ACTEC 2007 ANNUAL MEETING MUSINGS

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TABLE OF CONTENTS

1. .... LEGISLATION ISSUES 1
a. Pay As You Go; Impact of AMT Reform............................ 1
b. No Estate Tax Reform Likely in 2007............................ 1
c. Stop Tax Haven Abuse Bill S. 681.............................. 1
d. .... Possibility of Carryover Basis in 2010 3
2. FLP ISSUES.. 4
a. .... Korby, 471 F.3d 848 (8th Cir. 2006) 4
b. Applicability of REIT Comparables for Valuing Real Estate LLC Interests, Estate of Langer, T.C. Memo 2006-232................ 4
c. .... Appeal Settlement Guidelines 5
d. In-House Appraisals... 6
3. 9100 RELIEF ALLOWING LATE GST EXEMPTION ALLOCATIONS.............. 6
a. Statute and (Absence of) Regulations........................... 6
b. New IRS Restrictive Position.................................... 7
c. Legislative History... 7
d. IRS Suspicious.. 7
e. Practical Pointer... 7
f. Accountant Response... 7
4. CREDIT SHELTER TRUST THAT IS GRANTOR TRUST AS TO SURVIVING SPOUSE. 7
a. Goal.. 7
b. Advantages.. 8
c. Approach.. 8
d. Tax Effects... 8
e. Reciprocal Trusts... 10
f. Caveat.. 11
5. VALUATION ISSUES.. 11
a. Effect of Rule 144 Restrictions, Redemption Agreement, and Actual Purchases After Valuation Date, Estate of Gimbel.............. 11
b. Pending Case Involving Rule 144 Stock with Contractual Restriction on Sale.. 12
6. PENALTIES ON APPRAISALS...................................... 12
7. PATENTING TAX STRATEGIES..................................... 12
a. So-GRAT Patent Litigation Settled............................... 12
b. AICPA Position and Legislative Proposals........................ 12
c. Subpoenas... 12
d. Task Force.. 13
8. .... GRANTOR TRUST ISSUES; TRANSFER OF INSURANCE POLICIES TO GRANTOR TRUSTS, REV. RUL 2007-13.............................. 13
a. Transfer to Grantor Trust Does Not Violate Transfer for Value Rule.. 13
b. Reconfirming Position That Grantor Is Treated as Owner of Trust Assets For

Income Tax Purposes... 14
c. .... Advantages of Transferring Policies Between Trusts 14
d. Planning Concerns With Transfers Between Trusts............... 14
e. Using Partnership to Assure Transfer for Value Rule Not Violated 15
f. Transfer to Insured (or Grantor Trust) Cleanses Prior Transfer for Value Problems.. 15
g. Achieving Grantor Trust Status for Life Insurance Trusts...... 15
h. Grantor Trust by Buying Asset From Trust For Note............. 16
i. Effect of Crummey Clause in Grantor Trust..................... 16
j. Grantor Trust Conversion During a Year........................ 17
9. BASIS BOOSTING.. 17
10. NEW QUESTION ON FORM 706... 17
11...... PRIVATE ANNUITIES USING DEFECTIVE GRANTOR TRUSTS—EFFECT OF THE PROPOSED REGULATIONS... 18
a. Gain Recognized Immediately................................... 18
b. .... Effective Date 18
c. Grantor Trusts.. 18
d. Beneficiary Guarantees to Avoid Age 110 Rule for Private Annuity Sales to
Grantor Trusts; Avoiding Section 2036 Risk................... 18
e. State Law Fiduciary Issues.................................... 19
12. APPLICATION OF 2% HAIRCUT UNDER §67 TO TRUST INVESTMENT ADVISOR FEES; RUDKIN... 19
a. Appeal to Supreme Court....................................... 19
b. .... Effect on Trust Beneficiaries 19
c. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67.. 19
d. Position of Corporate Trustees................................ 19
e. Partnership With Profits Interest............................. 19
f. Treasury Project.. 19
13.. MORE FORM 1041 AUDITS 20
14. INCOME TAX ISSUES WITH TRANSFER PLANNING STRATEGIES............ 20
a. Grantor Trust Treatment “Until It Hurts”...................... 20
b. .... Obligation Secured by Escrow 20
c. Re-election of S Status Required Upon Transfer to a Non-Grantor Trust.. 20
d. .... Loans as Part of Basis As to S Corp Losses 20
e. .... Allocate S Corporation Income After Transfer 20
f. Grantor Trust Reporting....................................... 20
g. Treatment of Grantor Trust on Grantor’s Death................. 21

15. .... **INCOME TAX "NUGGETS" FOR THE ESTATE PLANNER** 21
a. Note Forgiveness 21
b. Section 1031 Exchanges Between Related Parties 21
c. Sales of Depreciable Assets to Related Party 21
d. Sales of Depletable Property to Related Party 22
e. Guarantee of Loans to Related Parties 22
f. Gifts Reacquired From Decedent Donee Within One Year 22
g. Pre-Mortem Planning; Consider Giving Loss Assets 22
h. Terminate Sales Agreement That Would Generate IRD 22
i. Recognize Losses in Marital Trust 22
j. Gathering Income Tax Information By Executor 22
k. Protective Claim by Surviving Spouse For Liability on Joint Final Return 22
l. Filing Status if Final Return is Not a Joint Return 23
m. Place for Filing Final Form 1040 23
n. Allocating Income Between the Final Return and the First Estate Income Tax Return 23
o. Treatment of Final Paycheck 23
p. Dependency Exemptions 23
q. Estate or Trust Beneficiary Who Dies Before End of Year Must Report Distributions .... 23 Actually Received Before Death 24
r. Income Tax Relief for Military or Civilians Killed in Terrorist Actions 24
s. IRD Items in Flow-Through Entity 24
t. Non-Probate Property Includible in Estate Gets Basis Adjustment At Death Even if No Form 706 is Filed 24
u. .... Depreciable Property Following Decedent's Death 24
v. .... Undistributed Property When Beneficiary Dies 24
w. . Long Term Status When Capital Gain Property Is Sold After Death 24
x. .... Uncertainty of Beneficiaries 24
y. Distributions Made by Mistake Should Not Carry Out DNI 24
z. "Specific Bequest" Exception to Carrying Out DNI; Application to Specific Dollar Gift 25
aa. .... Loss on Funding Pecuniary Gift 25
bb. Distribution of Installment Notes Receivable by Executor or Trustee 25
16. CHARITABLE PLANNING ISSUES 26
a. Split Interest Trusts Participating in Investing in Endowment Funds 26
b. Robertson Case 27
c. Bishop Trust 27

d. Senator Grassley's Continued Leadership........................27
17.......GIFT TAX EFFECT OF AGREEMENT TO GIVE REMAINDER OF PAINTING TO CHARITY...27
18. ....USE OF IRA TO SATISFY PECUNIARY CHARITABLE BEQUEST TRIGGERS INCOME; CCA 200644020..28
19............NON-GRANTOR TRUST ALLOWING DISTRIBUTIONS TO GRANTOR WITH THE CONSENT OF ADVERSE PARTIES..................................29
a. ....Long Term QTIP Alternative 30
b. Approaches to Avoid State Income Taxes on Trust Distributions.30
20.................ATTORNEY CLIENT PRIVILEGE ISSUES IN TAX LITIGATION 30
a. Important Roadmap...32
b. Fact of Representation and Presence at Meetings Discoverable..32
c. Engagement Letter...32
d. Billing Records...32
e. Nature or Substance of Legal Advice...........................32
f. IRS Can Rephrase..32
g Waiver of Privilege..32
h. ....Strategic Decision 33
i. Burden of Proof and Penalties..................................33
j. Business Advice vs. Legal Advice..............................33
k. Communications Prior to Attorney-Client Relationship..........33
21...LIFE INSURANCE ISSUES 33
a. ....Life Settlements 33
b. Proposed Viatical Settlements Act.............................35
22........................BUSINESS SUCCESSION PLANNING NON-TAX ISSUES 36
a. Get a Temporary Plan in Place..................................36
b. ....Family Communication Issues May Get Tougher After Sale of Business..36
c. Tough Communications With Client..............................36
d. Communicating the Plan With the Family.......................36
e. ....Family Council to Deal With Family Issue 36
f. ....Outsiders on Boards of Family Businesses 36
g. Ethical Issues..37
h. ....Entrepreneurial Clients Prefer "Business" Consultants 37
i. ....Provide an Exist Strategy for Children Not Involved With the Business..37
j. ....Motivating Clients to Act 37

k. Involvement of In-Laws ... 37
l. Invite Business Owner's Spouse to the Meeting ... 37
m. No "Right" Answers ... 37
n. Explore Real Reasons for Wanting to Sell ... 37
o. Do Not Let One Dysfunctional Family Member Upset the Entire Succession Plan ... 37
p. Adequate Liquidity for Business Owner is Imperative ... 37
q. Succession Planning Client is Often Not a Long Time Client ... 38
s. S Corps More Family Friendly ... 38
t. "Principles of Family Business Succession" ... 38
23. PRACTICAL PLANNING FOR LONG TERM TRUSTS—100 YEARS IS A LONG TIME ... 38
a. Modification or Termination of Trusts ... 39
b. Designating Investments and Retention of Particular Assets ... 39
c. Protectors ... 40
d. Letters of Wishes ... 41
e. Incentive Clauses ... 41
f. Choosing Trustees for the Long Term; Successor Trustees ... 41
g. Overriding Drafting Goal With Respect to Special Assets ... 42
24. EXAMPLE LETTER—NUGGETS OF WISDOM FROM PARENTS TO CHILDREN ... 42
25. MEDICAID PLANNING AND CRUMMEY TRUSTS ... 44
26. EFFECT OF CRUMMEY WITHDRAWAL POWERS ON CREDITORS RIGHTS ... 44
27. INTERNATIONAL ESTATE PLANING ISSUES
a. U.S. Domicile ... 44
b. Person Residing in U.S. But Not U.S. Domicile ... 45
c. Non-citizen Spouse Domiciled in U.S ... 45
d. Inbound Gifts From Foreign Person to U.S. Person ... 46
e. Outbound Gifts From U.S. Person to Non-Resident Alien ... 47
f. Inadvertently Creating Foreign Trust ... 48
28. INTERESTING QUOTATIONS FROM 2007 ACTEC ANNUAL MEETING ... 48

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Introduction

Some of my observations from the 2007 ACTEC Annual Meeting (and other recent developments), are summarized below. I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the conferences and committee meetings. 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). ***This summary is posted on the ACTEC website for ACTEC Fellows, but it is not being widely distributed.***

1. LEGISLATION ISSUES

a. Pay As You Go; Impact of AMT Reform. In the "first 100 days" of Democratic rule, a "pay as you go" budget rule was adopted in the House. The Senate has not adopted it, but Democratic senators indicate they will follow it. This will impact future tax cuts and extending tax cuts in the future. The Chair of the House Ways and Mean Committee (Charles Rangel) and the Senate Finance Committee chair (Max Baucus) are both big proponents of repealing the AMT tax. That has a huge impact on the fisc. Rep. Rangel has already responded by reducing a tax cut in HB 976, to eliminate the lowest capital gains bracket.

   As to Representative Rangel's view of the world: Last week, Representative Rangel was asked what he thought of President Bush's presidency. His reply- "No matter what you think about the man, he has unilaterally killed the myth of "white supremacy."

b. No Estate Tax Reform Likely in 2007. The consensus is that the prospect of estate tax reform legislation this year is nil. Next year, both parties will discuss how best to proceed strategically.

c. Stop Tax Haven Abuse Bill S. 681. Levin, Coleman, Obama. This is a 251 page bill that covers a broad range of new areas.

   (1) Tax Patents. The bill has a prohibition on tax shelter patents, but it is broader than what we think of as tax shelters. It applies to "patenting any invention designed to minimize,

avoid, defer, or otherwise affect liability for federal, state, local, or foreign tax." It would eliminate most tax patents. It would be effective for patents not yet granted on date of enactment. So patents that have already been issued (such as the So-GRAT patent) are protected.

(2) Authority of IRS to Regulate Practitioners. Some have questioned the Scope of Circular 230 and have wondered if the Treasury exceeded its authority. Title 31, Section 330d would be expanded to permit the IRS to adopt these kinds of rules, and permit the IRS to pass rules that would go into more detail and regulate us even more closely than we dreamed possible under the existing Circular 230.

(3) Contingent Fees. Section 304 of the Rule would amend §6701 to prohibit charging fees for services provided in connection with tax advice that are calculated according to the tax benefits projected or achieved. It has some retroactive affect—because it applies to fees charged OR COLLECTED after the date of enactment.

(4) Offshore Secrecy. This is a large section of the bill. It creates puzzling rules with respect to any corporation, trust, partnership or other entity formed or operated in certain jurisdictions called offshore secrecy jurisdictions, which includes 34 named jurisdictions (including Switzerland, Bahamas, Cook Islands, Hong Kong, Liechtenstein and others). Any person with any connection with an entity in those jurisdictions—such as a person who creates or funds or receives benefits from or is a beneficiary of any of these entities in these jurisdictions, is considered to have "control" over the entity. It is not clear what that means—but at least for a trust, the person would be treated as the owner of the trust, and therefore taxable on all of its income. If there are 5 U.S. people who are beneficiaries of the same trust, possibly each one of them would be taxable on all of its income. The bill is silent on how to determine shares or proportions of ownership.

The bill creates a rebuttal presumption—but in name only. The individual must present clear and convincing evidence that the individual has NO control, and the person is not allowed to submit evidence in any court of any kind unless the foreign persons appear in court to authenticate any documents submitted as evidence and to testify in open court on any other evidentiary matter. As a practical matter, it will be very difficult to rebut the presumption, and the consequences of the presumption are unclear.

The bill would also create a new six year statute of limitations rather than three years for transactions with offshore secrecy jurisdictions. Also, the IRS can collect additional tax without assessment.

(4) Gatekeeper and Anti-Laundering. Reporting suspicious transactions and anti-laundering rules are extended to tax avoidance. Title 31 of U.S. Code has for a long time given the Treasury the authority to require any financial institution to report any suspicious transaction relevant to a possible violation of any law or regulations. If the financial institution does the reporting, it is not allowed to notify the person reported on that a report has been made.

The Section also requires financial institutions to have anti-laundering programs that are burdensome. Under this bill, attorneys will become financial institutions because the law expands the definition of financial institutions to include any persons involved in creating new corporations, limited liability companies, partnerships, trusts, or other legal entities. Therefore, attorneys will have these responsibilities for and against our clients.

The extended rules are not limited to notifying the IRS of suspected money laundering. The offense also includes the avoidance or evasion of U.S. tax—any transaction designed to interfere with the collection of U.S. tax.

(5) Extension of Distribution Rules for Foreign Trusts to Property Used by Beneficiaries. The use of real estate, marketable securities, artwork, jewelry, or other personal property will be treated as a distribution from a foreign trust for income tax purposes, unless the person who uses it pays full fair market value. Also, protector powers will be attributed to the grantor.

(6) Economic Substance Doctrine. The IRS has wanted to codify the 70 year old Gregory v. Helvering economic substance doctrine and this bill does that. The IRS's reason for codification is to be able to impose penalties. The trend in Congress is to use penalties to get compliance with the tax laws. The provision states that if the substance over form doctrine is violated, the penalty is 40% of the underpayment of tax. This obviously would be a huge deterrent.

Fortunately, there is an exception that appears to cover most of what we do. The exception reads: "In the case of an individual, this subsection [codifying the economic substance doctrine], shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income." This would seem to exclude most of the estate planning transactions that we do, but possibly not all of them. There is ongoing study as to whether this provision might also apply in the estate and gift tax area.

d. Possibility of Carryover Basis in 2010. With both political parties firmly entrenched in their positions on estate tax reform, there is a realistic possibility that a compromise will not be reached before 2010. The obvious result is that we could have a year with no estate, gift, or GST tax. Realize, also, however, this means that we can have a year of carryover basis.

