minor (and not the custodian).

b. *State Law Selection.* The person creating the custodianship may select the UTMA law of the state of residence of the transferor, the minor, or the custodian, or the state where custodial property is located. That state's UTMA will continue to govern the custodianship regardless of any subsequent change in any of the residences described above. UTMA §2(a).

c. *Investment Standard*. The prudent person standard applies. The custodian can retain any originally contributed property without liability. Unlike a trust, there is no rule compelling diversification of originally contributed property. UTMA §12(b).

d. *Termination.* The custodianship terminates when the minor reaches age 21 or dies before age 21, at which time the asset must pass to the minor outright or to the minor's probate estate. California and Pennsylvania allow a custodianship to last until age 25 for testamentary gifts (but not for inter vivos gifts because they would then not qualify for the annual exclusion).

e. *Tax Effects*. The tax effects of custodianships are generally described in Rev. Rul. 59-357.

   Gift tax. A transfer to a custodian constitutes a completed gift that qualifies for the annual exclusion.

GST tax. Because the gift qualifies for the annual exclusion, it automatically avoids GST tax under §2642(c).

Estate tax. Any property remaining in the custodianship at the minor's death will be included in his or her estate. If the donor dies while serving as custodian, the custodial assets will be included in the donor's estate under §§2036(a)(2) and 2038. If an individual other than the donor dies while serving as custodian and if that individual has a legal obligation to support the minor (e.g., a parent of the minor), the assets may be included in the custodian's gross estate. §2041.

94. 529 Plans

a. *Five-Year Averaging.* Contributions to a 529 plan or treated as taxable gifts that qualify for the annual exclusion and the GST tax exclusion up to the amount of the available annual exclusion. The gifts are eligible for gift splitting.

Donors may "front-load" a 529 plan, so that contributions in one year are treated as having been made in equal shares during the year of actual contribution and the next four years to the extent that those amounts qualify for annual exclusions. This does not mean that a contribution of $30,000 in year 1 will use up the donor's annual exclusions in some or all of the first three years, freeing up annual exclusions in years four and five. Instead, one-fifth of the $30,000 is deemed to have been made in each of those five years. If the contribution exceeds available annual exclusions over the five-year period, the excess will be treated as a current taxable gift. Prop. Reg. §1.529-5(b)(2).

b. *Deemed Gift By Beneficiary.* Changing the beneficiary of the 529 plan by the owner (i.e., the person who created the plan) to a beneficiary in a lower generation than the prior beneficiary results in a taxable gift from the previous beneficiary to the new beneficiary. This is a bizarre result; it applies even though the new beneficiary had nothing to do with the change. The deemed gift qualifies for the annual exclusion to the extent available. (The IRS plans to issue new proposed regulations treating the beneficiary change as a deemed distribution to the account owner followed by a new gift — but that was announced five years ago and nothing has happened in the meantime.)

95. Section 2503(c) Trusts

a. *Requirements.* Section 2503(c) is a statutory exception to the general rule that a trust interest is a gift of the future interest. Transfers into a §2503(c) trust qualify for the annual exclusion if the following requirements are met: (1) the property or its income must be expendable by or for the benefit of the beneficiary before reaching age 21; (2) there can be no substantial restriction on the trustee's discretion in determining the amounts to be distributed (for example, a HEMS standard cannot be used); and (3) remaining assets must pass to the donee at age 21, provided that the donee can merely be given a limited period of time to withdraw the assets at age 21 and un-withdrawn the assets would remain in trust until a later stated termination date; and (4) if the beneficiary dies before receiving the trust assets, the assets must be payable to the beneficiary's estate or pursuant to the beneficiary's general power of appointment.

b. *Withdrawal Period*. Section 2503(c) trusts typically use the withdrawal-right-at-21 approach. Using the withdrawal right rather than having an absolute distribution requirement is advantageous because the minor's parent may be able to convince the minor that it is not in his or her best interest to exercise the withdrawal right. If the

beneficiary does not exercise the withdrawal right, for income tax purposes the beneficiary will be treated as having withdrawn the assets and re-contributed them, so that the trust becomes a grantor trust as to the beneficiary following the withdrawal period.

c. *Tax Treatment.*

Gift tax. By definition, transfers within the available annual exclusion will qualify for the annual exclusion.

GST tax. If the beneficiary is a skip person, the §2503(c) trust will meet the requirements of §2642(c) to qualify for the GST annual exclusion exception.

Estate tax. If the trust assets are not distributed to the donee prior to his or her death, the assets will be included in the beneficiary's gross estate. The assets will not be included in the donor's estate unless the donor is the trustee. If the donor's spouse is serving as trustee, there is a possibility that the assets may be included in the spouse's estate (if the spouse has a support obligation for the minor).

d. *Practical Use.* Some planners rarely use §2503(c) trusts, under the theory that Crummey trusts are much more flexible. Some planners do use them; one of the panelists "uses them more than rarely."

96. Crummey Trusts

a. *Commonly Used*. The Crummey trust is the most common method of qualifying trust gifts for the annual exclusion. *Crummey v. Commissioner* (9th Cir. 1968) allowed an annual exclusion to the extent that donees could withdraw contributed property, even though the demand right lapse at the end of the calendar year.

b. *Mechanics — Best Practices*. An excellent best practices resource is Katzenstein and Sellers, *Giving Crummey Notices: Best Practices,* Tr. & Est. 20 (Aug. 2011). Best practices include:

- Require reasonable notice of withdrawal rights (some planners disagree based on the *Turner* case);
- Designate someone to receive notice on behalf of minors;
- Release the trustee from liability for failure to provide timely notice (other than for bad faith);
- Put the notice in writing (otherwise there can be a proof problem to establish that notice was given);
- Actual notice is sufficient (a trustee-beneficiary does not need to send himself a written notice);
- Give a continuing notice at the outset indicating that the grantor intends to make regular annual gifts for which there will be withdrawal rights (the IRS has not blessed such a continuing notice as generally being sufficient, but several PLRs have approved annual exclusions based on a continuing notice, PLRs 81201069 & 81303070);
- The beneficiary should not waive notice in advance (TAM 95302001);
- The beneficiary should not waive the withdrawal right after receiving notice because the waiver may be treated as a taxable release rather than a "lapse"; and
- Provide an exit memo addressing the care and feeding of the trust including withdrawal notice forms, and make clear that the grantor is the attorney's client and not the trustee (to avoid inadvertently establishing an attorney-client relationship with the trustee).

Both panelists offer to clients that they will handle the annual withdrawal notices (for a modest reasonable fee) but they get no takers.

c. *Hanging Powers*. Hanging powers are often used, but realize that the un-lapsed withdrawal amount can grow quite large. When the trust grows in value above $280,000, the 5% amount that can lapse each year will be greater than $14,000 per year and the un-lapsed withdrawal rights may begin to diminish. At a beneficiary's death, any un-lapsed withdrawal rights will be included in the beneficiary's estate.

d. *Cascading Powers*. As an example, children can be given withdrawal rights up to the amount of their available annual exclusions, and any excess transferred during the year could then be withdrawn by grandchildren, etc.

e. *CCA 201208026*. This CCA concludes that withdrawal rights were "illusory" because of (1) a "no contest" clause excluding any beneficiary from receiving further benefits if the beneficiary brings or participates in a civil proceeding to enforce the trust, and (2) a provision requiring that the construction, validity and administration of the trust be determined by an arbitration system (what the CCA refers to as "other forum rules").

f. *GST Exemption Allocation Required*. Most Crummey trusts do not satisfy the "single vested beneficiary" requirements under §2642(c); therefore, gifts to the trust do not qualify for the GST annual exclusion exemption. GST exemption must be allocated to transfers to the trust (or the automatic allocation rules must apply) in order for the trust to be GST exempt. There is the option to elect into automatic allocation (even if the trust is not a "GST trust" as described in §2632(c)). Best practices would be to affirmatively allocate GST exemption every year (to best keep track of exemptions that have been allocated). If the "opt-in" election is made, if exemption is inadvertently not affirmatively allocated to some transfers made during the year, the trust would still be GST exempt by reason of automatic allocations of GST exemption to such transfers.

g. *Non-Citizen Spouse*. A Crummey trust can receive present interest gifts for a non-citizen spouse qualifying for the $143,000 (in 2013) annual exclusion available for non-citizen spousal gifts.

