ACTEC 2007 Fall Meeting Musings

October 31 – November 4, 2007

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Introduction

This is a summary of observations from the ACTEC 2007 Fall Meeting held at The Greenbrier on October 31-November 4, 2007. Unfortunately, I arrived at the meeting late, so I missed a variety of meetings that I would otherwise attend. (The observation that made the strongest impression on me is that The Greenbrier is a one-of-a-kind marvelous resort. Danny, we thank you for arranging for us to meet in this wonderful setting.)

The first four items come from a seminar by Ed Manigault and George Albright, "The Mathematics of Post-Mortem Estate Planning."

1. Decision of Whether to Pay Estate Tax at the First Spouse's Death

There are various unknowns with the deferral vs. prepayment decision. (1) Possibility of future estate tax repeal or lowering of rates. (2) Appreciation or depreciation of estate assets. If the assets depreciate, the prepayment was wasted. (3) Consumption and gifting by the surviving spouse. Spending rates are often more important than investment rates; not only how the spouse will consume the assets, but how the spouse will be able to take advantage of leveraged transfer planning opportunities. (4) Spending rate of the bypass trust.

a. If paying estate taxes at the first spouse's death causes illiquidity, that may force the sale of illiquid assets, which may remove the discount that would otherwise apply at the surviving spouse's death, and the estate may be forced to sell at a low price.

b. The estate tax payment may alter lifestyle of surviving spouse.

c. Who bears the burdens and benefits of prepayment? Even if prepayment is an overall benefit to the family, if one party is hurt and another benefits, there may be some unhappy beneficiaries.

2. 2013 Credit Tax for Prior Transfers (TPT Credit)

a. Overview of §2013 credit. A credit is available to a transferee decedent who received a property interest that was taxed in the estate of a prior decedent who died within 10 years before (or two years after [this would be an unusual situation]) the transferee decedent. The amount of the maximum available credit is based on two limitations that limit the credit to the lesser of the estate tax the transferred property generated in the first estate and the estate tax the transferred property generates in the second estate. (The second limitation is based on the actuarial value of the transferred property at the transferee's death, even if the asset is not in his or her gross estate. For example, if a life estate is transferred, the second limitation is the actuarial value of the remaining life estate at the transferee's death, even though there is nothing to report in the transferee's estate from that life estate. Rev. Rul. 59-96.) The maximum available credit is further reduced by a percentage based on the time between the first death and second death. 100% is allowed if death occurs within two years, 80% if the second death occurs in years three or four after the first death, etc.

   Because of the first limitation, no TPT credit is allowed at the transferee's death if no estate tax was paid at the death of the transferor. This raises the primary question of whether the estate should forego all or part of the available marital deduction at the first spouse's death in order to generate some estate tax, which could yield some credit at the second spouse's death.

b. The planner must inquire about the surviving spouse's health when administering the first spouse's estate. Example: The attorney has represented H and W for years. At H's death, the estate qualifies for the marital deduction and no estate tax is due. The attorney advises W when H's 706 is filed. Two years after H dies, W dies. The daughter now calls the attorney, and asks if the attorney considered the §2013 tax credit when administering H's estate. Response: "I thought W was in good health. The §2013 credit is only helpful if the beneficiary dies within 10 years. It is especially helpful if the beneficiary dies within about four years." Daughter's response: "If you had asked, W would have told you she was not in good health."

c. The estate tax savings can be substantial.

d. Elements to qualify for the §2013 credit:

- Must have two deaths. (So this is not a happy situation.)
- Deaths must occur within 10 years of each other. Within two years, there is a credit of 100%; thereafter the credit drops 20% every two years.
- There must be a transfer of property included in the first decedent's estate from the first decedent to the second decedent.
- The first decedent must pay estate taxes.
- (The property transferred from the first decedent to the second decedent does NOT have to be included in the transferee's estate.)

e. Drafting Tip: Think long and hard before using an outright marital deduction bequest. Doing so gives up much of the flexibility of using the §2013 credit. Even if the client wants an outright marital bequest, consider using a QTIP with broad distribution authority, or give the spouse a right of withdrawal after a period of time.

f. Calculate the credit based on the actuarial value of the W's interest at H's death (for example, the value of the income interest for the W's actuarial life expectancy). By forcing taxes to be paid in first estate, the credit is available in the second spouse's estate, even though assets are not included in second spouse's estate.

g. The age of the surviving spouse drastically affects the amount of the credit. (A younger surviving spouse has a longer life expectancy, and the actuarial value of the interest at the surviving spouse's death is much greater.)