Consider drafting issues in light of the ever growing possibility of no reform compromise being reached before 2010. Formula marital deduction and credit shelter requests may be unclear if there is no estate tax. The typical best structure would be for all of the estate to pass to a bypass trust. Documents should clarify what happens if there is no estate tax at the testator's death, and generally should direct that the assets go entirely to the bypass trust. (However, if the state has an independent estate tax, consider whether additional state taxes will be incurred by leaving all of the estate to a bypass trust. There could be state tax confusion even if assets pass to a QTIP trust. For example, New York says that QTIP treatment is available for state tax purposes only if the federal QTIP election is made, but in 2010, there may not be a federal QTIP election.)

Carryover basis drafting issues are very complex.
(1) Can the executor (who allocates the $1.3 million basis step up) allocate the entire basis step to non-probate assets? The executor owes primary fiduciary responsibility to beneficiaries under the will. The will might give the executor the authority to allocate to assets passing outside the will.
(2) Can the executor allocate the basis adjustment to him or herself? This is not clear. If the executor can allocate the basis adjustment to him or herself but instead allocates the adjustment equally to beneficiaries, has the executor made a taxable gift?
(3) Assume the $3 million of additional basis adjustment for assets passing to the surviving spouse remains. If the will leaves all of the estate to a bypass trust, the estate would lose out on the right to the $3 million additional basis.

To take advantage of the spousal basis adjustment, should assets be left outright or to a QTIP trust? Using a QTIP trust could be advantageous because the bequest could qualify for the $3 million basis step up, but §2044 may not apply at the surviving spouse's subsequent death if there is an estate tax at the surviving spouse's death because the first spouse's estate did not get a marital deduction.

How much do you put into that trust? It is not $3 million, but assets that have $3 million of unrealized gain. Do you minimize the amount passing to that trust (i.e., by using assets with the most built-in gain), or do you minimize income tax? For example, the gain on marketable securities is long-term capital gain, but some depreciable real estate would be recaptured as ordinary income. If real estate is used to fund the QTIP trust (even though it does not have as much built-in gain as other assets), there may be more income tax savings.

These clauses are extremely difficult to draft, but imagine how hard they will be to administer. The executor would have to determine the value and basis of every asset to make basic funding decisions, taking into account loss carrybacks, etc. Some kind of simplified rough justice approach to specify assets going to each trust would be very helpful. Carryover basis will make administration of estates much more difficult.

Despite these various administrative difficulties, it is likely that many attorneys will continue to ignore these drafting issues.

2. FLP ISSUES

a. Korby, 471 F.3d 848 (8th Cir. 2006). The decedent kept only about $10,000 and withdrew all living expenses from the partnership. This would seem to be an open and shut case to begin with. It is troubling that Judge Laro pointed to other factors as well—such as the absence of negotiations. The absence of negotiations was just one more factor heaped onto a pile of bad facts in Korby. However, it is a factor keeps getting repeated in cases (despite being specifically rejected in Kimbell). It is likely that the IRS will cite this case to support that negotiations are required.

John Porter likes to see the next generation family members involved in the formation of the partnership, and at least send them a copy of the draft of the agreement for comment. The client may not agree with comments. (This may be similar to the right that an attorney has to comment on the firm partnership agreement when it is sent around to be signed each year. After making comments, the managing partner will thank the attorney for the thoughtful comments—and ask if he or she wants to sign the agreement or not.)

b. Applicability of REIT Comparables for Valuing Real Estate LLC Interests, Estate of Langer, T.C. Memo 2006-232. The decedent contributed a 60 acre tract and his brother (and his wife) contributed an adjoining 36 acre tract to an LLC to develop the property. Because the decedent was about 90 years old when the LLC was formed, the parties contributed properties to the LLC with the agreement that their interests would be based upon the ultimate valuations of their respective tracts. (That detail was not questioned in the subsequent IRS estate tax audit.) The decedent died two years after the formation. The IRS agent originally raised §2036, but later dropped that issue. (There were excellent facts to rebut the § 2036 argument: the organizational and transfer documents were proper, the decedent lived two years after the transfer, the common development scheme created ample business purpose, the LLC generated little income, and no distributions were made to anyone during the decedent's life.) The taxpayer's appraisal applied a 63% discount in valuing the LLC interests. The IRS expert did not prepare a full appraisal, but just critiqued the taxpayer's appraisal, concluding a 23% discount should be used based on REIT comparables. A primary issue was whether the REIT comparables were appropriate. REITs trade at a very small discount, but the taxpayer argued they were irrelevant, because they were larger entities with professional management that distributed 90% or more of their income, and there was no way that these properties could become a REIT. Ultimately, the parties settled on a 47.5% discount.

c. Appeal Settlement Guidelines. The Guidelines show the focus going forward in IRS audit emphasis.

(1) General Statement That Distributions are Taxable??? The document states that distributions from a partnership are generally taxable events for income tax purposes. That's incorrect generally—but it is stated as the general rule. One attorney has had two agents bring that up since then. The agents are taking that general statement seriously. (Fortunately, there is an easy defense in most circumstances.)

(2) Discussion of Cases; Recognition of Investment Partnerships. The Guidelines have a pretty evenhanded discussion of the cases. They acknowledge that the partnership could consist of a business operation or other meaningful economic activity. Mil Hatcher says that this is perhaps the clearest statement that we have seen by the IRS acknowledging that an

investment partnership should be on the same footing as an active business.

(3) Valuations. The Guidelines say to focus on the Lappo, McCord, and Peracchio analysis. They used the average discount for closed end funds and based the minority discount on the types of assets in the partnership proportionately. They tried to distinguish the Kelly case (T.C. Memo 2005-235), which allowed a 32% discount for certificates of deposit. The guidelines said the case was an aberration, and the government expert made a mistake. The guidelines also don't discuss the Dailey case (T.C. Memo 2001-263), which allowed a 41% discount and ignored the Dr. Bajaj analysis. Instead, they focus on three cases decided by two judges. Appeals officers will try to slot discounts into the amounts described in those cases.

(4) Indirect Gift; Gift on Formation Argument Dropped. The Guidelines do not discuss the old gift on formation argument (but do address the indirect gift argument under Shepherd and Senda). Does this reflect that the IRS has given up totally on the gift on formation argument? One attorney mentioned that he's had the step transaction issue raised in two or three recent audits. That appears to be a hot topic to the IRS.

(5) Personal Use Assets. it is interesting that the Guidelines discuss personal use assets in light of the Strangi case. They did not discuss whether rent paid for using assets was market rent, but suggested that merely using assets placed into the partnership was a bad fact. This highlights the degree of hostility that the IRS has to contributing personal use assets into an FLP or LLC.

(6) Post-Mortem Considerations. The Guidelines state that contributing substantially all of one's assets is a negative factor under the §2036 analysis. The guidelines did not mention postmortem considerations. Some other recent cases have mentioned the need to have some assets set aside outside the partnership for post-mortem expenses. Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005). There is no mention of that in the Guidelines.

(7) Section 2036(a)(2) and 2038. There is very little discussion of §§2036(a)(2) and 2038. The Guidelines hint that the IRS is increasingly focusing on §2036(a)(1) even when the decedent has the sole power over the partnership. It seems to be backing off the §2036(a)(2) analysis when there are fiduciary principles involved.

(8) Penalties. The Guidelines are clear that if one fails to obtain appraisals, or if the appraisal applies an “egregious discount,” penalties would apply. Mil Hatcher summarizes that “if there is not an appraisal, you are making yourself into a human piñata.” If an egregious discount is claimed, the IRS may well assert penalties (and you can’t trade penalties for other issues.) There is a possibility that if an appraisal relies upon pre-IPO studies, the IRS might be inclined to apply the egregious discount penalty. That is unclear because of redactions in the Guidelines.

(9) Freedom of Information Request. The precise directions to appeals officers at the end of the Guidelines are redacted. Some attorneys have questioned if a Freedom of Information Request could be made.

d. In-House Appraisals. There are indications that some IRS offices will not depart from an in-house IRS engineer’s valuation. However, the appeals officer will consider hazards of litigation. The IRS appears to be following an approach of getting in-house appraisers qualified so they can appear in court. (Some tax litigators think that is great. They would love to have in-house IRS appraisers testify in their cases—because they do not have any objective credibility.)

3. 9100 RELIEF ALLOWING LATE GST EXEMPTION ALLOCATIONS

a. Statute and (Absence of) Regulations. Section 2642(g)(1)(B), adopted as part of ERTA 2001, directs the Treasury to adopt regulations describing the circumstances and procedures for granting extensions of time to make the election to allocate GST exemption and to grant exceptions to the time requirement. If such relief is granted, the gift or estate tax value of the transfer to the trust would be used for determining the GST exemption allocation. IRS released Notice 2001-50 providing guidance regarding the procedures for requesting relief for retroactive GST exemption allocations, pointing out that taxpayers should follow the procedures for 9100 relief. However, in the intervening five years since the statute was passed, the IRS has not observed the direction in the statute to adopt regulations implementing this change.

b. New IRS Restrictive Position. A large number of these extensions have been granted, but the IRS has recently adopted a new and very restrictive internal written rule providing that late allocations will not be granted if the original transfer involved a discounted asset and if the gift tax statute of limitations has expired on the initial transfer. The new rule is binding in all situations. It does not matter that the initial transfer did not involve an FLP and that the discount was reasonable. However, the decision was made "at the highest levels" not to apply this rule if the original transfer was reviewed in a substantive gift tax audit. One attorney, however, has reported that the IRS questioned granting an extension even though the gift tax return had been audited, when the IRS thought the taxpayer got “too good a deal” in the gift tax audit. If the gift tax statute of limitations is still open, presumably the late exemption allocation request would be granted, but a gift tax audit would be opened.

c. <u>Legislative History</u>. Some attorneys indicate that the new IRS position conflicts with the legislative history adopting §2642(g)(1)(B).

d. <u>IRS Suspicious</u>. The IRS seems to be very suspicious about these requests. Some attorneys report that they are being asked why they waited so long in making the extension request.

e. <u>Practical Pointer</u>. Call the IRS to determine if they will entertain the extension request before spending thousands of dollars drafting the request.

f. <u>Accountant Response</u>. Accountants are very actively moving forward to address this. They are very concerned. There are many cases where accounting firms were lined up to submit requests. Some are filing their requests even with the ruling position in place—to get it on record. When (and if) this situation is straightened out, their rulings will be in line, and it will appear that they are being responsive and not just delaying to “game the system” by determining if the values are going up or down.

4. CREDIT SHELTER TRUST THAT IS GRANTOR TRUST AS TO SURVIVING SPOUSE

Professor Mitchell Gans, Jonathan Blattmachr and Diana Zeydel are writing an article about the “Supercharged Credit Shelter Trust” [a term they have service marked] (a credit shelter trust that is a grantor trust as to the surviving spouse). The article will be published in the near future in *Probate & Property* magazine.

a. <u>Goal</u>. Create a standard bypass trust for the surviving spouse that is treated as a grantor trust as to the surviving spouse for income tax purposes.

[Another possible way of achieving that goal—in appropriate circumstances—might be for the bypass trust to consist of ownership in an S corporation in which the surviving spouse consents to a QSST election so that the trust is treated as a grantor trust as to the spouse under §678. It is a limited grantor trust—only to the extent that all the income inside the S corporation is taxed directly to the spouse-beneficiary. There are several problems with the QSST approach: 1. Inability to make assets available during the spouse's life to someone else, and all income must be distributed annually to the spouse. 2. Under the QSST regulation, the beneficiary who is the deemed owner under the QSST election is not treated as the owner of the S stock itself. So the surviving spouse would not be able to buy the S corporation stock from the trust in a tax free transaction.]

b. Advantages.

(1) Assets in the bypass trust could compound income tax free (assuming the surviving spouse has sufficient assets to pay the income taxes on the bypass trust's income).

(2) The surviving spouse can enter into income tax free transactions with the bypass trust (for example, swapping cash for appreciated assets before the surviving spouse's death so that the appreciated assets would be in the surviving spouse's estate and get a stepped up basis).

(3) The bypass trust can be created utilizing the deceased spouse's estate tax and GST exemptions (or using the other spouse's GST exemption).

(4) Distributions could be made to other family members after the first spouse's death without gift tax consequences. Perhaps the surviving spouse could also have a broad limited testamentary power of appointment over the trust.

c. Approach. For simplicity, assume husband is expected to predecease wife. Wife would create an inter vivos QTIP trust for husband. (Alternatively [and more aggressively], the trust could be a revocable inter vivos QTIP trust in which the power to revoke the trust lapses at the husband's death.) At the husband's death, the assets pass to a bypass trust for wife that allows discretionary distributions for health, education support and maintenance of the first spouse and other family members (and if assets in the trust exceed husband's remaining estate tax exemption, the excess—determined under a formula—would pass to a QTIP trust for wife or outright back to wife).

d. Tax Effects.

(1) Wife makes a completed gift when the trust is created. Wife will file a Form 709 for the year of the gift, making the QTIP election for the trust, so the gift qualifies for the gift tax marital deduction. (This approach cannot be used for a gift to a

non-citizen spouse; there is no lifetime QTIP (or QDOT) available for gifts to a non-citizen spouse.)

(2) If the more aggresive revocable inter vivos QTIP approach is used, the gift is not complete when the trust is created because of wife's revocation power. The gift from wife to husband is completed at husband's death, when the revocation power lapses. (Support: PLRs 200604028, 200403094, 200210051, 200101021; cf. Estate of Sarah Greve v. Comm'r, T.C. Memo. 2004-91 (decedent could withdraw assets from trust only with consent of adverse party, which meant it was not a general power of appointment, but requirement to get consent of adverse party terminated at the decedent's death; held that the general power of appointment came into being *at the moment of death* and the property was includible in the decedent's gross estate).) The PLRs say that the gift is complete the moment before death so the gift is to a spouse that qualifies for the marital deduction. The theory here is similar- that the completed gift occurs the moment before death when there is a surviving spouse for whom a QTIP trust could be created. *[To avoid the risk that the IRS would change its position on the "metaphysical" concept of the gift being completed by reason of the death of the spouse and whether the QTIP election can be made if the spouse is not alive the instant the gift to the trust is completed, wife could relinquish her revocation right—and complete the gift to the QTIP trust—sometime clearly before husband dies (for example, when he is critically ill). However, that approach would likely remove any argument for a stepped up basis at husband's death if husband dies within one year in light of §1014(e)-except to the extent that assets passing from a donor to a decedent and back to a trust with discretionary distributions for the donor is not subject to §1014(e).]*

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

(4) The trust assets are included in husband’s estate under §2044.

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

(6) Husband can allocate his GST exemption to the bypass trust (i.e., wife would not make the “reverse QTIP” election). Thus, the bypass trust can be GST exempt, using husband’s GST exemption. Alternatively, wife could make the reverse QTIP election and allocate her GST exemption to the inter vivos QTIP when it is created, so that future appreciation after that time would be GST exempt, and husband could then allocate his GST exemption available at his death to a QTIP trust that he would create for wife (he would make the reverse QTIP election as to the QTIP trust that he creates at his death).

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

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

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

can reach only the trust assets that the trustee could distribute to the grantor under a maximum exercise of discretion. See Restatement (Third) of Trusts, §60, Comment f.]

(10) Another possible issue is whether §2033 would apply by reason of wife's possible ability to subject the trust assets to her creditors. However, while wife may be able to relegate the trust assets to her creditors during her lifetime, her power to add more creditors with rights to the trust assets ends at her death. If the right lapses at death, §2033 should not apply. (Lapsing at death does not avoid the §2041 hook, but it does avoid the §2033 hook.)