97. FLP and LLC Interests; Annual Exclusion Gifts With "Ugly" Assets

a. *Background*. Three prior cases have refused to allow an annual exclusion for gifts of limited partnership or LLC interests, for various reasons based on the facts in those cases. *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo. 2010-2; *Fischer v. Commissioner*, 105 AFTR2d 2010-1347 (S.D. Ind. 2010). Relying on *Fondren*, the cases reasoned that the donee must have a substantial present economic benefit by reason of use, possession, or enjoyment of (1) property or (2) income from the property. The reason that the donees did not have use of the *property* was because of restrictions on withdrawals or transfers of the FLP or LLC interest, and did not have enjoyment of *income* from the transferred interests either because no income was expected or income was not expected to "flow steadily" to the donee.

b. *Wimmer v. Commissioner*. *Estate of Wimmer v. Commissioner,* T.C. Memo 2012-157 held that donees of limited partnership interests did not have immediate use, possession or enjoyment of the gift *property* (i.e., the gifted limited partnership interests) because of restrictions on the ability of the donees to transfer their limited partnership interests.

However, the court concluded that the donees had the use, possession, or enjoyment of *income* from the property, under a three-part test: "(1) the partnership would generate income [the opinion later referred to this as a "partnership that expected to generate income"], (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained."

c. *Planning Strategies*. Possible planning strategies to bolster an argument that the donees have enjoyment of the *property* (i.e., the transferred interest) include:

- Do not prohibit transfers but allow transfers under a right of first refusal with a reasonable purchase price provision;
- Consider giving donee-partners a put right for a limited period of time; or
- Consider giving donees a Crummey withdrawal power with respect to gifts of limited partnership interest that would enable them to withdraw the fair market value of the interest for a limited period of time.

Possible planning strategies to bolster an argument that the donees have enjoyment of the *income* from the transferred interests include:

- The agreement should not favor re-investments over distributions;
- Regularize distributions;
- Consider mandating distributions of "net cash flow";
- Consider whether to require "tax distributions"; and
- Specify that the general partner/manager owes fiduciary duties to the other partner/members.

98. Section 2503(e) Tuition and Medical Expense Gifts

Direct payments of tuition to an educational organization or amounts paid directly to a provider for medical care qualify for the §2503(e) exclusion. Writing checks to these specific providers can be mechanically cumbersome. Mickey Davis suggests creating an account and giving family members check-writing authority over the account, but execute a durable power of attorney that limits their authority to write checks only for payments of tuition or payments to medical care providers. A gift is completed when the children spend money from the account, and the gift would qualify at that time for the §2503(e) exclusion.

Items 99-103 are observations from a seminar by Duncan Osborne and Jack Terrill: FATF and Circular 230: The Expanding Impact of Federal Initiatives on Legal Ethics.

99. Increasing Role of Federal Government in Regulating Conduct of Lawyers

The common theme of the American response to the Financial Action Task Force (FATF) and Circular 230 is the increased role of the federal government in regulating the conduct of lawyers notwithstanding the traditional state management of legal ethics and the practice of law.

Many tax attorneys were not aware of Circular 230 prior to its amendment to include the covered opinion rules. However, Circular 230 has for decades regulated the conduct of lawyers with the Internal Revenue Service. (Circular 230 is about to be amended to eliminate the covered opinion rules.) The covered opinion rules in Circular 230 were preceded by tax shelter rules, premised on the concept that lawyers were responsible for selling tax shelters to the public and that lawyers were part of the problem. The current focus is to engage the Office of Professional Responsibility

(headed now by Karen Hawkins) to more actively involve the IRS in the disciplining of lawyers at the federal level (in practice before the IRS). A useful resource about the activities of the Office of Professional Responsibility is the following website: http://www.irs.gov/Tax-Professional/Circular-230-Tax-Professionals. Being disciplined from practice before the IRS would dramatically impact the practices of many estate planning attorneys.

Circular 230 already has substantial rules impacting the practices of lawyers before the IRS. These include, as disciplinary matters, obligations to submit certain records, the obligation to advise clients of the fact of noncompliance with the law, avoiding unreasonable delays, restrictions on fees (including contingent fees), complex conflicting interest rules (much more complex than the Model Rules of Professional Responsibility), and prohibitions on signing tax returns that take positions that lack of a reasonable basis. New §10.36 will provide that there must be a structure within law firms of reasonable steps to comply with the disciplinary rules.

An Advance Notice of Proposed Rulemaking has been issued from the Treasury that will ask financial institutions to make even more detailed disclosures. Buried in that Notice is a suggestion that these rules may also apply to law firm accounts.

Similarly, FATF has as one of its underlying concepts that lawyers are part of the problem and make it possible for criminals to launder money. The concept is that lawyers should be part of the police force. Indeed, lawyers can be part of the solution, and "blowing the whistle" can help solve money laundering. English solicitors have the obligation to call Scotland Yard about suspicious activities and not tip off clients about such reports. Indeed, English solicitors have been jailed for failing to do that. That concept is now commonplace throughout Europe. The American bar has strongly resisted this approach, based on the strong sense of professional duties to clients and attorney-client confidentiality, but this resistance has been met with skepticism by many of the international FATF members.

100. Real Life Examples of Money Laundering

The following are real life examples that seem quite innocent but may actually involve money laundering.

- A prospect visited a trust lawyer in Atlanta saying that she would receive an inheritance from Mexico and would wire money to the firm's trust account so that the firm could assist the prospect with planning.
- A prospect wired $5 million to a lawyer to be his nominee. The prospect described various transactions that were contemplated in which the prospect wanted to remain anonymous in order to avoid driving up the price of the transactions.
- A New York hedge fund manager prospect wanted to acquire farms in Georgia and wanted to remain anonymous (again, to avoid driving up the price of the purchases).
- A prospect contacted the attorney and said that her husband had just died leaving a house and cash. She brought suitcases of cash to the lawyer.
- A Pakistani prospect wanted to benefit his medical school in Pakistan. He wanted to make a contribution to a U.S. charity that would make distributions to his Pakistani medical school. The prospect brought cash to the attorney for implementation of the planning. (A lot of terrorist activity financing is through nonprofit organizations.)

Money laundering transactions can be made to appear innocent to an attorney who is not sensitive to the potential abuses that could occur.

101. Background of FATF

FATF was established in 1989. Within a year it had made 40 recommendations for financial institutions to combat money laundering. In 1999, FATF sought to expand those rules beyond financial institutions to Designated Non-Financial Businesses and Professions. In 2011, the scope of FATF was extended to cover terrorist financing.

An effort to limit applying the rules governing financial institutions to lawyers, notaries, and other designated legal professionals, a working group of U.S. lawyers engaged with all lawyers from other countries to adopt a risk-based approach. In 2008, FATF adopted the Risk Based Approach Guidance for Legal Professionals. It is a broad template from which member companies can generate tailored guidance appropriate to their respective legal systems.

In the United States, there are various laws addressing money laundering, including the Money Laundering Control Act of 1986 and the Bank Secrecy Act as modified by the USA PATRIOT Act (2001). The Bank Secrecy Act addresses 25 specific professional and business entities that are considered "financial institutions" subject to the Act's extensive reporting requirements. There is also a "catchall" provision allowing the Treasury Secretary to designate as a financial institution "any other business… whose cash transactions have a high degree of usefulness in criminal, tax, or regulatory matters." This provision arguably allows the Treasury Secretary to designate attorneys or law firms as financial institutions and make them subject to the extensive reporting requirements of the Bank Secrecy Act. There are also various laws in the United States addressing terrorism, including the Antiterrorism and Effective Death Penalty Act passed in 1996 and amended in 2001, and the Intelligence Reform and Terrorism Prevention Act passed in 2004.

FATF has implemented a multi-faceted process for monitoring the measures that member countries take to improve their anti-money laundering systems. The U.S. underwent an evaluation in 2005-2006, which resulted in FATF's issuance of a 300-page evaluation report concluding that U.S. lawyers were noncompliant in various areas including customer due diligence procedures and filing suspicious activity reports.