h. Giving the surviving spouse a "5 or 5" withdrawal power can substantially increase the §2013 credit, so consider including a 5 or 5 power in the QTIP. (That must be done in drafting before the first spouse dies.) Calculating the value of the 5 or 5 power can be difficult. The outline includes a mathematical model suggested by Larry Katzenstein for making this calculation, to which Larry concludes: "This is just a guess as to how the IRS would value this, but I think it makes sense."

i. A Clayton provision, which removes the mandatory income interest or makes other changes if the QTIP election is not made, affects the §2013 credit.

j. Do you ask beneficiaries other than just the surviving spouse? Get as many people as possible to sign on. Warn the family of all the things that can go wrong — like living too long. The seminar materials include a sample letter. "You've decided to pay estate tax early to leave the flexibility to use the §2013 credit. Here are some things that can go wrong."

k. If the surviving spouse dies within 15 months, paying estate tax at the first spouse's death and using the §2013 credit will very likely save taxes overall. Most people will extend the filing date on first spouse's death to take advantage of knowing whether the surviving spouse becomes seriously ill in the 15 months following the first spouse's death.

l. If the estate extends the filing deadline by six months (see paragraph k above), should the attorney also request a payment extension? If the surviving spouse should die or become seriously ill within the first five months, the executor may decide to make no QTIP election and pay estate tax in the first spouse's estate. If no payment extension is requested, the return would be timely filed, but late as to payment, which may trigger penalties and interest. Some recommend asking for an extension of time to file AND time to pay. The extension request will not be granted without good cause. But some attorneys routinely submit the payment extension request and they always get the extension. (Steve Gorin suggests the following language for the extension request: "It is impossible or impractical to pay the full amount of the estate tax by the return due date because we are waiting on information which is necessary to complete the return. Based on our preliminary assessment, we do not believe that an estate tax will be due for the estate of the decedent. Nevertheless, when the information becomes available over the next six months to complete the return, there may be an estate tax due. Until such information is received, no realistic estimate can be made of the amount of such tax.")

3. Making Distributions from QTIP so Spouse Can Make Gifts

The estate may choose not to prepay estate tax at the first spouse's death by making the full QTIP election or may choose to defer only part of the estate taxes by using a QTIP trust. If the spouse later wants to employ gift planning to reduce the estate tax that would otherwise by due with respect to the QTIP trust at the surviving spouse's death, what planning options are available?

a. The spouse may exercise a 5 or 5 withdrawal power if it exists in the QTIP, and make gifts of those assets. (That is another excellent reason to include a 5 or 5 power in the QTIP). (Giving the spouse a 5 or 5 power would make the trust a partial grantor trust with respect to the surviving spouse under §678(a).)

b. If principal distributions can be made in the "sole and absolute discretion" of the trustee, there is a lot of flexibility.

c. If an ascertainable standard applies for principal distributions, and if the trustee makes large distributions so that W can make gift, there may be a potential breach of fiduciary duty. Before making large distributions from the QTIP so that the surviving spouse can make gifts (to take advantage of the fact that the gift tax is cheaper than the estate tax if the donor lives at least three years after the gift), it is best to get the informed consent from beneficiaries, and maybe even a court order.

d. Even if the remaindermen all consent to the large distribution (presumably, not within the ascertainable standard), could the IRS challenge it as a blatant disregard of the trust?

e. If there is a very strict distribution standard or no authority to make principal distributions, significant gift planning would seem at a dead end. But maybe not; a nonqualified disclaimer might be possible. Fourteen states have adopted the Uniform Disclaimer of Property Interests Act. The Uniform Act removes bars such as time limits or acceptance of benefits on having a valid disclaimer. Even if an attempted action is invalid as a disclaimer, it still acts as a transfer of property. "This is distinguishable from an assignment of the income interest which could be barred by a spendthrift provision or, even if effective, may not accelerate to the remainder as would happen under the UDPIA."