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

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

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

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

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

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

5. VALUATION ISSUES

a. Effect of Rule 144 Restrictions, Redemption Agreement, and Actual Purchases After Valuation Date, Estate of Gimbel. In Estate of Gimbel v. Comm'r, T.C. Memo. 2006-270, the court valued a large block of stock subject to Rule 144 dribble-out restrictions and the effect of a redemption agreement. The estate owned 13% of the stock of Reliance, a NY stock exchange company. Almost all of those shares were unregistered, and subject to the Rule 144 dribble out rules (in any 3 month period, the greater of 1% of the outstanding class of stock to be sold or the average weekly trading volume for the prior four weeks). The parties estimated that it would take 39 months to sell the restricted shares under the dribble-out rules. In addition, the Company had a formal Redemption Plan, and two weeks before the decedent's death, the CEO said at a steel conference that the Company had a "record year" and would consider repurchasing Reliance shares at around $19/share [but did not say how many shares would be repurchased, and the company was considering a large acquisition that would have required significant cash and credit, and the largest prior repurchase was about $11 million]. In fact, the Company repurchased 63% of the estate's shares 4 months after the date of death at a price that reflected a 7.027% discount from the average trading price on the date of death. The estate claimed a 20.7% marketability discount on the Form 706, but an additional trial expert determined a 17% discount. The IRS claimed an 8% discount in the deficiency notice, and the IRS's trial expert concluded that a 9% discount was appropriate. The court held: (1) It was reasonably foreseeable on the date of death that the Company would repurchase about 20% of the estate's stock, and the court used the IRS's expert conclusion of a 13.9% discount for that block; (2) As to the remaining 80%, the IRS expert said that an owner would use hedging contracts (i.e. costless collars) that would reflect a 5% discount, but the court concluded that hedging contracts were not available for this stock, and used the taxpayer's expert's conclusion of a 14.4 % discount considering the present value of the future payments and the risk that the stock might decline during the dribble out period. (The court refused to apply a private placement analysis, because there was no strategic purchaser.)The overall discount was 14.2%.

The court also addressed the effect of actual purchases after the valuation date. In fact, the Company repurchased 63% of the estate's shares 4 months after the date of death at a price that reflected a 7.027% discount from the average trading price on the date of death. The court concluded that it was reasonably foreseeable on date of death that the Company would repurchase about 20% of the estate's stock (rather than the 63% actually purchased 4 months later), and the court used the IRS's expert conclusion of a 13.9% discount for that block (as opposed to the 7.0% discount in the actual repurchase). The actual redemption of 63% of the shares at a lower discount did not control as to the valuation of that 63% block. The court gave the standard reasoning: "Post death events are generally disregarded…However, subsequent events which are reasonably foreseeable as of the valuation date may be considered."

The appraisal attached to the Form 706 did not consider the redemption agreement and the company's history of prior repurchases at all—in spite of the fact that the Company in fact purchased 63% of the estate's stock at a price that reflected only a 7.0% discount. Perhaps that was the primary red flag that triggered the audit and the lawsuit.

b. <u>Pending Case Involving Rule 144 Stock with Contractual Restriction on Sale</u>. An attorney reported that he has a case set for trial this spring involving the value of Rule 144 stock in a publicly traded technology company. There is a contractual restriction on selling stock for four years. The government expert did a costless collar analysis, applying a 20% discount. We may find that the hedging analysis may be used more frequently by IRS appraisers to limit discounts.

6. PENALTIES ON APPRAISALS

The Pension Protection Act penalties on appraisers may apply to a lawyer who charges a fee in connection with valuation services (such as, for example, applying a generic discount to fractional interests in real estate). However, the appraiser penalty provision may just apply to gross misstatements for estate and gift tax purposes, and there is some question about whether it applies at all to estate and gift taxes. (A technical flaw may make the appraiser penalty totally inapplicable to estate and gift taxes, but the legislative history said the intent was for it to apply.)

7. PATENTING TAX STRATEGIES

a. So-GRAT Patent Litigation Settled. The Federal District court patent infringement litigation in Connecticut against John Rowe, former chief executive of Aetna, Inc. for contributing non-qualified stock options to a GRAT apparently has settled, but the key details have not been disclosed. Under the settlement, apparently the parties acknowledge that there are facts that would allow a trier of fact to conclude that the patent is not invalid and not unenforceable, but there is no admission of liability for infringement. The parties agreed in a confidential patent license and settlement agreement to resolve their differences without admission of liability by either. See *Patents on Tax-Related Ideas Stir Worry*, Wall St. J. D-3 (March 14, 2007).

b. AICPA Position and Legislative Proposals. The AICPA has written several good letters to legislators urging legislation that would prohibit tax patents or provide an exemption from liability for taxpayers and their advisors—similar to an exemption in the medical field. The Texas State Bar Tax Section has also drafted legislation that would exempt clients and advisors from liability for infringing tax patents. As discussed in Item 1.c(1) above, the Stop Tax Haven Abuse Bill S. 681m filed by Senators Levin, Coleman, and Obama would ban the patenting of tax strategies.

c. Subpoenas. Before the So-GRAT case settled, apparently a number of persons on various committees and Task Forces that have been addressing the issue of tax patents were subpoenaed to disclose any information that they knew about the patent and using options with GRATs. One attorney who was deposed before the settlement indicates that a question in his subpoena was whether he had suggested using options with GRATs. He said yes, about 20 times. Query if they would have had a right to get the names of those individuals. Query whether promotional conversations with a prospect who was not yet a client would have been privileged.

d. Task Force. A Task Force comprised of ACTEC and various other organizations is providing resources to instruct patent examiners about resources available for tax research. (Unfortunately, the amount of time the examiners spend on any application is only about 25-30 hours. So there is limited ability to find prior art in the tax area, even if the examiners were expert at it.) The Task Force will probably also coordinate a project to identify and publicize tax patent applications and issued patents.

8. GRANTOR TRUST ISSUES; TRANSFER OF INSURANCE POLICIES TO GRANTOR TRUSTS, REV. RUL 2007-13

a. Transfer to Grantor Trust Does Not Violate Transfer for Value Rule. The IRS has ruled privately in various rulings that transfers of a life insurance policy among grantor trusts do not trigger the transfer for value rule. PLRs 200514001, 200514002, 200518061 and 200606027 all held that an exchange of a policy between grantor trusts was not a taxable event and did not trigger the transfer for value rule because the grantor was the treated as the owner of both trusts for income tax purposes. Some of the rulings have also relied on the “same basis” exception in the transfer for value rule [§101(a)(2)(A)].

Life insurance proceeds are generally excludable from income under §101(a)(1), but if the policy has been transferred for consideration, the death proceeds are taxable income to the extent the proceeds exceed the consideration paid for the policy and premiums or other amounts later paid by the purchaser of the policy. §101(a)(2). There is an exception to the transfer for value rule if the policy is transferred to the insured, a partner of the insured, a partnership of which the insured is a partner, or a corporation in which the insured is a shareholder or officer. §101(a)(2)(B).

Rev. Rul. 2007-13 addresses a transfer of a policy between grantor trusts and from a non grantor trust to a grantor trust. Rev. Rul. 2007-13 covers two situations. In Situation 1, the Ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts. The "wholly-owned" term apparently means that the trust is a grantor trust as to both income and principal of the trust, and that the grantor is the only grantor of the trust. Cf. Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975) (transfer of policy to a grantor trust did not constitute a transfer for value, but only to the extent of the grantor’s 91% of contributions to the trust).

In Situation 2, the Ruling reasons that the sale of the policy from a non-grantor trust to a grantor trust is a “transfer” for income tax purposes. [Accordingly, the sale could generate taxable gain if the consideration paid exceeds the owner's basis in the policy. While the Ruling does not specifically address the gain issue, other private letter rulings have addressed that transfers between two grantor trusts do not result in gain recognition. E.g. Pvt. Ltr. Rul. 200606027.] However, the Ruling concludes that the transaction is treated as a transfer to the grantor, so the "transferred to the insured" exception to the transfer for value rule applies if the policy insures the grantor's life. We've been waiting since Swanson for the IRS to rule that "grantor trust equals the insured" for transfer for value purposes. This was particularly important in Situation 2, because the ruling could not rely on the "same basis" exception to §101, but had to conclude that the transfer was treated as a transfer to the insured-grantor.

b. Reconfirming Position That Grantor Is Treated as Owner of Trust Assets For Income Tax Purposes. The IRS officially restates its often cited 20-year-old position in Rev. Rul 85-13, 1985-1 C.B. 184, which treats the grantor as the owner of the trust assets of a grantor trust for income tax purposes. (Some commentators have suggested that the grantor trust rules are now being used proactively by taxpayers and that the IRS may seek to retreat from that position at some point. This ruling reiterates that the IRS is not changing its position anytime soon.) Therefore, transfers between grantors and grantor trusts do not trigger gain for income tax purposes.

c. Advantages of Transferring Policies Between Trusts. Transfers of policies to or between grantor trusts are very helpful for two reasons. First, sales of policies may help avoid the three-year rule of §2035 that generally applies if an insured gives a life insurance policy on his life within three years of his subsequent death (and the ruling makes clear that a sale can be made to a grantor trust without violating the transfer for value rule.) There is an exception from the three-year rule under §2035(a)(2) if the transfer is for full consideration. (This may be more than the gift tax value, and should take into consideration the value of the policy in the secondary market for insurance policies.) Furthermore, the IRS might argue, based on the old Allen case, that the full consideration exception to §2035 only applies if the amount of the consideration is the amount that would otherwise have been included in the grantor's gross estate. United States v. Allen, 293 F.2d 916 (10th Cir. 1961). However, the IRS has ruled privately that sales of policies for their gift value would not require inclusion in the gross estate under §2035 if the insured died within three years of the sales. E.g., Pvt. Ltr. Rul.9413045 (sale of policies for interpolated terminal reserve value plus the value of any unexpired premiums). Interestingly, the ruling did not cite Allen. A difference with Allen is that a transfer of a life insurance policy requires future investment to bring it to fruition. Even if Allen does not apply, what is the value of the policy for purposes of the full consideration rule in §2035? The interpolated terminal reserve value was developed when the only cash value life insurance was whole life. However, for a universal policy, it is not clear that additional premiums will be paid. So, it is safest if the policy is issued directly to the trust; but if that is not done, a sale may avoid the three year rule and a sale is permitted without violating the transfer for value rule if the transfer is to a grantor trust.

Second, a transfer to a new grantor trust may provide helpful flexibility if the insured decides that he or she becomes unhappy with the terms of the original irrevocable trust (and may be unwilling to contribute additional gifts for paying future premiums.) The existing trust might sell the policy to a new grantor trust having acceptable trust terms. (The trustee of the selling trust would have to exercise diligence to assure that the trust is receiving full value for the policy.) The transfer to the new wholly-owned grantor trust would not trigger the transfer for value rule.

d. Planning Concerns With Transfers Between Trusts. There are several reasons to be cautious with these kinds of transfers between trusts.
(i) The sale should be at fair market values, and the life settlement industry might suggest higher prices than just the cash surrender value. (The regulations under §2042 refer to the cost of a comparable policy.)
(ii) If a beneficiary thinks the trust sold the policy for too low a price, there are fiduciary liability possibilities.
(iii) Make sure that the trusts are grantor trusts or else the transfer for value rule may cause the proceeds to become taxable.
(iv) A typical plan is to move a policy from an old “bad” trust to a new “good” trust. If the “good” trust is better because it cuts out certain beneficiaries or restricts the rights of beneficiaries, there may be fiduciary liability concerns that individual trustees often totally overlook.

e. Using Partnership to Assure Transfer for Value Rule Not Violated. Some attorneys like to have a partnership in which the trust and grantor are partners. In case it is not a grantor trust for some reason, the transfer is still protected from transfer for value rule under the partnership exception in §101(a)(2)(B). There have been several private rulings where the partnership was formed moments before the transfer for that purpose—and IRS still held it worked. (But reliance on that position would not seem appropriate in the planning stage.) A simpler solution would be for the grantor trust and the insured to buy units of a master limited partnership. However, that may not work. The legislative history to §101 suggests that §101 refers to a true partnership of partners joining together and not an investment vehicle.

f. Transfer to Insured (or Grantor Trust) Cleanses Prior Transfer for Value Problems. The regulations under §101 say that if a policy is transferred to the insured, that cleanses all prior transfers for value. Treas. Reg. §§1.101-1(b)(3)(ii) & 1.101-1(b)(5)(Ex. 7). So if there has been a transfer for value "hiccup' somewhere in the history of the policy, the problem can be cleansed by a transfer to a grantor trust.

g. Achieving Grantor Trust Status for Life Insurance Trusts. If the trust does not prohibit paying premiums on life insurance policies on the life of the grantor, is that sufficient to make the trust a grantor trust? (One attorney reported having an agent take the position that trust is a grantor trust if it does not expressly prohibit paying life insurance premiums of the life of the insured, because the trustee would have the authority to purchase a policy.)

(1) Statutory Provision. The grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. I.R.C. §677(a)(3). This statutory provision appears to be very broad. Literally, giving a trustee the power to pay life insurance premiums on income of a trust would conceivably cause all of the income and corpus of the trust to be a grantor trust.

(2) Grantor Trust Treatment May Apply Only as to Actual Payment of Life Insurance Premiums. The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. §1.677(a)-1(b)(2). However, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. Weil v. Comm'r, 3 T.C. 579 (1944), acq. 1944 C.B. 29: Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd., 116 F.2d 929 (8th Cir. 1940),

cert. denied, 313 U.S. 594 (1941); Moore v. Comm'r, 39 B.T.A. 808, 812 (1939), acq., 1939-2 C.B. 25; Letter Ruling 6406221750A (June 22, 1964). But see Letter Ruling 8852003 (power to pay premiums causes entire trust to be grantor trust). See also Letter Ruling 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income). See generally Zaritzky, Drafting and Planning Life Insurance Trust for Policies Both Traditional and Unusual, UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶403.2.D.2.a. (1994).

A troubling concept is that the IRS might extend this reasoning to more of the grantor trust triggers. This would suggest the wisdom of using a power of disposition in a non-adverse party.

(3) Not Useful to Assure Grantor Trust Status; Drafting Suggestion. Due to the case law limitations discussed above, the power is not useful as a tool to assure that a trust will be treated as a grantor trust. However, if the draftsman wishes to use this as one of multiple grantor trust triggers, provide in the trust agreement that the trustee may pay insurance premiums from income or principal, to build the best possible argument that the trust is a grantor trust as to both income and principal.

h. Grantor Trust by Buying Asset From Trust For Note. Most attorneys overlook that Revenue 85-13 (which concluded that transactions between grantor and grantor trusts do not result in gain recognition) says that a non-grantor trust can be converted into a grantor trust by having the grantor just buy back the trust asset for a note, and the grantor trust treatment is effective even as to that sale. Rev. Rul 85-13 stands for more than just no gain recognition. (Under §675(3), if the grantor has (directly or indirectly) actually borrowed corpus or income from the trust and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated a grantor trust. Grantor trust treatment will not result if the loan provides for adequate interest or security and if the loan is made by a trustee other than a related or subordinate party. Under the statute, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status.)

i. Effect of Crummey Clause in Grantor Trust. Despite arguments from the literal statutory language (the exception in section 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. (See also PLR

9141027, but in that ruling the spouse also had an inter vivos power of appointment of principal.) This issue was raised in a PLR request that was discussed by Jonathan Blattmachr at the 2005 Heckerling Institute and the IRS said (during discussions in 2004) that this issue was "in a state of flux." A recent PLR held that where a Crummey withdrawal power was held by the grantor's spouse, the trust was still a grantor trust as to the grantor "notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under §678." PLR 200603040 & 200606006. Jonathan Blattmachr indicates that the IRS has informally confirmed that this issue is no longer "in a state of flux" with the IRS.

In any event, the IRS can change its position from that taken in prior PLRs. If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power.

j. Grantor Trust Conversion During a Year. If a non grantor trust is converted into a grantor trust, as of what date does it become a grantor trust? The general consensus is that the trust does not become a grantor trust for the entire year, but only for a fraction of the year. However, for some triggers (such as borrowing from the trust), the trust would become a grantor trust for the entire year.

9. BASIS BOOSTING

A recent article discusses "basis boosting." Dunn & Park, *Basis Boosting*, 146 Tr. & Est. 22 (Feb. 2007). If an individual sells assets to a grantor trust and the individual dies, most planners think gain should not be realized at death. But the answer is unclear. Authors suggest contributing other property to the grantor trust with basis sufficient to eliminate gains. Example: An individual sells an asset with a basis of 10 for note for 50. The asset appreciates to 100 before the grantor dies. The potential gain would be 50 minus 10 or 40 when the trust is no longer a grantor trust. If the grantor contributes additional assets to the grantor trust with a basis of 40, that basis could be applied and offset the gain. However, it is not yet clear that this will work. The amount realized from the relief of liability (50 in the example) might have to be allocated between the two assets. If one must allocate the amount deemed realized between the two assets, the gain would not be totally eliminated.