The Treasury is responsible for implementing the FATF recommendations in the U.S., and has been actively involved with the ABA concerning guidance for lawyers. Various groups led by the ABA and acting in consultation with the Treasury prepared a voluntary good practices guidance for U.S. lawyers, and the ABA adopted the Good Practices Guidance in August 2010.

102. Good Practices Guidance

a. *Goal; General Approach.* An array of ABA sections and specialty bar associations have endorsed and approve the Good Practices Guidance. Following significant urging from the Treasury, bar groups are focusing on educating lawyers about the Good Practices Guidance. The goal is that the process will be voluntary and that the profession will remain self-regulated, but actual engagement and participation by the legal community must be comprehensive and serious. Failure of attorneys to respond will almost assuredly result in federal legislation binding upon lawyers and perhaps more restrictive than the provisions of the Good Practices Guidance.

b. *Practice Areas Subject to Good Practice Guidance.* FATF has identified a handful of specific activities as being at risk for money laundering. The practice areas subject to the Good Practices Guidance includes the following (generally, not including litigators):

- Buying and selling real estate;
- Management of client money, securities, or other assets;

- Management of bank, savings, or securities accounts;
- Organization of contributions for the creation, operation, or management of companies; and
- Creation, operation, or management of legal persons or arrangements in buying and selling business entities.

The last item on that list will be applicable to many of the activities of estate planning attorneys. The term "legal persons or arrangements" includes trusts.

c. *Identification of Risks by Category.* The Guidance is a risk-based approach, identifying a number of risk categories. The weight given to each category will vary from client to client, particularly given the size, sophistication, nature, and scope of services offered by the legal professional. The risk categories are:

- Country/geographic risk (Duncan Osborne observes that it is somewhat unfortunate that this was listed as the first risk factor, suggesting that international activities are the prime risk situations; indeed, he points out that 85% of money laundering activities in the United States have no international connections);
- Client risk (included as potential client risks are a category of clients known as Politically Exposed Persons ("PEPs"); financial institutions pay for expensive software programs to search if customers are PEPs, and hopefully that degree of diligence will not be extended to all attorneys);
- Service risk (including transactions involving the receipt and transmission of cash, services to conceal improperly the beneficial ownership of property, transactions with unusually short time periods for implementation, transactions without economic reality, and "out of character" transactions).

Many variables may impact risk, such as reputation of the client, businesses or companies that are otherwise regulated, and the lawyer's prior relationship with the client. These variables may reduce or increase risk.

d. *Summary of Good Practice Guidance Action Steps For Attorneys.*

(1) *Engage Management*. The Good Practice Guidance wants engagement at the management level of law firms. Persons running law firms should take this these matters seriously.

(2) *Compliance Officer*. Each firm should have a compliance officer to assure that policies and procedures and followed. (For example, at Duncan's firm, a paralegal has this responsibility for all new client intakes.)

(3) *Policies and Procedures*. The starting point for policies and procedures would be for the firm to adopt basic client intake procedures. Appendix A attached to the Good Practices Guidance provides an example checklist. (A firm's would not have to include all of these; the protocols should tailored to specific practice settings. What is important is that each firm has an intake protocol with these considerations in mind.) Appendix A to the Good Practices Guidance includes the following.

- Client Identity
  - Understand the client's objectives.
  - If the client is a natural person, get the name, employment background, place of birth, prior residential addresses, current residential address, business

address, phone numbers, date of birth, marital status, names of prior or current spouses and/or names of children, dates of birth and Social Security numbers of the above, the name and contact information of any other lawyers with whom the client regularly deals, the name and contact information of the client's certified public accountant, prior criminal convictions, pending lawsuits, and the status of tax filers with governmental authorities. The lawyer may also wish to obtain the client's driver's license or other federally issued photo identification.
  - If the client is a new entity, determine if it is a parent or subsidiary in a family tree of entities, obtain the names of governing managers of the entity, obtain federal ID numbers for each of them, determine the owners of the entity, and determine if someone not listed in the entity's formal documents is really making important decisions for the entity.
- Client Due Diligence.
  - Request letters of introduction or reference from other professionals that have past experience with the client.
  - Check the Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons list (the "OFAC list") at www.treas.gov/offices/enforcement/ofac/sdn/t11sdn.pdf for the name of the client, the client's spouse, the client's beneficial owners, and/or other related persons, and any relevant business entities.
  - Conduct a Google search of the client and related persons.
  - Various other search tools are available, at varying expense levels. Accurint (www.accurint.com) provides information on a client's past and current addresses, any bankruptcies, liens, judgments and UCC filings against the client, and any business entities and job titles associated with the client's name. It is a relatively inexpensive service.

103. American Lawyers' Response — Already Have Criminal Rules and Rules of Professional Conduct

There is some pressure by legislators (Senator Carl Levin has been leading the charge) and Treasury to adopt stricter laws governing lawyers with respect to money laundering and terrorist activities. For example, Senator Levin has on four occasions introduced measures similar to §114 buried in Senate Bill 268 (dealing with making corporations taxable currently on worldwide income) pending in the current Congress providing that people engaged in the formation of corporations, limited liability companies, partnerships, trusts or other legal entities will be subject to the Bank Secrecy Act. It is short and simple – lawyers would be subject to all of the detailed reporting requirements under the Bank Secrecy Act. Being able to report to the Treasury and Congress that actual engagement and participation by the legal community in responding to these issues and the Good Practices Guidance is comprehensive and serious will help in thwarting the push for federal legislation regulating lawyers in this fashion.

The general response in the United States so far has been that there is no prohibition on representing higher risk clients. The Good Practices Guidance leads attorneys in the process of understanding how other rules that govern attorneys' conduct might apply. There are already criminal laws regarding money laundering, with a series of extensive federal statutes. There are also extensive criminal statutes regarding terrorist financing. They all have conspirator elements, including the assistance of others in money laundering or terrorist financing. The goal is education

to lead attorneys in the direction of knowing when a proposed transaction is either a crime or violates the rules of professional responsibility for lawyers.

Treasury seems to keep pushing for additional rules governing the conduct of lawyers. The response of lawyers is that we already have rules, including criminal statutes and the rules of professional conduct.

a. *Model Rule 1.2(d).* "A lawyer *shall not* counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent…" (All states except California and the District of Columbia have adopted this rule.) The comments make clear that this involves transactions for which the lawyer "knows or reasonably should have known" the conduct is criminal or fraudulent.

b. *Model Rule 1.16.* "Except as stated in paragraph (c), a lawyer *shall not* represent a client, or if representation has commenced shall withdraw, if the representation will result in a violation of the rules of professional conduct or other law…"

   Observe that model rules 1.2 (d) and 1.16 are "shall not" rules, not "may" rules.

c. *Model Rule 1.6.* "A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

   (1) to prevent reasonably certain death or substantial bodily harm;

   (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

   (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

   (4) to secure legal advice about the lawyer's compliance with these Rules…"

Items 104-113 are observations from a seminar by Wendy Goffe and Professor Kris Knaplund: Who's the Spouse and Who's the Child: Impact on Estate Planning of New Developments in Same-Sex Relationships and Reproductive Science.

104. Overview of Issues and Significance

Issues include who's the spouse, child or issue? Who qualifies legally is often unclear. Genetic testing does not end the issue of parentage from a legal standpoint; there are other factors. Adoption (including the adoption of adults), nonmarital children, surrogate births, and children born of artificial reproductive technology (ART) have each clouded the picture.

ART is considered to be the use of donated sperm, donated ova, embryos, artificial insemination, and *in vitro* fertilization.

Couples using ART typically intend the resulting child to be their heir. But did the ancestors contemplate that descendants by ART would be their descendants?

Policy issues include the efficient administration of estates, carrying out the intent of the settlor, and determining the best interests of the child.

Legal issues include determining heirs for intestacy purposes or as beneficiaries under documents, the application of pretermitted heir statutes, determining whether an individual is a dependent for

Social Security or entitlement programs or is the beneficiary of life insurance or retirement plans, and determining the members of a class of beneficiaries (such as "descendants").

Example questions for clients illustrating these issues: Would you want your daughter-in-law to be able to use the frozen sperm of your deceased son to produce descendants that are beneficiaries under your documents? Would you want your son-in-law to be able to use the frozen embryo of your deceased daughter and find a surrogate to make more beneficiaries of your trust after your daughter is deceased?