4. Most Tax Efficient Way to Pay Estate Tax — Including Graegin Loans

a. Selling illiquid assets is a bad way to pay tax. Under state law, the estate may have to use personal property before using real property for paying estate taxes. That might necessitate selling the family business rather than the real estate.

b. Graegin loans. More than a majority of audience have used a Graegin loan.

c. Troubling §2036 issue with Graegin loans. *Erickson* (and to a lesser extent *Strangi*) suggest that using FLP assets to pay estate tax evidences an implied agreement for retained enjoyment causing inclusion of the partnership assets under §2036. There is at least one case pending now, where the IRS is arguing that because the estate did a Graegin loan and borrowed from the FLP, that will cause inclusion of the FLP assets under §2036 and will cause the loss of any discount. Previously, we just worried about loss of the estate tax interest deduction. Now have to worry about causing §2036 to apply.

d. Graegin loans are in process of becoming a national coordinated issue!

e. In two different audits, the estate tax agent required an affidavit under oath by all parties that there would never be a prepayment under the loan.

f. What if five years down the road, there is a new fiduciary who decides to prepay the Graegin loan? Are there disclosure issues? There is no consensus on that.

g. Third-party lenders want collateral. If the best collateral is in the FLP, then the estate must worry about the §2036 risk of using assets inside the FLP for collateral. (If the estate does so, it should pay a fee to the FLP for being able to use the FLP assets as collateral.)

h. Section 6166 does not reduce estate taxes (because the interest payments cannot be deducted for estate tax purposes); a Graegin loan does reduce the estate tax.

Note: Items 5-14 are based on a panel discussion by Carlyn McCaffrey, Diana Zeydel and Steve Akers, "Grantor Trust Planning."

5. Reimbursement of Grantor for Paying Income Taxes on Income of the Grantor Trust

a. Carlyn McCaffrey, on noting that from a transfer planning perspective it is best for the grantor to pay the taxes without reimbursement: "Sometimes clients don't know what's good for them, no matter how often we tell them."

b. An income tax reimbursement clause should not cause 100% inclusion in any event. Unless there is a 100% income tax rate, the grantor would not be receiving 100% of the trust income by reason of the tax reimbursements. So §2036(a)(1) should not cause 100% inclusion.

c. If the existence of an income tax reimbursement clause means under state law that creditors can reach the trust assets, does that make the gift to the trust an incomplete gift from the outset? For example, if a GRAT contains a reimbursement clause and that clause subjects the trust to the grantor's creditors, arguably the gift would not be completed until the termination of the GRAT. Because of that problem, NEVER use a reimbursement clause unless state law clearly provides that the existence of the clause does not open to trust to the grantor's creditors. (Some states are changing their laws to say that the mere existence of a discretionary reimbursement clause will not by itself allow the grantor's creditors to reach the trust assets. An example is Tennessee.)

d. State law often permits (or may permit) reimbursement of the grantor for paying income taxes on the trust income. In those states, the trust instrument should prohibit the trustee from reimbursing the grantor for paying income taxes on the trust income.

6. Spousal Unity Rule Is Applied Based on When the Trust is Created

Under §672(e), the grantor is treated as holding powers or interests held by the person who was the grantor's spouse *at the time the trust was created* or someone who became the grantor's spouse after the trust was created (but only as to periods after the individual became the grantor's spouse). Thus, the subsequent divorce of the grantor and grantor's spouse does not negate the spousal unity rule if the prior spouse continues to hold any interest or power in the trust. (However, the grantor would probably not want an ex-spouse to continue as a beneficiary of the trust or holding a power over the trust.)

7. Spouse as Discretionary Beneficiary

Having the spouse as a beneficiary makes the trust a grantor trust under §677(a)(1). As mentioned in the previous paragraph, a subsequent divorce will not negate grantor trust status if the ex-spouse continues as a beneficiary of the trust. In order for this to cause wholly grantor trust status, it is important that the distribution power to the spouse extends to both income and corpus.

8. Does Grantor Non-Fiduciary Substitution Power Cause Estate Inclusion Under Section 2036?

One of the items on the 2007-2008 Treasury-IRS Priority Guidance Plan is "guidance under §2036 regarding the tax consequences of a retained power to substitute assets in a trust." A non-fiduciary grantor substitution power is often used to cause a trust to be a grantor trust for income tax purposes. I.R.C. §675(4)(C). Most planners believe that a non-fiduciary power in the grantor to substitute assets of equivalent value should not cause estate inclusion under §2036, bolstered by the dictum in *Estate of Jordahl v .Comm'r*, 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1, which held that §2038 did not apply to a grantor substitution power where the grantor was a trustee. Among other things, the IRS argued that the decedent, through repeated exercise of the substitution power, could cause the trust to hold "highly productive property to deprive the remaindermen of benefits or, similarly, in unproductive property to deprive an income beneficiary of property." As to that argument, the court responded:

> "This Court and others have considered cases involving settlors who have retained the power to direct trustees as to investments, and, where settlors have been bound to act in good faith and in accordance with fiduciary standards, the retained powers over investment have not been treated as powers to alter, amend, or revoke."