The result might be better if the two assets are contributed to a partnership or LLC, which would require having another partner or member to avoid being treated as a disregarded entity. Then it would seem clearer that there would be no apportionment of the amount realized between the two classes of assets.

10. NEW QUESTION ON FORM 706

The new Form 706 (Part 4, Question 12e) asks if decedent ever transferred an interest in a closely held entity to certain trusts that are in existence at the decedent's death. One way around the question would be to terminate the trusts before the client's death. (But that is not practical in many situations.) Be careful in looking for technical ways to avoid this question. If the planner is "too clever," the IRS may say the planner is being misleading and allege a Circular 230 violation.

This question underscores the desirability of reporting sales of discounted interests in closely-held entities on a gift tax return. Eventually the IRS will learn about this transaction. This new question applies retroactively to all transfers made by decedents filing the new Form 706. Even if the planner could avoid the current question, the IRS can change the form in the future in reaction to clever plans to avoid the question.

Recognize that the question only applies to transfers to trusts and not to transfers to individuals.

11. PRIVATE ANNUITIES USING DEFECTIVE GRANTOR TRUSTS—EFFECT OF THE PROPOSED REGULATIONS

a. Gain Recognized Immediately. Prop. Treas. Reg. §1.1001-1(j) provides generally that if an annuity contract (other than a debt instrument subject to §§1271-1275 or a bargain sale charitable annuity) is received in exchange for property, "receipt of the contract shall be treated as a receipt of property in an amount equal to the fair market value of the contract, whether or not the contract is the equivalent of cash." This changes the current "open transaction" treatment of private annuities.

b. Effective Date. As a general rule, the proposed regulation applies (after issuance as a final regulation) to any exchanges after Oct. 18, 2006. (So the regulation is effective now (assuming it is finalized).) There is a delayed 6 month effective date (after April 18, 2007) for certain "vanilla" private annuity transactions: (1) The annuity is issued by an individual (not a trust or a commercial company); (2) The asset is not sold within two years; and (3) The annuity is not secured either directly or indirectly.

c. Grantor Trusts. If the exchange is between a grantor and his or her grantor trust, the regulation should not apply to the transaction (although the proposed regulation does not specifically address that issue). Private annuities with grantor trusts can still be advantageous (but the "exhaustion rule" must still be satisfied, which requires that there be sufficient assts in the trust to make the annuity payments to age 110 in order for the annuity to be given full value under the valuation tables in the regulations.)

Sales of assets to a grantor trust for a private annuity may be treated more favorably than under current law. When the grantor dies, can the IRS argue that all annuity payments made prior to death somehow become taxable (under a Frane analogy)? This would not seem possible under the regulations because the transaction is no longer treated as an open transaction. It would be no different than if the grantor sold assets to a grantor trust for cash and died five years later.

d. Beneficiary Guarantees to Avoid Age 110 Rule for Private Annuity Sales to Grantor Trusts; Avoiding Section 2036 Risk. The rule requiring that a trust has sufficient assets to fund annuity payments until age 110 should not apply if the beneficiaries guarantee the annuity payments. Treas. Reg.7520-3b2(i). Assets can be sold to an individual without looking to the net worth of the individual, as long as the facts are not so egregious that the IRS will say that there was no intent to enforce the annuity payments from the outset.

Do beneficiary guarantees also avoid §2036 issues? The grantor is no longer looking just to trust assets or income from the trust to pay the annuity, but the first recourse is still the trust. Section 2036 does not apply if the transfer is made for full and adequate consideration, and §7520 does not look at the ability of the obligor to make annuity payments. Attorneys differ as to whether having beneficiary guarantees avoids §2036 issues for private annuity sales to trusts. Those who think there may still be potential §2036 issues say that the issue is whether the grantor has retained rights to income/assets from the trust—not whether other beneficiaries are backing up the payments.

If one of three beneficiaries guarantees the annuity, does he make a gift to the other two? It would be better if all three guarantee. (Even then, there could be a potential issue if one beneficiary has wealth and others don't.)

e. State Law Fiduciary Issues. Would a trustee ordinarily take on an obligation that is open ended? Would the trustee have personal liability at some point? From a fiduciary standpoint, the trustee may be reluctant to make trust distributions until all payments have been made—to assure that the trust has funds to make the payment. The beneficiaries' rights are subservient to rights of the annuitant who sold assets to the trust.

12. APPLICATION OF 2% HAIRCUT UNDER §67 TO TRUST INVESTMENT ADVISOR FEES; RUDKIN

a. Appeal to Supreme Court. The trust is requesting that the U.S. Supreme Court grant certiorari to hear the Rudkin appeal.

b. Effect on Trust Beneficiaries. If the 2% limitation applies, the effect will be to increase DNI—so there will be a larger hit to beneficiaries of the DNI carryout. Trustees have typically taken the position that the 2% rule does not apply to the payment of investor advisor fees. If the IRS reverses that position on audit, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) amd who may have to go back and file three years of returns and pay penalties and interest.

c. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income). For example, if the trust distributes enough so that the adjusted gross income, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, then there is only a $200 "hit" even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then trust would lose the benefit of the $10,000 of administration expenses.

d. Position of Corporate Trustees. Some of the large banks are still deciding what position they are going to take with respect to the payment of outside investment advisor fees in light of the Second Circuit's affirmance of Rudkin. What if there are co-trustees in different Circuits (in particular in a Circuit other than the Second or Fourth Circuit)? Does it depend on who signs the return as to what position can be taken?

e. Partnership With Profits Interest. One possible option to avoid the 2% limit is for the trust to use LPs to make investments. The trust would be a partner, and the person giving investment advice would be the general partner. The general partner would receive compensation as a share of profits. The profits interest reduces gain allocated to others, so the effect is to reduce taxable income at the gross income level—without a 2% haircut.

f. Treasury Project. Section 67 is on the Treasury's regulatory agenda, so at some point the IRS may issue proposed regulations that may address investment advisor fees.

13. MORE FORM 1041 AUDITS

An IRS group manager in Florida indicated about a year ago that they are trying to get more 1041 audits, feeling that there is a shortage of estate and gift tax work because of the high thresholds on 706s. A Florida attorney has heard there are 10 active Form 1041 audits in Florida—while there used to be zero.

14. INCOME TAX ISSUES WITH TRANSFER PLANNING STRATEGIES

Tim Flanagan is leading a project to prepare a working checklist of income tax issues that must be considered when implementing transfer planning strategies.

a. Grantor Trust Treatment "Until It Hurts." Having the grantor bear income taxes of the grantor trust is good in allowing more wealth shift without gift taxation, but it may get to be "too much of a good thing." One client put it—"Can I have grantor trust treatment until it hurts?" The planner must address how to exit grantor trust status when "it hurts" for the grantor to continue paying income taxes on the trust's income.

b. Obligation Secured by Escrow. An obligation to the seller secured by an escrow or cash equivalent is treated as payment to the seller in the year of sale. Temp Treas. Reg. §15A.453-1(b)(3)(i).

c. Re-election of S Status Required Upon Transfer to a Non-Grantor Trust. The QSST or ESBT election must be made within 2 ½ months after the transfer of S corporation stock to a non-grantor trust. Treas. Reg. §1.1361-1(j)(6)(iii)(A) and (m)(2)(iii). This is often missed.

d. Loans as Part of Basis As to S Corp Losses. A transfer of S corporation stock may result in the loss of the ability to use the grantor-shareholder's loans to the corporation as part of his or her 'basis' for purposes of utilizing S corporation losses after the transfer to the trust. IRC §1366(d)(1).

e. Allocate S Corporation Income After Transfer. Divide the share of income on Schedule K-1 (attached to corporate Form

1120S) with the new shareholder after a transfer of stock, and determine the accounting method by which to divide the income for the year of transfer under §1377. This is often missed. (Often planners forget to advise the accountant of transfers and K-1s at end of year are not accurate.)

f <u>Grantor Trust Reporting</u>. A grantor trust must either must file a Form 1041, or follow the alternate reporting procedures described in Treas. Reg. §1.671-4(b)(2). If the trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the grantor for inclusion on the grantor's Form 1040. The grantor trust box on the Form 1041 should be checked.

In some circumstances, no Form 1041 need be filed (and the trustee of the grantor trust does not need to obtain a taxpayer identification number). Under Regulation § 1.671-4(b), if the trust (1) is a grantor trust, all of which is treated as owned by one grantor or one other person (2) if the grantor or other person who is treated as the owner of the trust provides to the trustee a complete Form W-9, and if (3) the trustee gives the grantor’s (or other person’s) name and taxpayer identification number to all payors to the trust during the taxable year, the trust need not file a Form 1041, and the items of income will be reported directly to the grantor. Reg. §1.671-4(b)(1), 4(b)(2)(i), and 4(b)(2)(ii)(B). Furthermore, if the grantor is also the trustee or co-trustee, the trust is not required to give a reporting information statement to the grantor. Reg. § 1.671-4(b)(2)(ii). If the conditions described above are satisfied, the grantor trust does not need to obtain a taxpayer identification number until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor or another person, or until the first taxable year of the trust for which the trustee no longer reports pursuant to Regulation § 1.671-4(b)(2)(i)(A). Reg. § 301.6109-1(a)(2)(i).

Despite the authority to report income from the grantor trust directly on the grantor’s Form 1040, some planners prefer to prepare an informational Form 1041, to document the trust’s tax treatment.

g. <u>Treatment of Grantor Trust on Grantor’s Death</u>. This is the biggest area of uncertainty regarding grantor trusts. Articles go both ways as to whether there is gain on death attributable to the unpaid balance of an installment note from the grantor trust to the grantor. Blattmachr, Gans & Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death*, 97 J. Taxn 149 (Sept. 2002); Dunn & Handler, *Tax*

Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates, J. Taxn 49 (2001); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. Taxn 3 (March 2000); Peebles, *Death of an IDIT Noteholder*, Tr. & Est. (Aug. 2005); Shore & Kaplani, *Post-Death Income Taxes*, 143 Tr. & Est. 9 (Sept. 2004).

In any event, be sure to divide the income before the date of death and after the date of death on separate K-1s for the trust in the year of death.

15. INCOME TAX "NUGGETS" FOR THE ESTATE PLANNER

Ted Atlass summarized wide ranging income tax planning "nuggets" for estate planning attorneys (many of which are not always recognized). I have summarized some of his excellent "nuggets" below (with his permission—and helpful edits).

a. Note Forgiveness. A gratuitous forgiveness of indebtedness, which is a true gift made gratuitously and with donative intent is not included in gross income (in effect, section 102(a) "trumps" §61(a)(12)). Helvering v. American Dental, 318 U.S. 322 (1943).

b. Section 1031 Exchanges Between Related Parties. If related persons exchange property with a related person in a §1031 tax-free exchange and if either party disposes of property received in the exchange within two years, the original transaction no longer qualifies for nonrecognition treatment. §§267 & 1031(f).

c. Sales of Depreciable Assets to Related Party. The sale of a depreciable asset to an unrelated party qualifies for capital gain treatment. However, a sale of depreciable assets (in the transferee's hands) to a related party results in ordinary income. §§267 & 1239.

d. Sales of Depletable Property to Related Party. There is a big difference for selling depletable property to a related party. Section 1239 does not apply, so there is no ordinary income upon selling depletable property to a related party. The children can get a new basis, and take cost depletion following the sale. PLR 8139052.

e. Guarantee of Loans to Related Parties. If an individual guarantees a related party's loan, and if the individual has to pay off on the guarantee, the individual is not entitled to any deduction (unless the individual received reasonable compensation for making the guarantee in the first place -- which usually does not happen in the family setting.) Lair v. Comm'r, 95 T.C. 35 (1990).

f. Gifts Reacquired From Decedent Donee Within One Year. Gifts to a dying person will qualify for a stepped up basis at the person's death, unless the asset is reacquired by the transferor by inheritance within one year. §1014(e). There are several old PLRs suggesting that this rule will not apply if the asset is "reacquired" by a trust permitting discretionary distributions to the original transferor.

g. Pre-Mortem Planning; Consider Giving Loss Assets. In the pre-mortem planning context, consider giving away loss assets. The basis of those assets would be stepped down if the owner keeps them until death. The donee's basis for loss purposes is the lesser of the donor's basis or fair market value on the date of the gift, so the gift will result in a step down in basis for purposes of determining loss. However, the donor's basis will apply for purposes of determining subsequent gain; so if there is future appreciation of the asset, a lot of future appreciation may escape income taxation by making a pre-mortem gift.

h. Terminate Sales Agreement That Would Generate IRD. An individual who has contracted to sell an asset with a large unrecognized gain may wish to terminate the sales agreement before death and reacquire the property in order to avoid the loss of a stepped-up basis at death. Ted Atlass has seen a situation in which a dying seller paid a buyer $50,000 to break an installment sales contract. The stepped-up basis at death made the termination payment worthwhile.

i. Recognize Losses in Marital Trust. This strategy is rarely discussed. Capital loss carryovers generally terminate at death. Similarly, assets with unrealized losses in a marital deduction trust will be stepped down in basis to their market value at the death of the surviving spouse. However, if the losses are realized prior to the beneficiary's death in a marital trust, they will be preserved for succeeding beneficiaries, and if not used within the trust, will pass out to the ultimate beneficiaries upon termination of the trust. §642(h).

j. Gathering Income Tax Information By Executor. The executor can request what tax returns have been filed by the decedent and can request K-1s, 1099s, and W-2s for any particular year. This information is provided without cost. Call 1-800-829-1040 for details. Previously filed tax returns can be requested for a set charge per return. Details are available from the "Area Disclosure Officer."

k. Protective Claim by Surviving Spouse For Liability on Joint Final Return. Because of the possibility that the surviving spouse will have joint liability for income taxes from joint returns (and particularly if the surviving spouse is antagonistic with the executor), the surviving spouse may wish to consider filing a protective claim against the decedent's estate if the decedent's estate is not passing entirely to the surviving spouse. In that manner, at least the surviving spouse would be able to force a share of additional income tax assessments to be paid from the decedent's estate.

l. Filing Status if Final Return is Not a Joint Return. If a joint return status is not used on the decedent's last return, the surviving spouse must file as "married filing separately" (not as a single person) for that year unless remarried. I.R.C. §6013(d)(1)(B).

m. Place for Filing Final Form 1040. The final Form 1040 should be filed with the IRS Service center for the district where the executor is located, not necessarily where the decedent filed income tax returns. I.R.C. §6091(b)(1)(A); Treas. Reg. §31.6091-1(a). (This is often filed incorrectly, but the IRS does not seem to care.)

n. Allocating Income Between the Final Return and the First Estate Income Tax Return. It is impossible to retitle all of the decedent's assets before 5:00 pm on the date of death. Some dividends and interest will be reported under the decedent's social security number, but the post-death income should be reported on the estate's return. To avoid problems with the IRS's matching program, report the gross amount of the income received on the decedent's final return, and include an attachment adjusting out the portion properly allocable to the estate's income tax return. "The computer will get excited if it does not see the correct gross amount."

o. Treatment of Final Paycheck. The final paycheck for the typical cash basis decedent that is paid after the decedent's death is an asset of the probate estate, and should be reported on the estate's income tax return rather than the decedent's final return. (The last paycheck can be substantial if it includes accrued but unpaid sick leave, vacation, etc.) For amounts paid in the year of the employee's death, no federal income tax is withheld, but Social Security tax, Medicare tax and Federal Unemployment tax must be withheld. IRS Publication #15 (1-98), Circular E, Employer's Tax Guide, Section 15. Amounts paid in the subsequent year after the decedent's death are not subject to any withholding (income, Social Security, Medicare or Unemployment tax). Id..