Even raising these issues with clients is difficult. (Wendy Goffe points out that if you, like her, begin your client interviews with "are you the same gender you were born with or have you changed genders?," these other questions are easier to ask.)

Documents need to contemplate "the known unknowns and the unknown unknowns" (as Donald Rumsfeld put it).

105. Current State and Federal Law on Same-Sex Marriage

a. *Significance*. Same-sex marriage issues impact not only the "who's the spouse" issue, but also may have an impact on various parentage issues.

b. *Rapidly Changing Laws*. Same-sex marriage laws are rapidly changing. As of January 1, 2013, nine states (Connecticut, Iowa, Maine, Maryland, Massachusetts, New Hampshire, New York, Vermont, and Washington) plus the District of Columbia allow same-sex couples to marry. More states are now considering same-sex marriage laws.

Some states specifically do not recognize same-sex marriages or recognize a marriage that was legally performed in another state. Thirty-eight states have adopted statutes or constitutional provisions that prohibit same-sex marriage. Most of these are modeled on the federal Defense of Marriage Act (DOMA).

c. *DOMA Constitutionality*. The constitutionality of DOMA is being considered by the U.S. Supreme Court in two cases. In *Perry v. Brown,* the Ninth Circuit in 2012 held that Proposition 8 was unconstitutional. It had withdrawn an existing right to marry for same-sex couples that had been declared by the California Supreme Court. Oral arguments in the United States Supreme Court are set for March 26, 2013. (It may be decided on very narrow grounds.) *Windsor v. United States* involves the availability of the marital deduction for a same-sex couple. The District Court and Second Circuit Court of Appeals held that DOMA was unconstitutional. Oral arguments are set for March 27, 2013. There are various other cases that had been stayed pending the *Windsor* decision.

d. *Civil Unions and Domestic Partnerships*. The National Conference of State Legislatures groups the state laws regarding civil unions and domestic partnerships into three categories: (1) Civil unions providing state-level spousal rights to same-sex couples (Delaware, Hawaii, Illinois, New Jersey and Rhode Island); (2) domestic partnerships providing nearly all state-level spousal rights to unmarried couples (California, Nevada, Oregon and Washington); and (3) Domestic partnerships providing fewer state-level rights for unmarried couples (Hawaii, Maine, Wisconsin and the District of Columbia).

106. Practical Issues Regarding "Who's the Spouse"

a. *Clients Validly Married in Another State*. Will my state recognize marriage from the other state? The odds are no, especially if your state does not recognize same-sex marriage.

b. *Divorce For Couple Validly Married in Another State.* Can a couple who has been validly married in another state get divorced? An excellent resource on this issue is Byrn & Holcomb, *Same-Sex Divorce in a DOMA State,* 50 FAM. CT. REV. 214 (April 2012). A number of states allow persons to enter into a valid same-sex marriage even if they are not residents of the state. However, to dissolve a marriage, an individual must often be a resident of the state. If the client is subsequently in a state that does not recognize the same-sex marriage, there may not be an ability to dissolve the partnership without at least one of the partners moving to another state that recognizes the same-sex marriage and that will dissolve the partnership. That requires looking at residency requirements. For example, to dissolve the marriage in Vermont, the individual must be a resident of Vermont for one year. Therefore, there is a "wedlocked" period of one year.

c. *Family Challenges?* Now that states are beginning to recognize same-sex relationships, will family members still challenge bequests to the same-sex partner, or will estate plans of same-sex couples become more accepted in society?

d. *Fewer Uses of Adoption?* As more states recognize same-sex marriage, will we see fewer couples using adoption as an estate planning technique? Having one partner adopt the other has become a fairly common way of establishing inheritance rights. Now that other options are available, they may be used instead. Adoption by a partner in a same-sex relationship is discussed immediately below.

107. Adoption Issues by Partner in Same-Sex Relationship

a. *Reasons.* Reasons that a partner in his same-sex relationship may want to adopt the other partner include: to establish a family relationship for purposes of entitlements and other benefits (e.g., Social Security, health insurance, survivor benefits), creating a legal bond with another individual, establishing a legal heir to secure inheritance rights in case the parties' wills are challenged (or cutting off the status, as heirs, of the adopter's relatives so they no longer have standing to contest an estate plan), and to bring an individual into a class of beneficiaries under pre-existing documents (perhaps created by other family members).

b. *Status of Legal Recognition.* Some courts have questioned whether adoption is appropriate when the parties will not have a parent-child relationship (for example, in New York). Some jurisdictions with statutes allowing adult adoptions have permitted adoptions of one same-sex partner by another (for example, Delaware). An additional complexity is what happens if the same-sex couple splits up after the adoption? The Maine Supreme Judicial Court refused to invalidate the adoption in that type of situation. (*Adoption of Patricia S.*).

Another potential issue is whether an adoption of one partner by the other in a same-sex marriage may violate incest laws. *See* Terry Turnipseed, *Scalia's Ship of Revulsion Has Sailed: Will Lawrence Protect Adults Who Adopt Lovers To Help Ensure Their Inheritance From Incest Prosecution?*, 32 HAMLINE L. REV. 95 (2009).

108. Adoption Issues in ART Context

a. *Who May Adopt?* An individual may be adopted by someone individually or by a couple jointly. The adoption may occur in a second-parent context in which one partner adopts his or her partner's biological or adoptive child without terminating the original legal parent's rights.

Adoption for ART children often arises in the context of same-sex relationships. (If the parties want a child who is the genetic child of one of the partners, the only way to achieve that is through ART.) Same-sex adoption is not yet permitted in all states (Mississippi explicitly prohibits adoption by ssame-sex couples and Utah prohibits adoption by unmarried couples). The adoption laws in some states are gender-neutral, paving the way for same-sex adoptions (for example in Washington and Pennsylvania).

The Uniform Probate Code (UPC) §2-119 presents a problem for adoption by a same-sex or unmarried-couple situation with respect to intestacy rights. That section cuts off the inheritance rights between the genetic parent and child, replacing the right of inheritance between the adoptive parent and child. It allows for the genetic parent's parent-child relationship to continue when a legal step-parent *spouse* adopts a child, but it does not contemplate a second-parent adoption outside of marriage. Therefore, when an unmarried partner adopts the child as the second parent, the UPC would terminate the genetic parent's parent-child relationship for inheritance purposes. Therefore, it is especially critical that parents have valid wills in place in this circumstance.

b. *Stranger to the Adoption Rule.* At common law, the adopted child is treated as the descendant of parents, but not ancestors.

c. *Declaration of Parentage v. Adoption.* Children may be born in a state that recognizes their parentage, and then moved to a state that does not. Even if the parents are named on the birth certificate, another state is not required to recognize the first state's birth certificate. (The Full Faith and Credit clause of the Constitution applies to judgments but not necessarily to a state's statutory laws.) Therefore, parents of ART children may want to obtain an order of parentage and not simply rely on statutory default provisions. Without such an order, the child may be at risk of losing access to benefits or entitlement programs based on parentage.

109. De Facto Parentage

If an individual has a parent-like relationship with a child that is later cut off, the individual in some states (including Delaware, Oregon, Washington, and the District of Columbia) may be recognized as a "*de facto* parent," standing in parity with the legal parent. For example, in *Parentage of L.B.,* partners in a registered domestic partnership conceived a child using ART. The domestic partnership was later automatically terminated by one of the partners getting married to another individual. The non-genetic partner had been active in raising the child. The Washington Supreme Court adopted a four-part test to determine the existence of a *de facto* parent-child relationship: (1) the natural or legal parent consented to and fostered the parent-like relationship; (2) the petitioner and the child lived together in the same household; (3) the petitioner assumed obligations of parenthood without expectation of financial compensation; and (4) the petitioner has been in a parental role for a length of time sufficient to have established with the child a bonded, dependent relationship parental in nature.

While a *de facto* parent stands in legal parity with a legal parent, it is only an equitable remedy so a legal adoption or written agreement is always preferable. "In the absence of either a biological parent-child relationship or legal adoption, there is little certainty with respect to the rights and responsibilities between an adult and child."