In *Jordahl*, the grantor was one of three trustees, but the court's reasoning would suggest that the same result—no inclusion—would occur if the grantor's power was not held in a fiduciary capacity:

> "Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprive the remainder of benefits or to deprive an income beneficiary of property]."

Several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl), 9227013 (unclear whether substitution power was in fiduciary or nonfiduciary capacity), and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

Despite the prior private letter rulings and the *Jordahl* dictum, the IRS has recently refused to rule in a ruling request that a *non-fiduciary* substitution power would not cause §2036 inclusion. Letter Rulings 200603040 & 200606006. In the negotiation process over those rulings, IRS officials reportedly stated that the IRS is considering issuing a published ruling taking the position that a non-fiduciary substitution power causes §2036 inclusion, but suggested that if the IRS were to take such a position, it might be prospective only.

For example, PLR 200603040, issued on 1-20-2006, addresses a trust with a substitution power where "the instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity." The PLR concluded that the substitution power would not cause estate inclusion under §§2033, 2036(a), 2036(b), 2038 or 2039. The PLR focused on the fact that the instrument said that the substitution power could only be exercised in a fiduciary capacity. In Jordahl, the decedent was a co-trustee so one might infer that all powers held by the grantor in that case were held in a fiduciary capacity. However, the PLR interpreted Jordahl as follows: "Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries." Under this reasoning, would any substitution power be exercisable only in a non-fiduciary capacity? That reasoning might suggest why the IRS refuses to rule in PLRs whether a substitution power is held in a nonfiduciary capacity (to be a grantor trust trigger under §675(4)) even though the instrument specifically says the power is not held in a fiduciary capacity.

However, the regulations and other authority under §§2036 and 2038 say that it makes no difference how the power is held. Treas. Reg. §§20.2036-1(b)(3) ("it is immaterial … in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent") & 20.2038-1(a) ("immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent"). The courts have focused on whether there is a standard of fairness that can be enforced in court.

Indeed, this issue has reached a new level of sensitivity in light of the IRS announcing it as an issue on the Treasury/IRS Priority Guidance Plan for 2007-2008. (Hopefully, if the IRS were to take the position that holding a nonfiduciary substitution power causes §2036 inclusion, it would only apply that position prospectively as to trust transfers to trust before the effective date of the regulation. Even more hopefully, the IRS will see the folly of treating fiduciary and nonfiduciary powers differently under §2036/2038 — if the grantor must pay full value, what difference does it make whether full value must be paid in a fiduciary or nonfiduciary capacity?)

In light of the additional uncertainty created by the inclusion of this issue on the 2007-2008 IRS "Business Plan," planners may at least consider giving a substitution power to a spouse or child instead of routinely giving the grantor a substitution power. (Any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. §672(e).)

9. Substitution Power Held By Third Party

Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor's brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). In addition, allowing a third party to hold the substitution power could create additional flexibility to "turn off" or to "toggle" grantor trust status.

The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power "exercisable in a nonfiduciary capacity by any person"); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by "any non adverse party"). However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. (If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under §4941(d).) Letter Ruling 9037011 gave one of the trustees a power to "acquire any property that held in trust by substituting property…". The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to "reacquire" trust assets.

Observe that the "reacquire" possible IRS argument does not exist if the grantor's spouse holds the substitution power, because any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. §672(e).

The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third-party substitution power to cause grantor trust status.

10. Inter Vivos Power of Appointment — A Little Used Trigger Power

Carlyn McCaffrey suggests giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment. Because the person is not a trustee, the exception in §674(c) would not apply. Because there is no standard, the exception in §674(d) would not apply. The testamentary power of appointment exception in §674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in Section 674 would apply, so the general rule of §674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset.