This is often done incorrectly. The employer tries to be comforting and helpful to the employee's surviving spouse, and cuts the check directly to him or her. That is wrong—the paycheck belongs to the estate. Ted Atlass is aware of a case where it was done incorrectly, and the estate decided that it was easier to recover from the employer rather than trying to get the money from the (estranged) surviving spouse.

p. Dependency Exemptions. The right to claim a dependency exemption under §152 may be impacted if the decedent does not provide over half of the dependent's support during the entire year of the year of death.

q. Estate or Trust Beneficiary Who Dies Before End of Year Must Report Distributions Actually Received Before Death. Distributions from an estate or trust are generally deemed to carry out income to the beneficiaries (up to the DNI amount) on the last day of the estate's or trust's fiscal year. However, for a cash basis beneficiary of an estate or trust, the decedent's final form 1040 must include any distributions actually received before the date of death. Treas. Reg. §§1.652(c)-2 and 1.662(c)-2.

r. Income Tax Relief for Military or Civilians Killed in Terrorist Actions. Active duty military personnel and certain military or civilian employees who are killed as a result of certain terrorist or military actions may have all of their income tax liabilities for the year of death and prior years excused. §692.

s. IRD Items in Flow-Through Entity. Tax preparers often do not make proper basis adjustments where an S corporation or partnership owns IRD items inside the entity. Generally, use the fair market value of the entity as the decedent's basis in the entity-and reduce that by the decedent's share of IRD items inside the entity. The basis of a partnership interest acquired from the decedent is the date of death (or alternate) value increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such a partnership interest. Treas. Reg. §1.742-1.

t. Non-Probate Property Includible in Estate Gets Basis Adjustment At Death Even if No Form 706 is Filed. A basis adjustment is available under §1014 even if no Form 706 is filed. This includes non-probate assets (such as assets that are properly includable in the estate under §2036). This adjustment for non-probate assets is often missed.

u. Depreciable Property Following Decedent’s Death. When cost basis is adjusted to reflect the changed basis at the decedent’s death, there is a new depreciation schedule as of the date of death. The Form 706 may not be filed for 15 months, and the estate may have already filed an income tax return. So go back and amend the return to use new depreciation schedule as of date of death.

v. Undistributed Property When Beneficiary Dies. Assume H dies first and the estate is open several years. There was a formula marital deduction gift to W. W dies before assets are retitled, and W owned a receivable from H’s estate at her death. Can she look through the receivable to specific assets and step up the basis of those assets? Two cases reached opposite results, neither citing the other. Manufacturers Hanover Trust 23 AFTR 2d 69-1371 (Ct. Cl. 1969) (NO) and Connecticut National Bank 937 F.2d 90 (YES). Does it make a difference if it is a pecuniary formula bequest?

w. Long Term Status When Capital Gain Property Is Sold After Death. After death, if the estate subsequently sells any capital gain property at a gain or loss, it is treated as long term gain or loss regardless of the actual holding period. §1223(11).

x. Uncertainty of Beneficiaries. There is a bequest to a trust to child for life then to child’s children. It is uncertain who the grandchildren who. During the pendency of the lawsuit, who do you tax on the DNI distributions? Higginson v. U.S., 238 F.2d 439 (1st Cir. 1956) said the trust gets DNI distribution deductions each year in which the trust mandated distributions, even though the trustee withheld the distributions pending a lawsuit over the validity of the trust.

y. Distributions Made by Mistake Should Not Carry Out DNI. Distributions from estates that are made properly carry out DNI to the recipients of the distributions. But if distributions are made by mistake, they should not carry income to those people. See Bohan v. U.S, 456 F.2d 851 (8th Cir. 1972), nonacq. Rev. Rul. 72-396, 1972-2 C.B. 312.

z. “Specific Bequest” Exception to Carrying Out DNI; Application to Specific Dollar Gift. The “specific bequest” exception in §663(a)(1) (providing that distributions in satisfaction of that bequest do not carry out DNI) does not apply if the bequest is payable in three or more installments. If the will leaves $10,000 to a grandchild and the executor chooses to pay that bequest in 10 monthly installments, the distributions may still qualify for the exception—even though the bequest is actually paid in 3 or more installments. [In order to qualify for this exception, the amount of money or the identity of specific property must be ascertainable under the terms of the will as of the date of death. Reg. §1.663(a)-1(b). For example, a marital deduction formula pecuniary bequest is not covered by this exception (because the amount of the bequest depends upon the amount of administration expenses and elections made by the executor.)]

aa. Loss on Funding Pecuniary Gift. The extension in 1997 of §§267 and 1239 (disallowing loss recognition on transactions between related parties) to sales or exchanges between an executor and a beneficiary of the estate does not extend to a sale or exchange that is in satisfaction of a pecuniary bequest I.R.C. §267(b) (13). Therefore, a distribution of a depreciated asset to a beneficiary in satisfaction of a pecuniary bequest can still qualify for a loss deduction. Furthermore, a distribution of an appreciated asset that is a depreciable capital gain asset in satisfaction of a pecuniary bequest will not be treated as causing the recognition of ordinary rather than capital gain income. I.R.C. §§267(b) & 1239(b). In funding pecuniary bequests, keep in mind the possibility of generating a loss deduction to the estate by funding the bequest with assets that have depreciated in value since the date of the decedent’s death.

This exception is available to estates, but not trusts. There is no policy distinction for that difference between estates and funded revocable trusts. The distinction can be avoided by having a funded revocable trust elect to be treated as part of the estate for income tax purposes under §645.

bb. Distribution of Installment Notes Receivable by Executor or Trustee. An installment note held by a decedent may be distributed by the estate without causing the immediate recognition of gain (as long as it is not distributed to the obligor on the note and is not distributed in satisfaction of a pecuniary bequest). §453B(c). However, if the estate or trust made a post-death installment sale, a distribution of the installment obligation would generally cause the transferor immediately to recognize any remaining gain which has been deferred by the installment reporting method. §453B(a). (The exception under §435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing from a decedent, rather than installment notes arising after the decedent's death.)

Ted Atlass was brought into a case involving an estate in which the beneficiaries were hard to identify and locate. The executor wanted to sell appreciated property on the installment basis. To avoid having 20 different deeds from the various beneficiaries (in addition to the problem that all of the beneficiaries had not been located), there was a single sale at the estate level and the executor later distributed the installment note receivable distributed to beneficiaries. The gain was accelerated immediately, even though the buyer did not make the payments until much later. The attorney and accountant who had planned the transaction were sued and ended up paying the capital gains tax. (Summary: Pre death installment notes can be distributed without accelerating gain, but installment notes from post death sales cannot.)

16. CHARITABLE PLANNING ISSUES

a. Split Interest Trusts Participating in Investing in Endowment Funds. The Harvard endowment funds have produced outstanding returns over the years (in the high teens). However, the endowment fund has some unrelated business taxable income (because much of the endowment assets are in hedge funds and debt financed investments), so it is not an appropriate investment for split interest trusts. Harvard created a contract right that allows split interest trusts to participate in the high returns of the endowment fund. The contract right would have the same return as units in the university endowment fund, typically with about a 4.5% annual payout. A charitable remainder trust would need additional funds to satisfy the 5% minimum payout each year, so the trust was allowed to redeem units each year, based on the net asset value of the endowment fund. Harvard secured private letter rulings approving the arrangement, ruling specifically that the split interest trusts would not be deemed to receive unrelated business taxable income. This has been a very successful tool for Harvard, including some very significant trusts since 2003 (especially CLTs). (The IRS agreed to grant a “class ruling" for CRUTs, CRATs, and CLATs instead of issuing separate rulings for each of the hundreds of split interest trusts at Harvard.) Martin Hall, in Boston, Massachusetts, obtained these rulings on behalf of Harvard.

As part of the negotiations to obtain the rulings, Harvard and the IRS stipulated that the annual payout from the fund would be taxed as ordinary income. Perhaps redemptions would result in long-term capital gains, but the IRS has not officially endorsed that result. Attorneys feel confident that the redemptions will lead to capital gains treatment.

After the Harvard rulings were issued, a number of other universities sought similar rulings. Over 20 colleges now have these rulings. The requests have led to an immense log jam with the IRS. They were not expecting this volume, and various colleges have been waiting for over three years before some activity in the fall of 2006 about granting additional rulings. The good news is that additional rulings are slowly being released for CRTs. Only a few have been published so far, but there are many more in process. The bad news is that the IRS has decided to no longer issue rulings as to CLTs. Existing CLTs under the Harvard plan would still be allowed. (Apparently the IRS is concerned is that non-charitable beneficiaries of CLTs would benefit inappropriately. All current distributions of the CLT would be offset by the charitable deduction for the trust. The extremely favorable returns from the endowment fund [which have greatly exceeded the section 7520 rate] would eventually pass to the noncharitable beneficiaries at the termination of the trust. Refusing to recognize the validity of this approach for CLT's just because the endowment fund has a record of over 850 basis points return on an annual basis in excess of the §7520 rate seems inappropriate.) Some of the more recent rulings that have recognized the endowment fund approach for CRTs, but not CLTs are PLRs 200702036, 200702037, 200702038, 200702040, and 200702041.

The income beneficiaries of only about half of the Harvard charitable remainder trusts have decided to use the contract approach. The stipulation with the IRS is that the payout rate will be characterized entirely as ordinary income. When projections are run on an after-tax basis, there is there is often little difference between the after-tax results of a typical portfolio (with a pass through tax treatment of the character of income from the portfolio) versus the after-tax results of the Harvard endowment fund yield taking into consideration that current payments are taxed as ordinary income. The contract approach appears more favorable for younger beneficiaries, who could benefit more from the long-term growth of the endowment fund portfolio. Interestingly, however, many donors have not cared about the after-tax impact. They focus on how much will pass to Harvard, and the endowment fund’s past experience suggests that substantially more would pass to Harvard during the term of the CRT by using the contract right based on the endowment fund return.

b. Robertson Case. In this case, the Robertson family is seeking funds that Princeton allegedly used for its own purposes vs. the purposes of the grant. Also, they want the funds (about $800 million) moved to another institution. Not much has happened yet in the case. There was a hearing by New Jersey Superior Court in November, 2006. The judge has taken various motions under advisement. There are no prospects of a settlement at this time; there may possibly be more settlement activity after the judge rules on the outstanding motions. Various articles say there have been $35 million of legal fees so far in the case. One wonders why this was not settled long ago.

c. Bishop Trust. The full Ninth Circuit Court of Appeals reversed the case, holding that the racial preference standards for the Kamehameha Schools were legal.

d. Senator Grassley's Continued Leadership. It is interesting that Senator Grassley is the front person on charitable issues, but he is no longer the Chair of the Senate Finance Committee. Senator Max Baucus is the new chairman, and he had been supportive of Grassley when he was the front person. Interestingly, Senator Grassley is still the front person.

17. GIFT TAX EFFECT OF AGREEMENT TO GIVE REMAINDER OF PAINTING TO CHARITY

If an individual gives a partial interest in a painting to a museum, the museum typically requires an agreement that the individual will give the remaining interest in the painting to charity at his or her death. Is that a completed gift of the remainder interest for gift tax purposes? Perhaps one approach is to promise that the charity *or a sister charity* would receive the remaining interest in the painting, so there is not a completed gift to either charity. Attorneys indicated that they cannot conceive that the IRS will take the position that is a taxable gift. (However, the answer may be different if this were done with the child rather than a charity. On the other hand, there is law that a promise to make a gift is not a gift even if it is enforceable. Charities do not have a good explanation that it is totally safe.)

Similar issue: Kirby Puckett died in Arizona late last spring. The judge just decided that there is an enforceable obligation to his fiancée. She alleges a creditor's claim against his estate—"he agreed to support me the rest of my life." If that is enforceable, was it a taxable gift?

18. USE OF IRA TO SATISFY PECUNIARY CHARITABLE BEQUEST TRIGGERS INCOME; CCA 200644020

A distribution of a right to receive IRD in satisfaction of a fixed sum of money bequest will likely cause tax on the IRD accelerated. Treas. Reg. § 1.691(a)-4(b)(2) says that if the right to receive IRD is transferred to a specific or residuary legatee, only the legatee includes the IRD in income. An implied connotation is that transferring IRD in satisfaction of a pecuniary bequest does not carry out the income tax burden to the legatee; if not, the distribution would seem to be treated as a transfer or sale of an IRD item under Reg. § 1.691(a)-4(a), which would trigger the income. See Reg. §1.661(a)-2(f)(1) & 1.1014-4(a)(3); Ltr. Rul. 9507008 (funding pecuniary charitable gift in revocable trust with Series E bonds causes trust to recognize income equal to previously unreported gain), 9315016, 9123036. Income generally is triggered to the estate to the extent of the present value of the right to receive the future payments. It appears that the estate should be entitled to a distribution deduction for the value of the right distributed, and that the legatee of the pecuniary bequest should receive a step-up in basis equal to the fair market value of the right to receive the future IRD payments. See generally Barnett, A Potpourri of Perverse Puzzles and Problems Pervading Fiduciary Income Taxation Plus Positive Planning Possibilities to Pursue, 26 Univ. of Miami Heckerling Institute on Estate Planning ¶17.04.3 (1992).

The acceleration problem does not occur if IRD is distributed in satisfaction of a percentage bequest where the executor had the right to make distributions in cash or in kind and to allocate assets to a particular beneficiary. Letter Rul. 200234019. Furthermore, allocating an item of IRD in satisfaction of a portion of a residuary bequest does not trigger acceleration. Ltr. Ruls. 200652028 (trustee's exercise of discretion under non pro rata funding authority to distribute IRA in satisfaction of residuary distribution of trust not a deemed transfer under §691(a)(1)); 200633009 (assignment of IRA to charity to satisfy residual bequest where estate was beneficiary of the IRA); 200526010; 200520004; 200452004 (assignment of IRAs and deferred annuity contracts by executors of decedent's estate to charity in satisfaction of its share of residuary estate will not cause estate or any of its beneficiaries to have any taxable income or cause estate to include any amount in its distributable net income).

A different result may apply in the situation of satisfying a pecuniary bequest with an IRA. For example, the IRS has issued several letter rulings that addressed the availability of a spousal rollover when a pecuniary marital deduction bequest was funded with an IRA without also addressing whether funding the pecuniary bequest with the IRA triggered immediate income recognition. Ltr. Ruls. 9808043, 9623056, 9608036, & 9524020. Some commentators believe that the taxation of distributions from qualified plans and IRAs is governed exclusively by §§672, 402(a), and 408(d)(1), and that no income recognition occurs until there is an actual distribution or some other transaction expressly made taxable under those sections. See Ice, Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Arena From the Sublime to the

Ridiculous, Texas Tax Lawyer 37 (Oct. 2000)(describing positions of Marjorie Hoffman and Merv Wilf). The issue is whether §§402(a) and 408(d)(1) are exclusive and, in effect, override §691. An argument can also be made under §691 itself that satisfying a pecuniary bequest with an IRA would not trigger acceleration. See Choate, Life and Death Planning for Retirement Benefits 103-08 (5th ed. 2003).

In CCM 2006-44020, a trust made a pecuniary bequest of $100,000 to charities. The trustee directed the IRA provider to put $100,000 of the IRA into the names of the charities (hoping to get the $100,000 IRA to the charity without anyone ever having to pay income tax on the $100,000 because of the charity's tax exempt status.) The IRS said that the distribution would trigger ordinary income to the trust, reasoning that a transfer of an IRA to a pecuniary fixed dollar legatee accelerates income recognition under §691(a)(2). There is a split among planners as to whether this is correct. For example, Professor Christopher Hoyt believes that the qualified plan rules should trump §691, and that there should not be gain recognition when an IRA is used to fund a pecuniary bequest. Leimberg Information Services Charitable Planning Newsletter #110 (Nov. 7, 2006). Natalie Choate thinks the IRS may have been right. Leimberg Information Services Employee Benefits and Retirement Planning Newsletters #395 & 396 (Dec. 26 & 28, 2006). Natalie reasons that the trustee had a choice of assets to use to fund the bequest, and because the trustee chose to use the IRA, that could be an assignment of income under §691(a)(2). Section 691(a)(2) says that after death of an owner of an "income in respect of a decedent" asset, a transfer of the IRD to someone else triggers immediate realization of income UNLESS the person is entitled to the asset under the decedent's will or trust. The ruling reasoned that the charity was not entitled to that particular asset. (The CCM went too far, though, in citing a 60 year old case that does not even mention §691(a)(2) as support for its conclusion.)