In drafting legal documents for unmarried couples, consider whether the parties want or do not want to recognize a parent under equitable principles.

110. Artificial Reproduction Technologies Parentage Issues Involving Living Parents

a. *Overview.* There are situations in which the law should give effect to recognize the clearly intended parents, even though they are not the genetic parents. Both the Uniform Parentage Act (UPA) and the UPC realized the need for a separate set of presumptions for parentage in ART situations.

b. *U.S. State Department Requires Genetic Parentage For Citizenship Purposes.* There are two ways to become a U.S. citizen by birth — (1) being born in the United States, or (2) being born abroad to a U.S. citizen. For purposes of the second test, a genetic relationship to the American citizen must be proved. For example, if a woman goes abroad and bears a child using ART by the implantation of an embryo, even though the woman gives birth to the child (and can show birth pictures, that her name is on the birth certificate, etc.), the U.S. State Department requires a blood test to show a genetic relationship.

c. *UPC.* The UPC provides default rules for intestacy and class gift purposes. Section 2-120 provides the following presumptions of parenthood:

- A husband or wife whose own sperm or eggs are used for ART by the wife (§2-120(a)(3)(A));
- The birth mother (§2-120(a)(3)(B));
- An individual identified on the child's birth certificate as the other parent (§2-120A)((3)(C), referencing §2-120(e)); and
- An individual who consents to ART with the intent to be treated as the other parent (consent alone is insufficient, intent must be proved) (§2-120(a)(3)(C), referencing §2-120(f)).

The UPC was amended in 2008 to address gestational carriers. Section 2-121 recognizes either (1) judicial approval of a surrogacy contract by court order, or (2) the intended parent functioning as a parent within two years of the child's birth.

If the birth mother places the child for adoption, the UPC provides that the parent-child relationship is severed and a new one is formed with the adoptive parent or parents (§§2-118(e), -119(a), & -119(e)).

d. *UPA.* The UPA generally deals with surrogacy and the donation of sperm and ova. In many ways, the UPC and UPA address common issues, but there are important differences. Prof. Knaplund generally prefers the UPC versions (but in the provisions in §2-121 dealing with posthumous conception her recommendation is to require that an individual deposit "genetic material" while living).

e. *Surrogacy and Gestational Carriers.* There is a difference between a gestational surrogate and a gestational carrier. A gestational surrogate provides her own egg and is artificially inseminated. A gestational carrier is implanted with an embryo of another woman (either from the intended mother or donor) that has been combined in the lab with the sperm of either the intended father or a donor. In either case, the gestational surrogate or carrier agrees to relinquish parental rights to the child.

Legal agreements can be used to protect the intended parents, but state laws vary widely on their enforceability. There are many cases in which the surrogate mother refuses to give up the child, and it is difficult to force the surrogate mother to do so. Cases fall into three categories: (1) states that recognize only the rights of the genetic parents of the child; (2) states that recognize the birth mother as the legal parent and disregard the rights of the

genetic parent or parents (except for the birth mother's husband, if she is married); and (3) states that look to the intent of the parties.

Many states do not allow a genetic mother to relinquish her parental rights until after the birth of the child, regardless of legal documents that may have been signed to that effect. An early high profile case, *In re Baby M* (N.J. 1988), held that the surrogate (who was the genetic mother and birth mother) was the legal mother of the child even though a surrogacy agreement provided otherwise. Following the *Baby M* case, most people prefer to use a gestational carrier instead of a surrogate, hoping that the agreement to relinquish the child will be enforced. Some states (such as Washington) do not allow compensating a gestational carrier (which makes it difficult to find a gestational carrier).

Article 8 of the UPA recognizes the validity of surrogacy contracts (some states specifically do not recognize the validity), but requires approval of the contract by a court. The parties must follow a similar procedure to adoption, requiring a home study and that the parties entered into the agreement voluntarily and with full understanding. The UPA only contemplates heterosexual couples obtaining judicial approval because it refers to "[t]he man and the woman" who are parties to the gestational agreement. UPA states do not allow court validation of a gestational carrier agreement involving a same-sex couple as the intended parents (and the gestational carrier would be the child's mother (§ 809)).

At this point, very few states have legislation governing surrogacy. There is case law in some states (the three categories of cases are summarized above). In the absence of legislation, parents must resort to traditional adoption.

111. Posthumous Conception (Obviously Using ART)

a. *Law Regarding Recognition.* Genetic material may be stored and children conceived after the death of one of the genetic parents. This might involve frozen sperm, eggs, or even embryos. Threshold legal issues are (1) whether the person is considered a child under state law, and (2) assuming the person is treated as a child, whether he or she has the right to inherit for the purposes of the controlling document or under governing default intestacy legislation.

Whether any genetic material has been stored and what the plans are to use that material to conceive children should be considered in drafting estate planning documents and coordinating with any other agreements a client might have with respect to ART.

Most states have adopted a form of UPC § 2-104, which provides that an individual in gestation at a decedent's death is deemed to be living at the decedent's death, if later born alive. The trend is also to consider a posthumously conceived child as a child of his or her deceased parent for inheritance purposes if the intention was clearly expressed by the deceased parent §2-120(f). The statute presumes the decedent to have given such consent if married to the birth mother with no divorce proceedings pending at the time of the decedent's death. §2-120(h)(2). Some states add that this presumption applies only if the child was in utero or is born within a certain timeframe after the decedent's death. The UPC treats a posthumously conceived child as in gestation at the parent's death if the child was in utero not later than 36 months or born not later than 45 months after the parent's death §2-120(k). (These 36/45 month time limits provide assistance in being able to distribute estates or trusts without continuing uncertainty as to whether there are additional descendants.)

Under the UPA, the sole method for establishing parentage of a deceased parent of a child conceived using postmortem conception is with written consent "that if assisted reproduction were to occur after death, the deceased individual would be a parent of the child." §707.

b. *Drafting Issues*. Documents regarding the use of stored genetic material should address use of the material at the termination of the individual's marital relationship or at the incapacity of the individual, use of the reproductive material after death, how long it may be stored, how it may be used (e.g., research or reproduction), how many times it may be used, and when it must be the destroyed. If the intent is to include posthumously conceived children in estate planning documents, at a minimum the dispositive provisions should include language such as "my children, including whatever children are conceived or born after my death from my frozen genetic material."

112. Administration Issues

Whether a person is recognized as a "spouse," "child," or "descendant" is obviously important in knowing who are proper beneficiaries of an estate or trust. ART also raises timing issues. In determining the remaindermen of a trust, the possibility of posthumous conception raises uncertainty as to when distributions may be made if posthumous children will be included as beneficiaries. The time limits under UPC §2-120(k) (in utero within 36 months or born within 45 months after the decedent's death) provide helpful limitations.

113. Raise ART Issues With Clients

It is unlikely that clients will bring up ART and its related issues with estate planners. Discuss what the client intends about adding to the family in the future, including through ART or adoption. Do not merely rely on intestacy statutes. The issue arises not only with parents but more remote ancestors. For example, do grandparents intend that posthumously conceived descendants will be included as beneficiaries? Storing genetic material has become a common occurrence. Planners need to ask routinely whether any genetic material has been stored, by the client or by the client's descendants. (Wendy Goffe points out this can make for some interesting conversations. "I was meeting with my estate planner yesterday and I just have a couple of questions ….")

The science of ART is advancing more rapidly than the law governing ART. There is an inconsistent patchwork of laws around the country. Until states can adopt consistent and predictable schemes, it is incumbent on the planner to be aware of potential contingencies.

Items 114-123 are observations from a seminar by Randy Grove, Stephanie Loomis-Price and Lou Mezzullo: It's Not A House of Cards: Step Transaction and Indirect Gift Planning and Defense Strategies.

114. Smell Test

Step transaction, indirect gift, and §2036 issues are "all about the smell test." In essence, FLP planning comes down to whether the planning makes sense; whether it is only done for tax savings; and whether it meets the client's goals. The role of the advisor in eliciting information from the client and restructuring plans in light of that information can make or break the defense of the FLP.

The *McCord* Fifth Circuit case noted that the reference in Judge Foley's dissent to the majority's "'olefaction' is an obvious, collegially correct synonym for the less-elegant vernacular term, 'smell

test,' commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision-maker's 'gut' feelings or intuition."