11. Toggling Grantor Trust Status Off and On

a. There seems to be consensus that repeated toggling of the grantor trust status has a suspicious appearance, and should be avoided.

b. Examples of reasons that a grantor might want to toggle off grantor trust status: (1) Grantor wants to avoid continuing to pay income tax on the trust income; (2) Grantor wants to avoid a high state income tax (and non-source income in a "non-resident" non-grantor trust may not be subject to state income tax in the grantor's state of residence or in the state where the trustee is located; or (3) Grantor wants to make a charitable gift that exceeds the grantor's percentage limitations (there is no percentage limitation on the charitable deduction of a non-grantor trust).

c. Examples of reasons to toggle on grantor trust status: (1) Grantor willing to pay income tax on trust income (for example, after a huge sale of a capital asset); (2) Save state income tax (for example, if the grantor moves to a state that does not have a state income tax); or (3) Desire to make a charitable gift of a large appreciated asset (a trust is entitled to a charitable deduction only for distributions from gross income, but an individual can get a charitable deduction for gifts of property).

d. Examples of ways to toggle off grantor trust status: (1) Spouse relinquish rights as a beneficiary (is that a gift? if the spouse is merely a discretionary beneficiary, the gift may be very hard to value); (2) Give someone the power to remove the spouse as a beneficiary; (3) Trust may give party holding a substitution power the ability to relinquish it (and that party should not also have the power to reinstitute it — the power to reinstitute the substitution power should be held by a third party, and even then, preferably only in a subsequent taxable year); (4) Relinquish power of related party trustees to participate in distributions that are not limited by a reasonably definite external standard; (5) Change trustees so that related party trustees are one-half or less of the trustees. A trust instrument may not anticipate and specifically permit any of those changes. Consider in drafting trusts giving someone the trustee a broad power to amend the trust within limits (for example, in a way that does not change the beneficial ownership).

e. Do not give the grantor the power to toggle the grantor trust status. Some say that would be an estate tax sensitive power. (Carlyn McCaffrey does not agree that it should cause estate inclusion — if creating a grantor trust in the first place does not cause estate inclusion, why would the ability to shift the trust to grantor or nongrantor trust status cause estate inclusion?) Still, out of a sense of conservatism, do not give the grantor that power.

f. Make sure that the trustee or other person exercising the toggle power is protected. The person should have the power in his or her sole and absolute discretion and not be accountable to beneficiaries for a decision to exercise or not exercise a toggle power.

g. When a toggle off power is exercised, the trust instrument should make clear whether the power can be reinstituted (and if so, preferably only in a subsequent taxable year).

h. Consideration from grantor for terminating grantor trust status? If the grantor trust status of the trust is terminated, the grantor is benefited by being relieved of the substantial income tax liability. Could the grantor pay consideration to the trust in return for the termination of the grantor trust status by the trust or other third person on behalf of the trust, without being treated as having made an additional taxable gift to the trust? If so, this could help relieve fiduciary concerns for the trustee to take steps to terminate the grantor trust treatment if that were desirable for some reasons (for example, if having a grantor trust subjects the trust to state income that otherwise could be avoided), even though doing so would subject the trust to federal income taxation. A drafting suggestion to anticipate this would be to provide that the trustee will take steps to convert the trust to non-grantor trust status if the grantor pays X dollars to the trust. Even with that provision, there is no general consensus that the grantor's payment to the trust for this reason would not be treated as an additional contribution (and gift) to the trust.

12. Decanting to a New Trust to Toggle Grantor Trust Status

a. Could there could be possible fiduciary concerns to the trustee exercising the decanting power if the grantor or a beneficiary disagrees?

b. What if the trustee seeks the grantor's consent before decanting? Is that a potential gift by the grantor if a nongrantor trust is decanted into a grantor trust? It should not be treated as a transfer by the grantor, because the grantor could have established a grantor trust in the first place and the grantor's payment of income taxes would not be a gift under Rev. Rul 2004-64. The theory of Rev. 2004-64 is that is not a transfer by the grantor, but payment of income tax by the grantor on a grantor trust is mandated by the Internal Revenue Code.

c. If the trust is in a state that does not have a decanting statute, the easiest approach would be to change the governing law that applies to the trust.

13. Using QSST to Cause Third Party Grantor Trust Status

Having a bypass trust being treated as a grantor trust as to the surviving spouse can be advantageous; the spouse can pay income tax on the trust income, allowing the trust assets to compound faster. Jonathan Blattmachr, Mitchell Gans, and Diana Zeydel have written articles this year proposing one way to accomplishing that (by using an inter vivos QTIP arrangement). Another way would be to have the trust own S stock and have the beneficiaries make a QSST election. That causes the S corp income to be taxed to the beneficiaries directly. 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.

14. IRS Reconfirms Informal Rulings That Using Crummey Trust Does Not Invalidate "Wholly Owned" Status of Grantor

In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. Theoretically, this may be endangered if the trust contains a Crummey withdrawal clause. However, recent private letter rulings reconfirm the IRS's position that using a Crummey clause does not endanger the grantor trust status as to the original grantor.

The Potential Problem: The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.