Other experts believe the ruling is wrong in requiring acceleration, reasoning that §408 should trump §691. Would the recipient of the IRA have basis in the IRA if gain is triggered? That complexity would be avoided by just acknowledging that §408 should govern the treatment of IRAs.

Planning Pointer: Natalie Choate points out that this ruling should not apply if the trust document says the trustee MUST satisfy the bequest with the IRA—even if it is a pecuniary bequest. Also, the ruling does not apply if the beneficiary designation itself contains the pecuniary gift. Id.

19. NON-GRANTOR TRUST ALLOWING DISTRIBUTIONS TO GRANTOR WITH THE CONSENT OF ADVERSE PARTIES

There have been six private letter rulings approving non-grantor trust/incomplete gift treatment. E.g., PLR 200637025. One attorney says that he has four rulings pending. Generally speaking, a grantor creates an irrevocable trust in which the grantor retains a limited testamentary power of appointment (making the gift incomplete). A distribution committee (including beneficiaries who are "adverse parties") has the discretion to make distributions to various persons including the grantor.

These trusts are created in a “self-settled trust state” such as Delaware. Assuming the trust is protected from the grantor’s creditors, this is a great alternative to a prenuptial agreement “which is a pretty lousy way to start a marriage.” Another virtue is the possibility of saving state tax in a high tax state (if the state in which the trustee resides and where the trust is administered does not tax the undistributed income of non-grantor trusts based on either of those factors). (Examples of states where this could work are New Jersey, New York, or Delaware.) One plan might be to put a nest egg in the trust that creditors could not reach. If there is no state income tax, the nest egg can grow faster.

One aspect of these trusts is shaky—whether beneficiaries who consent to distributions back to the grantor are making a taxable gift. In addition, the grantor has nontax risks—the Distribution Committee may decide not to distribute anything back to the grantor.

Carlyn McCaffrey suggests several alternatives.

a. Long Term QTIP Alternative. This is an alternative for happily married spouses who just want to avoid paying capital gains tax on the sale of a large asset. The spouse with the appreciated asset (say W) creates a long term QTIP (say lasting for the longer of 75 years or life). The remainder goes to a trust for children that is not a grantor trust. The trust is a grantor trust as to income but not as to principal. The trust is not subject to income tax in the state of its creator. It sells the asset and therefore pays no state income tax on the gain. The exit strategy: A number of years later, H buys the remainder interest from the children’s trust and simultaneously terminates the trust to avoid §2702. His purchase is a taxable gift, but that is a tolerable result. The gift is very small because the remainder is small if it is a long term trust (about a 1 ½%), and the children actually get the funds.

   Individuals who are already beneficiaries of trusts created by others are in a better position. All they need to do is to make sure the trust is not subject to state income tax.

b. Approaches to Avoid State Income Taxes on Trust Distributions. The clients may not be happy with just avoiding state income tax on the sale of a principal asset. Assume the client lives in NY and wants to get distributions from the trust, and not have to pay state or city tax on the distributions. (What's the point of protecting a QTIP from state income tax if all income must go to the spouse and he or she will pay NY tax?) Solutions:

(1) S Corporation. The trustee contributes all of the trust assets to an S corporation, and makes an ESBT election. Once the ESBT election is made, the trust acts as a blocker between the S corporation and the beneficiary, because under §641(c), the trust pays all of the income tax. The trust does not get a distribution deduction when it makes distributions to the beneficiaries; so the beneficiaries do not have taxable income when they receive the distributions. If state law follows federal law for defining gross income, and hasn't been clever enough to come up with an adjustment to reflect this, the beneficiary does not have any gross income upon receiving the distribution.

(2) Two Trust Approach. This approach has been used for many years with foreign trusts. Trust 1 has all of the assets. Trust 2 is the beneficiary of Trust 1. Daughter is primary beneficiary of Trust 1. Distributions can be made to her and to Trust 2. She and all of her children and grandchildren are beneficiaries of Trust 2. Trust 1 says all accounting income must be distributed each year to Trust 2. If it is done right, and it's a little tricky because of the difference between trust accounting income and gross income, you will flush out at the end of each year all of the DNI to Trust 2. As a result, distributions can be made whenever you want to the daughter who is a beneficiary of Trust 1 without any tax consequences. Unless there are huge capital gains, which can also be distributed out tax free, this trust will eventually deplete itself and then you'd have to use another strategy. But as long as there's principal in the trust, there will be state income tax savings on trust income.

20. ATTORNEY CLIENT PRIVILEGE ISSUES IN TAX LITIGATION

A recent case addressed the attorney-client privilege in a summons case involving an estate and gift tax audit about the formation of and transfers of interests in an FLP. U.S. v. Landon, 98 AFTR 2d 2006-7518 (N.D. Calif. Oct. 30, 2006).

Dale Landon and his wife transferred the bulk of his parents' assets from their revocable trust to a family limited partnership, and made gifts of units of the partnership in highly discounted chunks to

Dale and his brother. The interests were transferred without being subject to gift or estate tax. Following the father’s death, the IRS initiated a gift and estate tax audit. The IRS issued a summons to Dale and to the attorney, John Thornton, to answer questions regarding the FLP and subpoenaed associated documents. The stated motivation for the summons was to determine if the decedent’s estate qualifies for the "bona fide sale" exception to §2036. Mr. Thornton and Mr. Landon were interviewed but asserted the attorney-client privilege with respect to many of the questions and requests for documents.

The court’s rulings as to what is privileged can be categorized into three major categories:

(1) Written or oral communications that disclose legal advice or disclose the specific nature of services provided are covered by the attorney-client privilege. *Examples of this are requests to disclose a letter faxed from the attorney concerning the formation of the FLP, requests for correspondence from or to the attorney regarding the formation of the FLP, and requesting how many meetings were held with the attorney to form the LP.* Those questions are intended to confirm the specific subject matter of the attorney's representation.

(2) Questions that might implicate the confidential communication between attorney and client are also privileged. Examples of these types of questions are *"How did the idea of forming the LP come about?"*
"Who has personal knowledge of your reasons and motivations for the formation and use of the LP?"
"Did you see any calculations or projections of the tax benefits to be achieved by forming the LP?"
Answers to each of these questions may be that the idea, knowledge, or calculations came from confidential consultation with the attorney. The attorney-client privilege would cover such a response because the information would identify the specific nature of services provided by the attorney. However, each of these questions could be refined to ask if the idea arose prior to or independent of consultation with an attorney, if the persons other than the attorney had personal knowledge, or if he received calculations or projections outside his confidential attorney-client relationship. (The effect would be to solicit the information desired by the IRS -- if the individual had not received that information from others, it would be readily apparent that the information came from the attorney.)

(3) Billing records and invoices are not privileged, but Mr. Landon “may redact any privileged information which speaks to the specific

nature or substance of the services provided or reveals client motives or litigation strategy."

Requests that were not privileged include:

Questions regarding the formation or operation of the partnership that were independent of attorney-client communications.
How the client met the attorney.
Who made the decision to form the LP.
Whether the parents were aware of the LP.
The extent to which other persons (other than the attorney) were involved in the decision to form and use the LP.
Who was present at meetings with the attorney.
Who was present at each meeting about the LP.
Whether the individual took any notes at meetings to form the LP.
Whether the decedent attended or asked any questions at the meetings about forming the LP.
Whether terms of the LP agreement were negotiated among the partners.
Whether the parents were financially dependent on the LP distributions.

The court concluded that none of those questions (or other similar questions) implicate correspondence or other communications with the attorney.

a. Important Roadmap. The Landon case is an important roadmap to the estate planning attorney about the scope of the attorney-client privilege. Not all dealings with a client are privileged.

b. Fact of Representation and Presence at Meetings Discoverable. The fact that there was legal representation can be discovered. The fact that the attorney was present at a particular meeting is fair game. (For example, one estate planning attorney reported that in a current case, he excluded his notes regarding client meetings in the production of documents to the IRS. A litigation lawyer in his firm reviewed the facts and said that the attorney must disclose the date of the meeting and who was present at meeting, but can redact everything else.)

c. Engagement Letter. The engagement letter is discoverable, but the specific nature of the legal services can be redacted.

d. Billing Records. Billing records are discoverable, but anything related to the subject matter of the advice or nature of the representation can be redacted. (This should comfort estate planning attorneys regarding the preparation of billing records.)

e. Nature or Substance of Legal Advice. Anything related to or that even possibly implicates the nature or substance of legal advice is protected.

f. IRS Can Rephrase. Often the IRS can rephrase the question to extract the desired information. The court told the IRS how to rephrase questions to avoid implicating the privilege.

g Waiver of Privilege. The IRS did not allege in Landon that the attorney-client privilege had been waived. The privilege can inadvertently be waived by sending copies to third parties, including the accountant. The attorney will want to cooperate with other planners involved, but may not want to waive the attorney-client privilege. The attorney must spend a lot of time with clients going over the ramifications of waiving the privilege and what waives it.

In Landon, the court permitted questions that inquired about facts that may have occurred that would have waived the privilege—not the nature of the communications, but WERE there communications? The court appears to bend over backwards to force a response as to whether the taxpayer has waived the privilege.

h. Strategic Decision. "Always question how hard to play hardball with the IRS, because you often find harder bricks come back at you when you play hardball."—Mil Hatcher. John Porter points out that the attorney should assume that everything in his or her file will be discovered during the planning process. Even if the privilege is claimed, as a practical matter, litigation in the Tax Court will result in the same judge who is deciding the substantive issue also being the judge who decides the privilege issues. (In the Schutt case, the attorneys agonized over whether to waive the privilege and produce attorney-client communications. They ultimately decided to do so, and those communications were very helpful to the court in determining that there were "legitimate and significant non-tax reasons" for forming the business trusts involved in that case.)

i. Burden of Proof and Penalties. In Kohler, T.C. Memo 2006-152, the IRS tried (unsuccessfully) to shift the burden of proof to the taxpayer because the taxpayer asserted the attorney-client privilege. Attorneys report anecdotally that the IRS has asserted penalties in audits where the attorney-client privilege was claimed.

j. Business Advice vs. Legal Advice. Some attorneys report that the IRS has argued in some cases that certain advice by counsel is business advice rather than legal advice, and saying that business advice communication is not privileged. Ex.—Discussing the protection from creditors that an FLP may or may not afford. Landon seems favorable to upholding the privilege against that kind of attack. If a communication relates to anything in the nature of legal representation, it is privileged.

k. Communications Prior to Attorney-Client Relationship. Any communications prior to attorney-client relationship are not privileged. So any proposals or writings that predated the engagement of the attorney are fair game.

21. LIFE INSURANCE ISSUES

a. Life Settlements.

(1) Ask About Commission. If a policy is sold in a life settlement transaction, find out what gross amount is being paid by the purchaser. It may be much more than the net amount received by the seller. The difference would be substantial commissions paid to the broker. For example, a recent article said that the life insurance settlement purchase price could be 6% of the face amount of the policy plus one third of the difference between the purchase price and the cash surrender value. (It is not inappropriate for the broker to receive a commission; the client just needs to understand what the commission amounts are, particularly if the agent is also receiving commissions on the sale of a new replacement policy.)

(2) Application and Practical Planning Pointers. Often, the candidate for a sale of a policy on the life settlement market is an insured over age 70, with a minimum face amount of coverage of $250,000. Sometimes multiple policies can be bundled. Policies are sometimes being sold for 3 or 4 times the surrender value of the policies. This is a significant alternative if there is a purchaser for a particular policy. If a client no longer needs coverage, and is going to let the policy lapse or surrender it for its cash surrender value, as sale on the life settlement market may allow a windfall to the client.

Life settlements can also be helpful in premium financing situations in which the bank refuses to renew the loan several years later. One attorney reported that in those types of situations she has been able to sell the policy to repay the loan.

Clients must provide medical records and possibly provide a physical. The client might want to set parameters around access to medical records, limiting the number of requests in any given year.

Attorneys have indicated that they had had a number of situations where there was no market to purchase a particular policy. One attorney had a case where the client's ILIT had a $9 million, 600,000 CSV policy. The client tired of using annual exclusions for the premium payments and wanted to stop the ILIT. The client was in his early 70's and fairly healthy. There was no market to purchase the policy.

Second to die policies are less attractive to the life settlement market. Furthermore, if insureds are "too healthy," there will be no takers on buying the policy.

The policy cannot have restrictions (buy sell agreement, split dollar agreement, or any lien). The policy must beyond the two year contestability period.

Deal with reputable agents.

Use an escrow account—so money changes hands at same time the policy changes hands.

The sale agreement may provide a rescission period, in case the client dies soon after the sale.

An agent may suggest selling an existing policy and purchasing a newer policy. Be careful to check the total commissions being paid to the agent in that situation. There are reverse motivations when the client is trying to sell existing policy and purchase a new policy. For the new policy, the client will want to have a healthy condition. Purchasers in the sale transaction would prefer a poor health situation. The client must be careful to provide the same information on both sides of the transaction. Make sure the new policy is in full force and effect before giving up the old policy.

Bob Rosepink points out that there is a 9th Circuit case that now says the purchase of a life insurance policy is a purchase/sale of securities. If you want to protect a trustee who is selling a policy on the secondary market for policies, deal with someone who has a broker's license. The liability insurance policy for the agent will not cover the agent if he or she is acting without authority.

(3) <u>Income Tax Effects—Ordinary Income or Capital Gain</u>? Section 1001 would suggest that the sale of the policy is the sale of a capital asset, whereas §72 says that the inside build-

up of policy value in excess of the premium payment is ordinary income. However, §72 applies to the surrender of policies, not necessarily to the sale or exchange of policies. The reasoning behind §72 is that the owner hasn't paid income tax on the inside build-up, and the build-up in value is taxed as ordinary gain at surrender. However, in the last 10 years, a whole new market is developing where purchasers on the secondary market are not buying policies just for the cash surrender value. They are buying policies as a continuing investment to realize on the death proceeds. They don't care about the cash value. That smells like a capital asset. Some cases have recognized that the sale of a policy generates capital gain. E.g., Percy v. Phillips, 30 T.C. 866 (1958).

Lou Harrison's Conclusions: (a) If the sale proceeds exceed the cash surrender value, the excess should be taxed as capital gains; and (b) If the cash surrender value exceeds the basis of the policy, a conservative approach is to treat that much as ordinary income, or the more aggressive approach is to treat that amount as capital gain as well because the purchaser is planning to hold the policy until maturity – representing a capital asset.

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

Will the IRS go to the court on that? No one knows. Most commentators think they are dead wrong, and some attorneys indicate they would take that case on a contingent fee. Gallun v. Comm'r, T.C. Memo. 1963-167 did not reduce the basis of a policy that was sold by the use value of the insurance, and the provision of §72 relevant to the surrender of a policy to an insurance company does not reduce the "investment in the contract" by the use value. A number of cases have held that basis is not reduced by the use of the life insurance protection prior to the sale.

If you ask an insurance company for the basis of a particular contract, they typically will not tell you; they will just tell you total premiums paid.

b. Proposed Viatical Settlements Act. The new Proposed Viatical Settlements Act applies to life settlements beyond just the terminally ill insured situation. It covers a number of other issues:

- Policies cannot be sold for 5 years.
- There is a rescission right for 60 days.
- Escrow funds are used to close the sale.
- All offers must be reported to the insured.
- The agent represents only the insured and has a fiduciary duty to him.

Comprehensive changes are coming. A concern with these reforms is that our clients are often better off having these opportunities available even there are if risks and complexities. “Don’t kill the secondary market with these reforms. The secondary market can be very helpful.”