115. General Descriptions of Substance Over Form, Step Transaction, and Indirect Gifts

a. *Substance Over Form*. "Substance over form" is the application of financial reality of the situation in place of the legalities of the transaction. Lou Mezzullo summarizes: "Would you have done the transaction anyway if you would not have saved taxes."

b. *Step Transaction*. The "step transaction doctrine" is the consideration of formally distinct steps as an integrated transaction so that the tax effects are based on the entire situation and not just the individual steps. Various Tax Court cases have applied three separate tests; if *any* of these apply, the step transaction doctrine applies. (1) *Binding commitment*. The binding commitment test is based on whether there was a binding commitment to undertake the later step at the time the first step is entered into. (2) *End result*. The end result test is based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result." (3) *Interdependence test*. The interdependence test inquires whether the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series of transactions."

The step transaction doctrine historically has been more of an income tax doctrine, but it has been analyzed in a variety of transfer tax cases over the last decade. (*E.g., Senda, Holman, Gross, Linton, Heckerman, Pierre II*). A variety of older cases have applied the doctrine to gift tax situations as well. (*Oberwinder*, *Sather*).

The latest case to apply these three tests in the context of the creation of an FLP or LLC and gifts/sales of interests in the FLP/LLC to a trust was *Linton v. U.S.,* 630 F.3d 1211 (9th Cir. 2011). It held that none of the three tests applied. (1) The court reasoned that the binding commitment test only applies to transactions spanning several years. (2) The end result test did not apply because the end result sought was for the trust to end up with the LLC interest, not specific assets. (3) The interdependence test did not apply because contributing assets to the LLCs was a reasonable activity that made sense whether or not there were subsequent gifts of the LLC interests, so the various steps had independence. While the court reasoned that the step transaction doctrine did not apply, footnote 9 acknowledged that there are "timing requirements" between the funding of the LLC and the transfer of interest in the LLC. The court suspected that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances." The circuit court directed the district court to determine the timing facts and the effects of those facts, but that there would be no need to apply the three traditional step transaction doctrine tests.

c. *Indirect Gift*. The indirect gift doctrine can apply if facts are so muddled or capital accounts are so unclear (or do not exist at all) that the transaction is treated as if there was not really a formation of the partnership with subsequent gifts of partnership interests. Instead, the transaction is treated as if there were a proportionate gift of the underlying contributed assets (proportionate to FLP/LLC interests owned by persons other than the donor).

116. Doing Things in the Wrong Order May Result in an Indirect Gift

The *Shepherd* case is illustrative of potential problems that can arise if other family members own FLP/LLC interests before assets are contributed to the entity. Real estate was transferred to an FLP after the taxpayer's two sons each owned 25% of the partnership. Capital accounts may be established for each partner/member allocating a proportionate part of the contributed value to each party. The transaction is treated as a transfer of a proportionate interest in the underlying property rather than as an interest in the partnership or LLC.

The key to avoiding this result is doing things in the proper order.

To document the order in which events happened, use a notary to notarize signatures. If events happen on the same day, have the notary note the time that each document is signed.

The IRS asks about whether capital accounts have been created in every audit. It is best to set up capital accounts when the partnership is funded. Do not merely rely upon the first year income tax return to establish the capital accounts of the parties. Several cases have raised that capital accounts were not documented contemporaneously with contributions. If nothing else, make sure that the "Schedule A" to the FLP/LLC agreement is completed, reflecting the contributions by each of the parties and the percentage interests received by each of them.

Very simply – Form the entity on day 1, transfer assets to the entity on day 2 and credit the contribution to the transferor's capital account, and transfer a percentage interest in the entity on day 3.

Lou Mezzullo's summary of planning takeaways to avoid the indirect gift argument from events occurring in the wrong order:

> "To avoid the result in *Linton* and *Heckerman*, both the operative agreement and the contemporaneous records of the entity should make it clear that the transfer of the assets to the entity increased the capital accounts of the transferor. The operative agreement should also state that upon a liquidation of the entity, distributions would be based on capital account balances. It should be documented that the gifts occurred after the assets were transferred to the entity and the capital accounts of the transferors were increased by the fair market value of the transferred assets before the gifts were made."

Summary of Best Planning Practices.

- Establish the entity and finalize contributions, with accurate values and interests in exchange for capital contributions.
- Properly document the transactions in the order that was intended.
- Properly document the operating agreement.
- Establish capital accounts contemporaneously (query whether capital accounts on income tax returns are sufficient).
- Have the instruments notarized even if not required by state law.
- Make gifts after the entity is created and funded.
- For any additional subsequent contributions, issue interests and increase capital accounts proportionate to those additional contributions.

117. Short Time Between Creation, Funding and Transfers of Entity Interests

If an FLP/LLC is funded and interests in the entity are transferred days later, the timing between the entity creation and funding and the subsequent transfers may give rise to a step transaction attack.

A possible response to a step transaction argument is that the entity is created for significant non-tax purposes totally separate from the reasons for making transfers of interests in the entity. For example, real estate is traditionally held in a limited liability entity because of liability concerns. Contributing the real estate to the entity is totally independent of any subsequent transfers of interests in the entity, and arguably the three step transaction tests would not apply. (However, *Bigelow*, which involved real estate contributed to an FLP, points out that a partnership can be planned and operated so poorly that transfer tax issues (§2036 in that case) can arise even for real estate in a partnership which has at least to some obvious non-tax reasons.)

A lapse of a particular amount of time should not have any bearing on the application of the indirect gift or step transaction doctrines (although *Holman* and *Gross*, discussed below, suggest that there should be some lapse of time between funding the entity and making subsequent transfers of interest in the entity). In *Jones*, contributions to the entity and transfers of interests in the entity were done on the same day but in the proper order, and discounts were allowed. In *Senda*, the facts were muddled as to the order in which things happened, and the court concluded that "[a]t best, the transactions were integrated … and in effect simultaneous." Similarly, the timing of the various steps were unclear in *Linton* and *Heckerman,* and the district courts in those cases applied the step transaction doctrine (the district court was reversed in *Linton*). If timing were the key to the step transaction doctrine, *Mirowski* would have been a case to apply the doctrine, but the IRS did not even argue that it applied. In *Mirowski*, the LLC was formed on 8/27/10, patent rights (which were not volatile assets) were assigned to the LLC on 9/1/01, $62 million of marketable securities were transferred on 9/5-7/01, and gifts of LLC interests were made to the daughters on 9/7/01.

In *Holman* and *Gross* (both cases were written by Judge Halpern), the Tax Court ruled that the "integrated transaction" theory did not apply to gifts of limited partnership units made 6 days and 11 days, respectively, after an FLP was created. *Holman* involved shares of Dell stock, and *Gross* involved a portfolio of securities. The court focused on whether there was a real economic risk of a change in value during the delay period for the particular assets in the partnership. The court in *Holman* said that the IRS appeared to be arguing that the interdependence test applied, and that test requires that the legal relations created by one transaction would have been fruitless without a completion of the series. The court concluded that while the parents intended to make gifts of LP interests when they formed the FLP, it could not conclude "that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift." Indeed, the court noted that the IRS did not contend that the step transaction or integrated transaction doctrine applied to the gifts made in early 2000 (two months after the creation of the FLP) and in 2001. The court gave two reasons for distinguishing the *Senda* court's conclusion that transfers to partnerships coupled with transfers of limited partnership interests to their children on the same day were "integrated steps in a single transaction." First, the transfers in this case were not made the same day. Second, there is a "real economic risk of a change in value" of the Dell stock (and the value of the LP interests). The court believed that the IRS conceded that a two-month separation is sufficient to give independent significance to the funding and the gift two months later in early 2000, presumably because of the economic risk of a change in value during the two-month period.

Judge Halpern's analysis in *Holman* and *Gross* suggested that the amount of delay required to avoid a step transaction argument will depend on the nature of the assets contributed to the partnership or LLC. The court acknowledged in *Holman* in footnote 7 that the "real risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a six-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond." Similarly, footnote 5 in *Gross* suggested that an 11-day delay might not be sufficient for certain types of assets, such as a preferred stock or a long-term Government bond.