The IRS's position under Section 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" generally carries the connotation of an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. (Sections 2041b)(2) and the 2514(e) provide that "the lapse of a power… shall be considered a release of a power.") Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

Section 678(b) generally provides that if grantor trust status is conferred on the grantor under Section's 673-677 and on a beneficiary under Section 678, the grantor trust status on the original grantor will prevail. However, Section 678(b) literally applies only as to "a power over income" and a withdrawal power is typically a power to withdraw corpus. However, the 1954 Committee Reports make apparent that the language of section 678(b) contains a drafting error and that it was intended to apply to a power over income and corpus, similar to Section 678(a)(1).

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.

This has been confirmed by a number of recently issued private letter rulings, which all concluded that the original grantor continued to be treated as the "owner" of the all of the trust under the grantor trust rules despite the existence of a Crummey clause in the trust. Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, 200730011.

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. A message dated February 17, 2007 has been published that was sent from David Handler to Catherine Hughes (U.S. Department of Treasury) describing the problem of using a Crummey provision in a grantor trust and concluding that the issuance of private letter rulings does not solve the problem:

> "However, we cannot rely on private letter rulings, as you know. This uncertainty has caused great headaches or inconvenience for many practitioners and their clients. Guidance confirming what the letter rulings have concluded would be most helpful."

Unfortunately, the IRS and Treasury Department has not acted on that request. The 2007-2008 IRS Priority Guidance Plan does not list this issue as one of the projects for the upcoming year.

Conclusion: If grantor trust treatment for the entire trust is really important (for example, if various grantor trusts and the grantor are partners or members in an FLP or LLC that is to be treated as a disregarded entity), at least consider this issue in determining whether to use a Crummey withdrawal power.

Items 15-22 are based on a presentation by Jonathan Blattmachr, Mil Hatcher, and David Weinreb, "Selected Comparisons of Selected Estate Tax Reduction Strategies"

15. Terrific Resource Outline

The outline is a terrific summary of best practices for various wealth transfer planning strategies. The discussion includes a Monte Carlo analysis of anticipated numerical results of various strategies.

16. Soft Issues Impacting Willingness to Implement Transfer Planning

Important soft factors include: (a) Grantor's desire to retain control over management of assets; (b) Psychological factor — family golden rule — the person with the gold rules, sometimes referred to as the "King Lear effect"; Will the children continue to phone on Father's Day and Mother's Day if the parent has already transferred huge wealth to the child? (This may be ameliorated by transferring the asset in trust. In some states, the beneficiaries do not have to be notified. A discretionary distribution provision or a power in a third party to transfer trust assets to a charity may keep the children being attentive to parents); (c) Psychological factor — can the parent handle the psychological effect of the children owning far greater wealth than the parent?; (d) Will there be sufficient assets to provide living expenses for the client, even if the "rainy day" occurs. A starting point for any transfer planning strategy is to determine what the grantor needs for living expenses and make sure that is retained.

17. Grantor Trust Has Very Substantial Effect

Transferring assets to a grantor trust as opposed to a nongrantor trust or an outright gift is a huge advantage. Over a long time frame, there is a very significant difference.

18. Advantage of Grantor Trusts-Ability of Grantor to Purchase Low Basis Assets To Get Stepped Up Basis At Death

Jonathan Blattmachr described an actual situation in which a client borrowed money from a bank to purchase low basis assets from the grantor trust. The client died soon thereafter, and resold the assets (now with a stepped-up basis) to the trust and repaid the bank. The loan was outstanding for only 11 days.

19. GRAT Planning Factors

a. Separate GRATs for Separate Assets. This is advantageous because there can be wealth transfer for each separate asset that grows above the §7520 rate. However, the mechanics can be difficult for a large number of separate GRATs. In order to avoid an argument by the IRS that the separate GRATs are really just part of one overall GRAT, Jonathan Blattmachr uses separate trusts with different creation dates, different terms, different remainder beneficiaries, different remainder values, etc.

b. Short-term (two-year) rolling GRATs are highly likely to transfer more wealth than long-term GRATs.

c. For short-term rolling GRATS, the key driver is short-term volatility, not long-term growth. Indeed, the assets may have a zero long-term growth, but substantial value can be transferred if there are significant up years alongside other down years.

d. The economics are substantially better if the GRAT remainder passes to grantor trusts.

e. To facilitate rolling GRATs, Jonathan Blattmachr includes a provision in the GRAT instrument that authorizes the grantor to contribute annuity payments to a new GRAT using the terms of that instrument, so that there is no necessity of signing a new GRAT instrument each year.