22. BUSINESS SUCCESSION PLANNING NON-TAX ISSUES

Danny Markstein, Ed Koren, and Joe Goodman provide a number of “nuggets” for business succession planning. (This is a “red-book” of planning nuggets coming from careers of advising business owners—reminiscent of Harvey Pennick’s famed “red-book” of notes that he made over the years in teaching golfers.)

a. Get a Temporary Plan in Place. You do not have to address all of the “soft issues” before doing the succession planning. Get a temporary plan put in place as a jumping off point.

b. Family Communication Issues May Get Tougher After Sale of Business. The sale of the business may generate a huge amount of cash. If the family has previously implemented intergenerational transfer planning, the second and third generation may receive a lot of money. A family business pulls everyone together. Without that, the family may have more difficulty communicating values when there are just investment assets.

c. Tough Communications With Client. How do you discuss with the client that if she turns over the business to her less than stellar son, the business will fail? Similarly, another attorney described a situation in which he told the client that he had to discontinue his relationship with his mistress if he ever wanted to resolve family tensions in his business. “Your wife and children are all pissed off; Nothing will happen until you get rid of the mistress.” (The client fired the attorney, but later rehired him six months later.) Communicating these types of issues is a tough call, but essential. Clients like to deal with someone who agrees with them, and tend to fire the attorney if the attorney does not agree.

d. <u>Communicating the Plan With the Family</u>. Communicating after the client’s death a dispositive plan that disappoints beneficiaries invariably creates problems. In those situations, a family should know the dispositive plan while the business owners is alive. Clients don't like that. However, while nobody likes to hear bad news, the client is in the best position to deliver the bad news in a manner that will effectively be heard.

e. <u>Family Council to Deal With Family Issues</u>. While a family business is a business, it is also a family. Creating a separate family council to deal with family issues (succession, distribution policy, etc.) may be the best approach.

On the business side, money is the key. On the family side, personal issues are much more important than the rate of return.

f. <u>Outsiders on Boards of Family Businesses</u>. Some people say that you can’t get good outsiders to sit on family companies. However that is not the case—if you recruit carefully and pay them appropriately.

g. <u>Ethical Issues</u>. The attorney must be very careful about who the attorney represents and what can be communicated. It is important to have engagement letters identifying who the clients are. (That sometimes changes during the engagement.)

h. <u>Entrepreneurial Clients Prefer “Business” Consultants</u>. Consultants who act like psychologists are typically just blown off by business owner clients. If the business consultant approaches the engagement as a business matter (and addressing family issues in that context), he or she is more likely to be successful. Psychologists have a hard time relating to the stereotypical entrepreneur, who typically really is interested in a dynasty. “It is hard for those old timey guys to respond to a psychologist.”

i. <u>Provide an Exit Strategy for Children Not Involved With the Business</u>. Often some children can function in business and others can’t. The biggest problem in that situation is the failure to provide an exit strategy. You cannot just hold a child's capital hostage. If you try to do that, you will end up in court.

j. <u>Motivating Clients to Act</u>. There have been two notorious cases in Florida of business failures because of the lack of succession planning. Clients are motivated to avoid that.

k. <u>Involvement of In-Laws</u>. Do you invite sons and daughters-in-law to the planning discussions? Some families decide yes and others no. One attorney says every time he has done that, one of the spouses turns out to be a total jerk.

l. <u>Invite Business Owner's Spouse to the Meeting</u>. Bring the client's spouse into the office. You'll find out from the spouse what the client's real motivations are with respect to selling or keeping the business within the family.

m. <u>No "Right" Answers</u>. There are no "right" answers for all cases. But raise the issues with the client.

n. <u>Explore Real Reasons for Wanting to Sell</u>. If a business owner wants to sell the business, search for the real reasons, realizing there are more than just tax issues involved. Is this an irresistible economic opportunity? Or does client just want to get out of the hassle and avoid difficult family issues? "My kid can't run a candy shop, let alone a multi million dollar business." The client may be running from something, so thinks that selling the business is the answer.

o. <u>Do Not Let One Dysfunctional Family Member Upset the Entire Succession Plan</u>. There are emotional and dysfunctional people out there—but that can't cause the entire family to get stuck. Where there are family problems (alcohol, etc.) the attorney probably won't be able to solve it—so put a band-aid on it or put a bridge across it. Isolate the family problem. Then the problem child is not holding up the boat. (You may consider then bringing in a psychologist to help Johnny—the problem child. If so, the ultimate answer may be therapy for other family members to accept the problem.)

p. <u>Adequate Liquidity for Business Owner is Imperative</u>. Before the business owner will turn over control, the planner must find a liquidity event to make the parents happy. Otherwise, the parents will have a hidden agenda. For example, they will not sell the business to the children for an installment note for fear that payments will not be made. But if the parents get $10 million cash up front, the parents are then willing. Their lifestyle is assured regardless of whether note payments are made.

q. Succession Planning Client is Often Not a Long Time Client. The odds are this is not a long time client. If it is, the odds are that there will be too close of a relationship with someone in the family so the attorney can't ethically serve in the role as an advisor to lead the process. Also, it is very difficult for the attorney to be brutally honest and deliver unwanted news to a client who is the largest client in the office.

s. S Corps More Family Friendly. S Corporations are more "family friendly" than C corporations because of their additional flexibility for allowing distributions without adverse dividend treatment.

t. "Principles of Family Business Succession". Joe Goodman offers the following paraphrase of the wisdom of Craig E. Arnoff, Ph.D and John L. Ward in their book, *Family Business Succession: The Final Test of Greatness*.

- *The lack of effective succession and continuity planning by a large majority of family firms seriously threatens private enterprise in America.*
- *Emotionally uncomfortable succession transition is clearly the Number One concern of families who own businesses.*
- *The vast majority of parents and most of their offspring want their businesses to continue in family hands. Successful continuity of the family firm is a cherished ideal.*
- *Succession is a process-not an event. When done well, hardly anyone even notices it.*
- *The ability of a business owner to "let go" is the final test of greatness.*
- *Concern about the need for succession planning is difficult to initiate.*
- *Unless the parents have personal financial security, no succession plan is secure.*
- *No succession plan is complete until the parents transfer voting control to the next generation. The surprise return of a once-retired business owner is frightfully common.*
- *Participation in the family business must be seen as a voluntary opportunity, not an obligation.*
- *In the vast majority of cases, significant outside work experience is a prerequisite to a healthy career in the family business.*
- *Business owners can rarely retire "cold turkey"-they need five years to prepare and substantial interests outside the business to look forward to.*

- *Unless the business is very large and/or an affordable mechanism for shareholder liquidity is defined, stock ownership should only rest with family actively leading the business.*
- *For succession to be complete, funded buy-sell agreements among the new owners should be in place. Future career development plans for other family members and key executives should be clearly laid out.*
- *A deep commitment to the philosophy of stewardship is the most essential attitude for the next generation of the family business.*

23. PRACTICAL PLANNING FOR LONG TERM TRUSTS—100 YEARS IS A LONG TIME

Terry Christensen and Michael Graham provided insights into a number of issues that arise in planning and administering ultra-long term trusts, and trusts with special provisions designed to carry out the grantor's special instructions. The materials include a number of alternative form drafting suggestions.

a. Modification or Termination of Trusts. Under the Uniform Trust Code, a non-charitable irrevocable trust may be modified or terminated with the consent of the grantor and all beneficiaries, even if the change is inconsistent with a material purpose of the trust. (§411). Even without consent, a trusts may be modified or terminated as appropriate to further the purposes of the trust in accordance (to the extent practicable) with the grantor's probable intention. (§412).

Most changes to irrevocable trusts arise as a result of scrivener errors.

Planning alternatives include giving a protector or trustee the authority to modify the trust, including decanting provisions. (Sample clauses are provided.)

b. Designating Investments and Retention of Particular Assets. The grantor may wish to direct the trustee to retain certain assets, under either a discretionary or mandatory provision. The trustee has a duty to sell property to follow prudent investor rule absent language to the contrary.

(1) Clients Have No Clue of the Diversification Requirements. Clients almost universally have no idea that the law MANDATES that the trustee sell assets in order to achieve diversification.

(2) Practical Approach With Client. If a client wants an asset to be retained, instead sit with the client and talk about:

1) The law does not favor that (and may not respect it); and 2) There is a better chance to implement your goals if you develop the scenarios in which you would want the asset sold (for example, if none of descendants are involved in management, indices within the industry change in a certain way, etc.) This kind of detailed guidance would be very helpful in giving guidance to a court at a later date.

(3) Settlor Directions May Not be Appropriate on a Long Term Basis. Imagine what a 350 year old trust would say about investments, etc. To what extent is the settlor's intent appropriate at all?

(4) Restatement (Third) of Trusts on Permissive and Mandatory Directions. Under the Restatement (Third) of Trusts, any directions that are permissive have some value, but one comes away with feeling that it is not much more than just a pretty piece of paper. Permissive guidance does not relieve the trustee in any way of the investment standards on trustees under the Uniform Prudent Investor Act.

On the other hand, mandatory language, such as "Don't sell Enron or Dell or Microsoft, that's where I made all my money" will provide the trustee with more protection. (It is interesting that some settlors who made great wealth with a concentrated stock position are now washing cars. There have been various cases regarding the long term retention of Eastman Kodak stock.) Even with a mandatory direction, there is a concept that there is still a point at which the trustee should exercise powers to sell. That may take going to court to modify the agreement.

(5) Dumont Case. The Dumont case deals with failing to diversify Eastman Kodak stock in light of strong language in the trust instrument to retain the stock except for "some compelling reason other than diversification." The lower court held that the retention clause "cannot trump the application of prudence in the management of an estate." The decision was overturned on procedural grounds and in particular, reversed the damages holding. The appellate court decision does lean more toward carrying out the intentions of the grantor. In re Will of Dumont, 809 N.Y.S.2d 360 (2006), rev'g 2004 N.Y. Slip Op. 50647U, 2004 N.Y. Misc. LEXIS 896 (June 25, 2004). (The same bank was involved in a series of cases involving the retention of Eastman Kodak stock.)

(6) Considering Allowing Derivatives to Mitigate Risk. If the settlor wishes to use mandatory language regarding trust

investments, one option might be to allow the trustee to use derivatives to mitigate the effects of an investment portfolio that has an over concentration in one stock.

(7) Draft Explanation of Reasons. It is helpful to draft an explanation of the reasoning why the settlor does not want the trustee to diversify investments. This explanation could be helpful to a court in deciding whether to exculpate a trustee for failing to diversify or to relieve a trustee from liability for his decision to sell assets in contravention of the trust agreement.

(8) Draft in Light of Court's Preference to Diversify. Instruments should be drafted with the assumption that any court reviewing the language will have a strong preference to find a duty to diversify.

(9) Example Forms. There are several alternative form examples regarding retaining closely held business interests. (However, the speakers indicate they're not sure they are of much help in protecting the trustee.)

(10) Business Interests vs. Investment Assets. It's one thing to direct retention of the family closely held company, but another to direct retention of a certain investment asset just because it had good returns in the past.

(11) Outside Directions. Perhaps you don't leave these issues in the hands of the trustee, but leave these decisions to an outside board or family member etc.

(12) Preference Not to Relieve of Duties Under Prudent Investor Act so Trustee Will Have Power to Adjust. Mike Graham prefers not relieving the trustee from the Prudent Investor Act, but saying that a third party can direct the trustee to retain assets if the settlor has a strong preference to retaining assets. He likes not getting out from under UPIA because if UPIA applies, the trustee can reallocate income and principal to achieve an appropriate balance between current and future beneficiaries. If UPIA does not apply, the trust loses the benefits of the adjustment provisions.

c. Protectors.

(1) Purpose. The purpose is to name someone who will survive the grantor to exercise powers from the perspective of the grantor.

(2) Who to Serve. Often, it is best to have a council of advisors, dominated by independent people. Before naming the closely held business CFO, remember potential conflicts of interest, which could create fiduciary limitations (for example, see §170 of the Restatement). Also, it may be important to name someone who is not a "related or subordinate party subservient to wishes of grantor" under §674 of the Code.

(3) Compensation. Do you provide compensation? "People will not do things that involve liability for free. If you want people to do work for you, you have to pay them. If you pay them $2,000, they'll do $2,000 worth of work…If you want the protectors to do something that requires courage, you are going to have to pay them."-Terry Christensen

(4) Forms. There are various example form clauses for protector appointments, rights and duties of protectors, successor protectors, reimbursements, and exculpation.

d. Letters of Wishes. The settlor may prepare a separate letter of wishes and guidance, separate from the trust instrument. IF the trustee follows the letter of wishes, the trustee is usually not held liable. "It works most of the time." [That's not overly comforting to a trustee.]

Various samples, including a sample letter of wishes concerning a business, are provided.

e. Incentive Clauses. Controlling settlors sometimes want to encourage accomplishment by including objective incentive provisions. "This is dead man control taken to excess."

(1) Do Not Use Objective Clauses. "These never work." The speakers are strong proponents of using wide discretionary standards in the trust and giving a letter of directions to the trustee of guidance to encourage beneficiaries.

If using incentive clauses, there are lots of details to consider. For example, when can the beneficiary retire? Can the beneficiary take off time to raise children? The trust will probably still provide for emergencies.

(2) Drug Dependency. Some trusts say that a beneficiary who is drug addict is cut off—provide basic maintenance, but the trust will not terminate and no large distributions will be made to the addict.

(3) Clients Drop Them Over Time. As the children get older, clients tend to get rid of these clauses in their wills as the children prove themselves.

(4) Examples. A number of form clauses are included, including drug clauses and family mission and values statements.

f. Choosing Trustees for the Long Term; Successor Trustees. Corporate trustees may have heavy turnover, but at least they have systems in place to serve permanently.

g. Overriding Drafting Goal With Respect to Special Assets. "The overriding goal in drafting trusts with special assets is not to so terrorize the trustee that the trustee does not do the right thing." –Terry Christensen

24. EXAMPLE LETTER—NUGGETS OF WISDOM FROM PARENTS TO CHILDREN

John Warnick (Denver) discussed drafting methods to clearly express the client's wishes. The following Guidelines (from Warnick & Holmes Roberts & Owen LLP, *The Power of Integrating Our Client's Values into Wealth Transfer and Business Succession Documents*, quoted with permission) read as a wonderful intimate dialogue between parent and child. These Guidelines appeared in an actual trust agreement; they could also be the basis of a heartfelt letter from parents to children to pass on deeply felt family and financial values. DON'T MISS THIS!! THIS IS WONDERFUL—THESE ARE REAL PEARLS OF WISDOM (*except for Item 19!; how could anybody possibly think that??*).

"Specific Guidelines for the Trustees and Beneficiary: I feel it would be valuable to share with the beneficiary as well as the Trustees some principles and core values which have assisted our family in achieving a level of financial success that affords us many opportunities.

Since the assets which have been or will be contributed to this trust have either come directly from my parents or from investments or investment opportunities with which they have had some significant connection, it is also appropriate to attempt to summarize the values which have guided our family in the successes we have achieved. Here are the nuggets of wisdom, which I have mined from my own life experiences and from my parents and which I hope will provide positive direction and encouragement to the beneficiary as she faces the myriad challenges that lie ahead of her:

1. Money you have earned is much more satisfying than money you have been given, but you should not feel guilty about the money you

inherit or are given by your family. Remember the pleasure it gives us to provide you with certain things. Your obligation is to use it wisely and honorably, and not squander it. My intent is to give you a “leg up” in your pursuits, not to eliminate your obligation to become a productive and self-sufficient person. View the distributions you receive as a “hand up” rather than a handout.

2. Make certain that you can always take care of yourself. Do not depend on someone else to support you. Even if you choose not to work, you should have a set of skills that will enable you to support yourself and your dependents should circumstances make it necessary.

3. Be honest in your business and personal life.

4. Don’t borrow money if you can possibly avoid it. If you must borrow money, make repaying the loan your first priority.

5. Using a credit card is the dumbest form of borrowing money. Pay off your entire balance every month.

6. If you cannot afford to pay cash for a luxury item (vacation, fancy car, jewelry), you cannot afford it. Borrowing money for an item you cannot afford he is stupid.

7. Wealth is about relationships and friends. It is not about dollars and cents.

8. Don’t ever try to control anyone with money.

9. Don’t risk what you can’t afford to lose.

10. Take some risks, if you can afford to lose your investment. Gamble on someone or something you believe in. If your gamble does not pay off, walk away with what you have learned.