Waiting a particular period time so that the assets may change in value between the steps seems to have little relevance to the step transaction doctrine. If the intent is to take several steps that are abusive in reaching a tax result, why should it matter whether days, weeks or months passed between the steps. Timing alone is a "red herring." In light of *Holman, Gross, Linton, and Heckerman,* courts are using Judge Halpern's "economic risk of a change in value" test, but the cases are not yet well developed. We have not yet had the "Bongard" case of the full Tax Court weighing in on the approach to apply regarding application of the step transaction doctrine to the funding of an entity and subsequent transfers of entity interests.

One helpful planning strategy is to avoid making decisions about what gifts or sales will be made of interests in the entity at the time that it is being formed and funded. One possibility would be to avoid absolutely any discussion of subsequent transfers, but as a practical matter that is part of the overall planning, and a discussion of the tax as well as nontax issues involved in the formation of the entity should be appropriate. One panelist put it: "We are tax lawyers, and clients pay us for tax advice. We can make clear that we would advise creating the entity even if there were no particular tax advantages. But for sure, do not write in a letter 'this will get you a 45% discount.'" (Indeed, Judge Marvel in *Turner* said that she found the family members' testimony was not credible because they purportedly testified that they did not discuss tax effects at the outset.) In any event, do not prepare and give the client transfer documents at the time the entity is formed.

With respect to the discussion of tax issues in planning discussions, Stephanie Loomis-Price told of a case in which the file contained hundreds if not thousands of pages dealing with tax effects of the transaction, but relatively few pages dealing with nontax effects. The IRS agent argued that showed the FLP was just created for tax reasons. Stephanie responded that the first letter that the client sent to the lawyer described that his daughter had been married and divorced three times and each time it cost him $5 million. He wanted to know what he could do to avoid that the next time she got divorced. Stephanie told the agent that while there were many pages dealing with taxes, that is because the client did not understand the tax issues and needed a lot of information to get comfortable with tax issues, but that did not change the fact that the client's fundamental concern was planning for divorce protection.

Randy Grove suggests that in discussing non-tax reasons for the formation of the entity, also discuss long-term planning possibilities, but state that the planning should be done in appropriate "phases." [**Practical planning pointer: Use the term "phases" in planning discussions and communications instead of "steps." There is not as much of a ready link that the IRS can make to the "step" transaction doctrine.**]

Lou Mezzullo provides the following summary of planning takeaways to avoid the step transaction doctrine when phases of a transaction happen close together:

> "[T]here should be a legitimate and significant nontax reason for creating the entity to avoid the step transaction doctrine. Based on *Holman* and *Gross*, if the value of

> the assets is volatile, waiting a few days after the contribution before making gifts of interests in the entity should avoid the step transaction doctrine. However, if the value of the assets is not volatile, it will be important to be able to demonstrate that none of the three tests the courts have used to apply the step transaction doctrine is applicable. Avoiding the binding commitment test should be relatively easy by avoiding any binding commitment to complete the series of transactions. To avoid the interdependence test, each step should have a purpose other than achieving the end result. Finally, to avoid the end result test it should be clear that the result obtained, i.e., transferring an interest in the entity to the donees, was the reason for forming the entity and not transferring the underlying assets. Testimony and documents that indicate the only reason for setting up the entity was to obtain a discount will be persuasive that the taxpayer intended to transfer the underlying assets to the donees in the most effective way without any other reason for creating the entity first."

Summary of Best Planning Practices.

- Allow the entity to season or "cook" before making gifts.
- Consider and document all of the substantive nontax reasons that fit the situation.
- Avoid discussion of gifts until the entity is formed, funded and functioning.
- Properly document all transactions in the order intended.
- Memorialize gifts in formal transfer documentation (do not just do it orally).
- Have the accounts reflected in the books and records.
- Include signatures and dates for both the effective date and actual date signed
- Add a notary block so the documents can be notarized (even if not required by state law).
- Educate clients and the other partners or members regarding the logistics of the entity and compliance with governing documents.

118. Very Small Interest Owned by Other Partners

What if a partnership is formed that is owned 99.99% by the parent and 0.01% by a daughter? Will planning steps with that partnership be recognized as involving a valid legal entity? The IRS may argue that the daughter has not made a meaningful contribution to the FLP, and that the parent included daughter at the outset merely to obtain partnership status. If the partnership is not a valid entity, the parent would not have been able to convey a partnership interest and instead would be treated as having made a direct transfer of the underlying assets.

There is no requirement that partners have minimum interests, and the partnership should legally be valid. However, the panelists would not want to form the entity with the second partner having that small of an interest.

Pierre I held, in a case of first impression, that gifts and sales of interests in a single-member LLC to trusts (12 days after the LLC was created) are treated for gift tax purposes as transfers of interests in the entity (with the possibility of discounts) rather than as transfers of proportionate shares of the underlying assets, despite the fact that they single-member LLC is treated as a disregarded entity pursuant to the check-the-box regulations. There was significant concern as to whether this would be the result for single-member LLC, because Revenue Ruling 99-5 had concluded that if an owner of a single-member LLC sells an interest in the entity, that is treated as a sale of a proportionate part of the underlying assets.

Summary of Best Planning Practices.

- Do not include children as partners or members until capital contributions are made by them.
- Establish and document the nontax reasons for the formation.
- If a child is not in a position to make a contribution from his or her own assets, suggest a gift to the child so that the child can subsequently make a significant contribution to the entity (but that is not helpful if the child is a minor and the child does not have the ability to make an independent decision to contribute to the entity; in this situation, make the gift to a UTMA account with the custodian being someone other than the parents).

119. Gift Followed by Redemption of Parent's Interest

Assume that son owns 10% of the shares of a business, that father gives 39% of the shares to son on December 1, and that father's remaining shares are redeemed over the next two months in two separate transactions (so that a noncontrolling interest is redeemed in each of the transactions). The IRS may take the position that the gift and redemptions were part of an overall plan to transfer a controlling interest in the company to son while obtaining a lack of control discount on each applicable transfer. If the steps are collapsed, the various transactions would constitute a gift of all of the father's interest in the company (but the value of the company would be affected by the redemption price that was paid for father's redeemed shares).

This is similar to the facts of *Cidulka* (T.C. Memo. 1996-149). In that case, the decedent made gifts of stock to his son, son's wife, and their children, and on the same day the corporation redeemed his remaining shares. The son's wife immediately transferred her shares to the son, and the children were not listed as shareholders on the corporation's books. To make matters worse, the promissory note that the decedent received in the redemption did not reflect full and fair consideration for the redeemed stock. The court concluded that the gifts and redemption constituted one transaction and in substance passed a majority interest to the son. No minority interest discount was allowed.

This is a smell test situation. If a redemption has real economic substance (at a reasonable sale price) and a real economic purpose, it will be respected. However, when several steps are separated just to get a higher discount, that smacks of substance over form.

Transactions that are "too cute" may be disrespected.

Similar issues arise if gifts are made to "strawmen" who immediately gift the assets to the ultimate intended donee in order to generate more gift tax annual exclusions.

Summary of Best Planning Practices.

- Allow seasoning time between the gifts and the redemption.
- Include others as owners.
- Identify independent significance for the redemption.
- Keep "re-transfers" of entity interests separate in time as much as possible (and if possible, splitting calendar years).
- Make sure that books and records reflect all transfers, even if they effective for only a short period of time (the books and records should reflect the ownership even if an owner only owns the interest for five minutes).

120. Gift to Spouse Followed by Donee-Spouse's Gift to SLAT For Original Donor-Spouse

Assume Husband makes a gift to Wife, which Wife uses shortly thereafter to fund a trust for Husband's benefit (i.e., a "SLAT"). If Husband had created the trust directly for his own benefit, §2036 would apply.

Summary of Best Planning Practices to Mitigate Step Transaction Risk.

- Increase the amount of time between the gifts.
- If possible, Wife should fund the SLAT with assets that were not recently received as a gift from Husband. If Wife has a power of substitution, she might choose to substitute the assets received as a gift from Husband at a later date.
- After the initial gift to Wife, Husband and Wife could establish an LLC (for legitimate and significant nontax purposes) with Wife transferring certain assets to the LLC. After a sufficient amount of time has passed, Wife could contribute certain LLC interests to the SLAT.