f. Rolling GRATs allow the grantor to have more control than a straight gift (because of the ability to decide not to re-GRAT the annuity payments).

g. Jonathan Blattmachr indicates that some persons on the Treasury staff have suggested imposing (legislatively) a minimum 10% value for a GRAT remainder interest. This may be an issue that could arise in the process of overall estate tax reform legislation.

h. GRATs may take longer than a straight gift and payment of gift taxes (with the donor living at least three years) to achieve equivalent transfer tax savings, and GRATs are more complex than straight gifts.

i. The Monte Carlo analysis, taking into consideration historical volatility of assets, reflects that a series of rolling GRATs perform better than installment sales to grantor trusts for transferring value to non-skip persons. A primary reason is that GRATs involve virtually no gratuitous funding, whereas a financial loss in a sale to grantor trust risks the gift that was made to seed the trust prior to the sale.

20. Preferred Freeze Arrangement

Mil Hatcher addressed a transfer planning strategy using a preferred partnership interest.

a. General concept. There are two general types of preferred interests. A "regular preferred interest" is a preferred stock with an annual cumulative net cash flow preference or preferred dividend payments. A "balloon preferred interest" is a liquidation or redemption right to receive a mandatory payment of a "specific amount" at a "specific time." §2701(d); Reg. §25.2701-2(b)(4)(i). The current value of that future payment right may be discounted substantially (as described below), to reflect even higher returns than regular preferred interests (with a cumulative cash flow or dividend preference). One transfer planning alternative would be for the younger generation(s) to own a preferred interest. However, children or grandchildren often do not have investable assets to contribute to an entity to take advantage of these attractive preference returns, and the parent may not be willing to make large gifts of preferred interests. The strategy involves having the grantor make installment sales to a grantor trust of balloon preferred interests.

Advantages: Transfer of the preferred interest mitigates the downside risk of an installment sale to grantor trust because there is a greater likelihood that the asset that is sold to the trust will have long term investment growth that exceeds the interest rate on the note. Also, it increases volatility of the common interests to make a contribution of the common interests to a GRAT more attractive.

b. <u>Valuation of balloon preferred interests</u>. Section 2701 does not provide a safe harbor rate for valuing preferred interests. Generally, a market rate of return is likely to be materially higher than the favorable statutory rate that applies for GRATs or installment sales to grantor trusts. A "regular preferred interest" might be valued at par if it includes an 8% cumulative net cash flow preference. A reasonable discount on a balloon preferred interest that is payable at least 15 years in the future is about 11%, based on September 2007 factors. (A footnote indicates that Jim Brockardt of BCG Valuations gives the following "rough and dirty" means of estimating an appropriate balloon preferred yield:

> "add (1) the yield on a zero coupon U.S. Treasury bond with a comparable maturity and (2) the then-prevailing spreads between U.S. Treasuries and junk bonds, which can be found weekly in *Barron's* The resulting sum is then adjusted upwards to reflect a reasonable lack of marketability discount, which will probably be in the 10% to 20% range. Again, however, an independent appraiser will need to confirm the appropriate discount factor in the particular case."

c. <u>Effect on common interest</u>. The existence of the balloon preferred interest results in a discount and more volatility of the common interest.

> "The allowable discounts for the common interests are likely to be much greater than would be allowable for interests in an entity without a preferred interest, especially if the preferred interest is a balloon preferred interest and if no distributions are permitted with respect to the common interests until the balloon preferred liquidation or redemption preference is paid or is fully covered…If the preferred interest includes a balloon preferred interest, either alone or in conjunction with a regular preferred interest, the allowable discount is likely to be at least 10 percentage points higher (for example, 40% instead of 30%)."

In addition, the leverage of a substantial balloon preferred interest makes the common interests more volatile. This would make a subsequent transfer of the common interest to a GRAT even more attractive.

d. <u>Example.</u> Contribute $15 million to an LLC in return for a balloon preferred interest and a common interest. The balloon preferred interest is a right to receive a mandatory distribution of $32.3 million after 16 years. At an 11% discount rate, that is worth $7.5 million. The common interest would be valued with a 40% discount. (To avoid a possible risk of treating the preferred interest as debt rather than equity, "staple" 5% of the common interest to the balloon preferred interest to make sure that it has a participation in earnings.) The client sells the balloon preferred interest (with the "stapled" 5% common interest) for a 16-year interest only note with an interest rate based on the AFR (about 5% currently). In addition, the client would transfer the 95% balance of the common interests to a rolling GRAT strategy.

e. <u>Arbitrage.</u> Note that there is substantial arbitrage between the roughly 8% yield on a regular preferred interest or the roughly 11% discount on a balloon preferred interest and the roughly 5% interest rate that would be paid (using the AFR) on an installment note to the grantor.

f. <u>Income Tax Issues.</u>

- "[N]o net income will be allocable to the common interests until net income equal to the entirety of the difference between the ultimate balloon payment and the initial capital account balance for the balloon preferred interests is first allocated to the balloon preferred interest."