11. Don’t try to squeeze the last dollar out of a deal. When you make a deal, neither you nor the person you’re dealing with should feel “shafted.”

12. Be generous, but do not give money away because you feel guilty about what you have or to garner kudos.

13. In making a charitable contribution, consider doing it anonymously. If you can get a tax benefit from a charitable contribution, that is good, but it should not be the primary motivation for your alms. Also, don’t be content to merely be a

charitable check-writer. Don’t expect or seek to be at the head table or on the Board of Directors of the high-profile charities in your community. You will get much more than a tax deduction and a name in the program when you roll up your sleeves and serve people rather than burn your time in committee meetings.

14. Our Uncle John is perhaps the finest example I’ve seen as someone who moves quietly, without any regard for recognition or appreciation, to assist the poorest of poor. He won’t talk about it, but he could have been appointed to the U.S. Senate. It would have forced him to give up his privacy as well as the opportunities to teach and to organize like-minded and compassionate people at a grass-roots level. He chose to work in the trenches rather than walk the halls of Congress. There is nothing wrong with public service, and if you feel drawn to that pursue it. But never forget our roots, and our family’s tradition of working hard, but sharing generously and quietly.

15. When making investments, keep it simple. Unless you become a professional in that field, you should avoid the complicated investment vehicles. You can make money with your money with a few simple principles. Do not get greedy and do not believe you can predict markets – if it was that easy, everyone would be rich. Use common sense to adopt a logical long-term investment philosophy and stick to it, making changes as appropriate as circumstances change (e.g., your age, your need for income, market forces, etc.).

16. Don’t underestimate the value of objective, professional advice in any phase of life, including investments and financial planning. You know how important my professional relationship and friendship with our family’s CPA has been. I would never dream of making a major move without Pyles’ advice.

17. If you choose a job in a field you love, you won’t work a day the rest of your life. So be sure you find a career that you like – maybe even love. Do not be afraid to change your position if you find yourself dissatisfied. Do a great job at whatever you decide to do – be it waiting tables or brain surgery.

18. Make sure you can always look yourself in the eye. If you do something in your life of which you are ashamed or embarrassed, do not hide – make it right, apologize, make amends. Get up every morning and look in the mirror and see a happy person, without having to avert your eyes, and then set about doing the things you are passionate about.

19. Father always told me never to trust anyone from Dallas or Salt Lake City. He was right!!!!

20. Follow your dreams. I do not expect you to follow my dreams – either by entering the drilling business or by living in New Mexico. I do expect you to find a life that is as satisfying to you as mine has been to me."

25. MEDICAID PLANNING AND CRUMMEY TRUSTS

An attorney wrote a Crummey trust for an autistic grandchild in order to allow annual exclusion gifts for the grandchild. The Medicaid lawyer for the parents said that all trust assets would have to be depleted before the grandchild would qualify for Medicaid. That can be particularly problematic because some programs for disabled persons are only available through Medicaid—it does not matter how much money you have. For the future, the attorney is using contributions to §529 plans to make annual exclusion gifts for that grandchild.

26. EFFECT OF CRUMMEY WITHDRAWAL POWERS ON CREDITORS RIGHTS

There is only one case holding that a Crummey withdrawal power does not give the beneficiary's creditors the ability to reach assets that the beneficiary could have withdrawn. University Hills National Bank. (Some states, such as Texas, have statutes limiting the rights of creditors of Crummey beneficiaries.)

27. INTERNATIONAL ESTATE PLANING ISSUES

a. U.S. Domicile. The US estate and gift tax system applies to US domiciles, defined as persons residing in the United States with the intent to remain permanently. What are the effects of immigration status on that determination? For income tax purposes, if a person has a green card, the person is subject to U.S. tax on worldwide income. However that does not mean absolutely that the person is a U.S. resident for estate and gift tax purposes. If the person is present in the United States on a visa, the person is not permitted to remain in the United States permanently. Even so, the court in Estate of Jack, 90 AFTR.2d 2002-7580 (Fedl. Cl. 2002) refused to give the taxpayer a summary judgment. Thus, immigration status is not dispositive. One must look at all of the indicia of domicile.

   The modern estate tax treaties (including countries such as the UK, France, Germany and Sweden) all have similar rules providing that a person who moves between countries is still deemed to be domiciled in the original country for a period of time after moving with the intent to remain permanently in the new country.

b. Person Residing in U.S. But Not U.S. Domicile. There are two major issues: a) Tax issues (what assets are subject to the US estate tax?); and b) Succession law (what country's laws will govern?).

(1) Community Property; Pre-Marital Agreement. For a French person, the community property rules will apply. If the person was married in France, it is very likely that the spouses signed an agreement as to whether or not marital property would be community property. (In some countries, spouses can opt into or out of the community property regime.) Read Moore says always to ask, if clients are married in another country, if they have a premarital agreement. Often they will.

(2) Foreign Will; U.S. Will. It is more likely to find a person from a foreign country with a will if the person is from a common law country, such as the UK or Australia. In that case, the individual may also need a U.S. will to govern U.S. real estate. In preparing the U.S. will, be careful not to revoke the prior foreign will (unless that is intended).

If the client is coming from an English-speaking country, the client probably already has a will in English and the English will is probably valid in the United States. There is no need to have a separate U.S. will in all of those instances.

If the client is coming from a civil law country (for example, France or Belgium), the person may or may not have a will. If they do, it will likely be in a foreign language. If there is U.S. real property, it is much easier to have a U.S. will (in English).

(3) Consider Expatriation Rules Before Establishing U.S. Domicile. If the client may leave the United States at some point, the planner must consider the expatriation rules. They apply beyond just giving up citizenship. If an individual has a green card for at least eight years and leaves the United States, the person is treated as an expatriate. For the next 10 years, there is a modified year U.S. tax regime that applies to expatriates -- for income and for estate and gift tax purposes. So if the individual thinks that he or she may move back to a foreign country, keep the visa as long as possible before getting a green card. A visa does not start that eight year period.

c. Non-citizen Spouse Domiciled in U.S.. This is a very common situation. Consider a Canadian citizen who has lived in the United States a long time and has a U.S. domicile for estate and gift tax purposes and succession law purposes. However, the spouses are not US citizens. This raises gift tax annual exclusion and gift and estate tax marital deduction issues.

(1) Gifts to Non-Citizen Spouse With Annual Exclusion. There is an indexed exclusion for gifts to non-citizen spouses, which is currently $125,000 annually. No marital deduction is allowed for lifetime gifts—even to a QDOT. The only possibility of making inter-spousal gifts without U.S. gift tax is using the special indexed annual exclusion for non-citizen spouses.

(2) QDOT Issues. Bequests to a noncitizen spouse qualify for the estate tax marital deduction only if the bequest is to a Qualified Domestic Trust under §2056A (typically referred to as a "QDOT"). If the trust has over $2 million of assets, there must be a U.S. corporate trustee, unless there is a letter of credit or bond (both are very expensive and almost never used).

A QDOT does not have to be in the will, but can be created after the decedent's death. A post-death QDOT is more flexible; it can allow discretionary distributions to persons other than the spouse. However, for state QTIP elections, it may be best to structure it so that it satisfies the QTIP rules. The disadvantage of a post death QDOT is that it must be formed and assets must be transferred to it by the time the Form 706 is filed.

QDOTs work best for liquid assets that can produce a lot of income. For illiquid assets that don't produce income, principal distributions will be required if the spouse needs cash flow, and a tax must be paid on principal distributions.

To avoid the complicated QDOT rules, clients may just decide to become US citizens. If the spouse becomes a U.S. citizen after the decedent's death, the QDOT can be converted to a regular QTIP trust. The special tax paid on prior principal distributions cannot be recovered. However, tax on principal distributions paid after conversion would not be subject to the special QDOT tax on principal distributions.

(3) Equalize Estates. Optimal planning is to make gifts to the spouse during life that would equalize the estates, because QDOT principal distributions are taxed based on the first decedent spouse's rates. In community property states, it is not possible to convert separate property to community property without making a gift. However, a conversion to community property going forward for assets acquired after the conversion.

(4) Joint Survivorship Property. For joint survivorship property, all of the property is taxed in each owner's estate, except to the extent that the decedent's estate can show that the other spouse contributed to the acquisition of the property. If the joint property does end up in the first spouse's estate, a QDOT could be used to avoid estate tax at the first spouse's death.

(5) Special Treaty Rule With Canada. Canada and a few other countries have treaties providing that the executor of the first spouse to die can elect to get a second unified credit in lieu of using the QDOT deduction. (For large estates, this election would not make sense and a QDOT would be used.)

d. Inbound Gifts From Foreign Person to U.S. Person.

(1) Trust. If the person wishes to use a trust, realize that a civil law country will not recognize a trust formed in that country but may recognize a trust formed elsewhere. Therefore, the donor must consider forming a trust under a jurisdiction that recognizes trusts. Using a U.S. trust is often preferable if a trust will be used at all. The United States has the most extensive trust law of any country, and it may be possible to avoid state income tax, with proper planning. If the person is located in the United States it would be nice to have a trust with the American style we are familiar with.

It is generally best not to use a foreign trust. If the trust is a foreign trust, there will be no need to pay U.S. income tax on non-US source income. However, there are severe disadvantages. The throwback rule still applies to foreign trusts—if income is accumulated and later distributed to U.S. beneficiaries, there will be a tax and penalty, and the calculations can be quite complex. The longer the trust is offshore and more income that is accumulated, the bigger the problem gets. It is often better to pay U.S. tax currently -- especially with a 15% rate on capital gains and qualified dividends. (The throwback rule eliminates tax character, so there is no long-term capital gain or qualified dividend treatment.) In addition, a Form 3520 must be filed each year to report any distributions from the foreign trust.

It is probably not possible to have a foreign grantor trust so that the foreign person pays the tax. The typical grantor trust triggers do not apply to nonresident aliens. (The rules are intentionally designed that way to prevent this kind of planning.)

(2) Report Foreign Gifts Over $100,000. gifts from foreign persons to a U.S. person must be reported if the aggregate foreign gifts exceed $100,000 during the year. §6039F. (The statute says $10,000, but the IRS says, that means $100,000.) The gift is reported on Form 3520 when the donee files his or her income tax return.

(3) Tax Issues for the Foreign Person. As an example, some Switzerland cantons have no estate or inheritance tax, but some do. Even in the cantons that have an estate tax, gifts to a child or descendent are not subject to the gift tax, but gifts to a trust do not qualify for the exception. However, it is possible to obtain the equivalent of a private letter ruling in the Zürich canton if the trust is for the benefit solely of beneficiaries who are within the favored class. The trust must be drafted in a special way to qualify for this exception (there can be no general powers of appointment or non-general powers that would permit distributions to go beyond descendents.) In addition, the trust will probably need to be translated into German (to convince the Swiss authorities that the trust qualifies for the gift exception), so try to make the trust as short as possible.

In summary, donors in foreign countries are often not worried about foreign tax issues. Just realize using a trust may not be best from the donor's perspective.

e. Outbound Gifts From U.S. Person to Non-Resident Alien. As an example, assume the client is a U.S. person, whose will would leave assets to German individuals and charities.

(1) Estate Distributions to Foreign Beneficiary. Distributions from an estate to a foreign beneficiary could not require reporting. However, if income during the administration is in the estate's DNI, distribution of U.S. source income is subject to tax in the U.S., which the executor would have to withhold and report on Form 1042 and 1042S. The executor should obtain a Form W-8 from the foreign beneficiaries.

(2) No Double Tax. Germany has a gift and the inheritance tax in which the donee pays the tax. Is it possible that there would be an estate tax paid in the US, and the donee tax paid in Germany? No, the U.S./Germany Treaty says that Germany gets credit for the U.S. tax paid.

(3) Outright Gifts Are Probably Best. Despite the non-tax advantages of trusts, outbound gifts may be best if made outright. Tax issues with using trusts are described below.

(4) No Significant U.S. Tax Problems From Using Foreign Trust. If a U.S. trust is used for foreign beneficiaries, the trust would pay U.S. income tax on undistributed income. However, if a foreign trust is created in a tax haven country, the trust for foreign beneficiaries should avoid paying U.S. tax. If there are no U.S. Beneficiaries, the classic foreign trust problems are not present and the foreign trust may be preferable to a U.S. Trust. There are reporting issues with a foreign trust; estate distributions to a foreign trust must be reported on Form 3520. If there is appreciation between the date of death and the distribution date, there is a deemed disposition generating gain recognition under §684. However, this is typically not a problem in the estate situation with a stepped-up basis assuming the asset can be distributed before further appreciation occurs.

(5) Trust May Cause Substantial Foreign Tax Problems. Using a trust may be a terrible idea for German tax purposes. It is a civil law country, so does not have the trust concept in its law. However, the law says that any time a German beneficiary receives a distribution from a foreign trust, it is treated as a gift (the donee pays the German gift tax) without crediting, so there could be a double tax. In addition, Germany has the equivalent of a throwback tax -- an anti-deferral mechanism with a penalty on accumulated income.

(6) Bequest to Foreign Charities. Bequests to foreign charities present no particular problem, because §2055 allows an estate tax charitable deduction for gifts to foreign charities. (Contrast this with a lifetime gifts; a US income tax deduction is generally not allowed for gifts to foreign charities.)

f. Inadvertently Creating Foreign Trust. This is the biggest trap for the unwary. If a U.S. person names a nonresident alien as fiduciary under the client's estate plan, the trust can be converted into a foreign trust. A trust is a foreign trust unless a) a U.S. court can exercise primary supervision of the trust (court test) AND b) one or more U.S. persons can control all substantial decisions for the trust (control test).

If a trust becomes a foreign trust by reason of a shift in control, there is a 12 month grace period to reassert US control (for example, by changing a sufficient number of trustees so that U.S. trustees control all substantial decisions).

If an inter vivos trust becomes a foreign trust, it becomes a grantor trust, and the shift is a deemed disposition that triggers gain recognition.

28. INTERESTING QUOTATIONS FROM 2007 ACTEC ANNUAL MEETING

a. Introduction of William Howard Taft (a very large man) by Chauncey Depew (chairman of the board of directors of the Vanderbilt railroad system and Senator from New York): “The truth is that President Taft is pregnant.”
President Taft’s response: “Yes it’s true. If it is a boy, I’ll name him after me. If a girl, we’ll name her after my wife. If, as I suspect, it is a bag of wind, we shall name it after Chauncey Depew.” –quoted by Dr. William Schulz in the Trachtman Lecture

b. Upon receiving the gavel as the new ACTEC President, Danny Markstein said he felt a special connection to the new Alabama State Bar President, Bobby Segall. At his induction, Mr. Segall said that he had asked his wife, “Honey, in your wildest dreams did you ever think that I would someday be the Alabama State Bar President?” She replied to him: “Bobby, you are not in my *wildest* dreams.”

c. “If you have no appraisal, you are making yourself into a human piñata.” –Mil Hatcher, referring to the IRS’s comments on how penalties apply to FLPs in the Appeals Settlement Guidelines.

d. “Always question how hard to play hardball with the IRS, because you often find harder bricks come back at you when you play hardball.”—Mil Hatcher.

e. “The tax fairy died last November.” -Joe Goodman in pointing out that clients who have delayed estate planning in hope that the estate tax will be repealed are beginning to do planning.

f. “There’s no such thing as an independent trustee as long as the settlor is alive.” James Casner (as quoted by Terry Christensen)

g. “The overriding goal in drafting trusts containing special assets is not to so terrorize the trustee that the trustee does not do the right thing.” –Terry Christensen

h. “People will not do things that involve liability for free. If you want people to do work for you, you have to pay them. If you pay them $2,000, they’ll do $2,000 worth of work…If you want the trust protectors to do something that requires courage, you’re going to have to pay them.”-Terry Christensen

i. Pre-Mortem Planning—“For the client who has not died yet, but they’re circling the drain.” -Ted Atlass

j. Most professionals don’t have a lot of experience with preparing and filing final 1040s at an individual’s death. “Specializing in final 1040s is not the way to build a growing tax practice.” -Ted Atlass

k. “The divorce lawyer has more repeat business than the probate lawyer.” -Ted Atlass