121. Partition of Community Property Followed by Gift of Partitioned Separate Property From One Spouse to the Other Spouse

Similarly, assume spouses in a community property state partition community property and that one spouse subsequently makes a gift to the other spouse. Assuming the each spouse receives one-half of the partitioned assets, and if assets are divided in a non-pro rata manner, each spouse receives half the value, the situation should be different than the gift followed by re-gift situation. In the community property partition situation, (1) each party is receiving adequate consideration for the initial split of assets, and (2) the partition changes their property rights. For a pro rata severance, there should be no necessity of waiting a particular time period between the partition and the subsequent gift.

122. Subsequent Contributions to FLP/LLC

When subsequent contributions are made to an entity, the transferor should receive an interest in the entity proportionate to the ratio of the value of the property contributed to the *value of the entity's aggregate assets immediately following the additional contribution*. The assets must be "marked-to-market" or else gifts will be made.

Summary of Best Planning Practices.

- Value additional contributions at fair market value.
- Value the assets of the entity at fair market value.
- Exchange additional contributions for additional interests in proportion to the ratio of value of the assets contributed to the value of the entity's assets ("mark to market").

123. Timing of Gift and Subsequent Sales to Grantor Trusts

If gifts are made to a grantor trust and the donor soon thereafter sells additional assets to the trust, the IRS conceivably might argue that the entire transaction should be collapsed into a single transaction for §2036 purposes. It might argue that the combined transfer is treated as a transfer for less than full and adequate consideration with a retained interest (i.e., the note payments), so that the sale portion of the transaction no longer qualifies for the "bona fide sale for full consideration" exceptions to §2035 and §2036. There is no reported case in which the IRS has made that argument, and perhaps the IRS will never even make that argument let alone find a court receptive to it.

If the initial gift is not the same asset that is being sold, collapsing those separate transactions involving separate assets would be more difficult (perhaps unless the gift asset is used as downpayment for the sale transaction).

This may be a matter of degree. If there are other bad facts implicating §2036, the IRS may be more inclined to make this step transaction argument.

The downside risk of this potential argument is so great that it makes sense to take steps to avoid the argument, to the extent possible, by delaying the sale transaction for some "appropriate" period of time after the gift. (Although the court applied the step transaction doctrine in *Pierre* [merely to disallow lack of control discounts for the separate gift and sale transactions], the gift and sale transactions in *Pierre* occurred within "moments" of each other (as noted in the court's conclusion). That may have been an especially important factor in the court's decision. Indeed, there was no hint that the court would have been receptive to applying the step transaction doctrine to the funding of the LLC and the subsequent gifts and sales made 12 days later even if the IRS had made that argument in *Pierre*.)

Summary of Best Planning Practices.

- Increase the time between the gift and sale transactions.
- If the client intends to limit the amount of gifts for economic reasons (i.e., the client is not willing to relinquish more value than a desired amount) and to make further transfers only as sales that will not deplete the client's assets, document that intent.
- To every extent possible, focus on the economics of the separate sale transaction, and implement the sale transaction in a way as to give credence to the sale transaction, including making principal payments on the note over time.
- Do not refer to the gift as a "seed" gift.
- If consistent with the client's intent, give and sell different assets. (Of course, there could be no aggregation for valuation purposes if there are different assets, but more importantly, using different assets may help thwart a §2036 argument by the IRS.)
- Structure the sale as an arm's length transaction.
- Create notes with immediate economic significance.

Item 124 consists of interesting quotations from throughout the seminars.

124. Quotations

a. *Hydra With Hands.* In discussing planning alternatives with clients following ATRA, Ron Aucutt observes "I am constantly referring to 'the other hand.' I can't imagine the creature that has all those hands." – Ron Aucutt

b. *Repeal?* "It now takes the most eternal optimist who thinks that estate tax repeal is going to cure all problems." – Lauren Detzell

c. *Real Solutions.* "Providing a solution that is not implemented is not a solution…. Communicate client solutions in a way that empowers clients to move forward with those solutions." – John Bergner

d. *You Gotta' Believe.* "Complication is a big problem for clients. Our job is to tell clients that the complicated alternative can still be helpful. (It helps if the attorney really believes that.)" – Turney Berry

e. *Grantor Trusts*. On waiting to see what the Administration proposes regarding grantor trusts: "We may change from all grantor trusts are evil to sales to grantor trusts are sometimes evil." – Jim Lamm

f. *Healthy Lifestyles*. "Despite my prolific consumption of Diet Coke, I am unlikely to survive another 99 years." – Turney Berry (in discussing his concept of 99-year GRATs)

g. *Abusive Transactions*. Why does Turney suggest 99-years for his long-term GRAT? "Because 100 years is clearly abusive." (As authority for using 99 years, he points to the fact that the United States leased the Panama Canal for 99 years, and Great Britain leased Hong Kong for 99 years.) – Turney Berry

h. *But If It's Not Illegal Now*. The Greenbook proposes limiting the terms of a GRAT to life expectancy plus 10 years. Turney observes that there is nothing better to validate a strategy (his 99-year GRAT strategy) than that someone wants to outlaw it. – Turney Berry

i. *Reliance*. In discussing PLR 201233011, which allowed relief from retroactive allocation of a ruling denying an extension of time to make a QTIP election for an inter vivos transfer because of the taxpayer's reliance on the prior incorrect ruling, Carol Harrington concludes that the lesson is that if a favorable letter ruling is issued that seems questionable, do something to rely on it. – Carol Harrington

j. *It's Magic!* In the *Kite* case, on March 28, 2001 the mother replaced the trustees with her daughters and they contemporaneously terminated the trusts — all as of January 1, 2001. "I don't know how you do that except with magic." – Carol Harrington

k. *It's All in the Perspective*. In *Kite*, the mother sold assets to her children for a 10-year deferred annuity, but died three years later before receiving any payments to be included in her gross estate. "Sadly the mother died within three years. Of course, 'sadly' is according to your perspective." – Carol Harrington

l. *Stabbing the Knife — and Turning It*. In *Keller* the executor heard about the *Church* case at a seminar to take the position that a partnership had legally been created even though the decedent did not fund it before her death. The result was a huge taxpayer victory. "I do hope the cost of the seminar was deducted as an administration expense." – Carol Harrington

m. *Saving the Idiots*. Carol Harrington summarized the effect of PLR 201250005, which voided a GST exemption allocation to a 2010 direct skip: "If you advertently allocated GST exemption to a direct skip in 2010, not only you are an idiot, but we'll let you take it back." – Carol Harrington

n. *You've Got to Know the Rules*. "If some rule is not followed and a problem arises, the client may be 'disappointed' — which we know is a synonym for 'plaintiff.'" – Mickey Davis

o. *The Greatest Thing*. "Is is the greatest thing since sliced bread, which makes you wonder — what was the greatest thing before sliced bread? Unsliced bread?" – Mickey Davis and Clary Redd

p. *How Gutsy Are You?* "I guess you could not say in a Crummey trust that if the beneficiary were to exercise the withdrawal right, the individual would no longer be a beneficiary of the trust?" (However, Clary thinks that technically any particular gift to a trust with that provision should qualify for the annual exclusion because there is no

impediment to the beneficiary being able to acquire the assets represented by that gift. Clary admits he is not gutsy enough to try that.) – Clary Redd

q. *The Known and the Unknown.* "Trust documents need to contemplate 'the known unknowns and the unknown unknowns' (as Donald Rumsfeld put it)." – Wendy Goffe

r. *It's All in How You Say It.* In describing a transaction with various elements, avoid using the word "steps" in describing the long range planning. Instead refer to implementing the long-range planning in appropriate "phases." (That at least makes it more difficult for the IRS to draw a link between the communications and the "step" transaction doctrine.) – Randy Grove

s. *But That's What We Do.* In discussing whether tax advantages of entity planning should be discussed at the outset of the planning, Lou Mezzullo's strong reaction: "We are tax lawyers, and clients pay us for tax advice. We can make clear that we would advise creating the entity even if there were no particular tax advantages. But for sure, do not write in a letter 'this will get you a 45% discount.'" – Lou Mezzullo

t. *What Do You Know?* "If you don't know what you don't know, you can really be dangerous." – Randy Grove