- A guaranteed payment is a payment for services or the use of capital that is determined without regard to the net income of the partnership. If the preferred interest is treated as a guaranteed payment by the IRS, the income realization to the recipient will be ordinary income with a deduction to the entity. (The downside risk is that when the mandatory payment is made, there would be ordinary income rather than capital gain treatment to the extent that prior allocations of partnership net income had not increased the capital account of the balloon preferred interest to the amount of the mandatory redemption payment.) A regular preferred interest should not be a guaranteed payment, but whether the balloon preferred interest is a guaranteed payment is a closer call. (However, if the ultimate balloon amount substantially exceeds all of the initial capital accounts, it may not be a guaranteed payment because the partnership must realize substantial net income before it could be paid.) At least for planning purposes the balloon preferred payment should probably be considered a guaranteed payment."
- A greater concern is that the preferred interest be treated as an equity interest rather than debt. (If not, the initial capital contribution would be a sale realization event and the OID rules would apply to cause a ratable realization of taxable income with respect to the preferred return without regard to partnership net income.) That is why a 5% common interest is attached to the balloon preferred interest. In addition, if the balloon amount substantially exceeds the initial capital accounts, there is an indication that the preferred interest must share in earnings, suggesting equity treatment.
- When the balloon preferred interest is sold to a grantor trust, there are substantial cash flow risks if the grantor dies before the balloon payment is made. There can be phantom income each year to the trust as net income is allocated first to the balloon preferred interest (to the extent of the difference between the balloon preferred payment amount and the balloon preferred interest's initial capital account), and the trust may have no cash flow to make the income tax payments.

g. <u>Financial results of analysis.</u> The Monte Carlo analysis rather surprisingly reflects that the preferred freeze arrangement did not perform better in down markets than a rolling GRAT approach (which would have been expected.) However, the preferred freeze arrangement did perform better than a straightforward rolling GRAT approach in the top 10% of market results (presumably because the existence of the balloon preferred interest resulted in a higher discount of the common interest that was transferred to rolling GRATs).

h. <u>Not appropriate for short term cash transfer.</u> This approach is not appropriate if there is a desire to transfer cash to the next generation in the short term. With this approach, there may be no cash flow to the junior generation for 16 years or more.

21. Series of Sequential Short-Term Installment Sales to Grantor Trusts Does Not Work

A series of sequential installment sales, with balloon payments in two years, does not make sense. The risk of forfeiting some of or all of the gift exemption used to seed the trust appears too high. Furthermore, changing the investment allocation from 100% equity to 80% equity does not materially help.

22. Self Cancelling Installment Note Valuation Uncertainties

a. Uncertainty about mortality factor. There are various different sets of mortality tables for IRS purposes, including (1) Table 90CM promulgated under §7520, and (2) tables under §72 to value private annuities. On the one hand, it may seem that the more conservative route is to use the Table that produces the largest premium in the interest rate or face amount of the note to reflect the mortality risk. However, that might result in a beneficiary "overpaying" for an asset, creating gift risks for the beneficiary as well creating potential additional §2036 risks for the grantor (if the IRS asserted that the overpayment constitutes evidence of a retained interest.) In *Dallas v. Commissioner,* T.C. Memo. 2006-212, it appears that the IRS relied on the 90CM Table in arriving at its value of the note.

b. Uncertainty about interest discount rate. A related question is what interest rate should be used to determine the actuarial risk premium. An installment sale to a grantor trust typically uses the AFR under §7872. However, private annuities use the §7520 rate. Section 7520 applies for valuing "any annuity, any interest for life or a term of years, or any remainder or reversionary interest." While a sale is not such an interest, GCM 39503 suggests, in some cases, that an installment sale will be treated as a private annuity. Therefore, it is unclear what interest rate should be used. The authors conclude:

> "Both the GCM and Constanza v. Commissioner indicate that unlike a private annuity, a SCIN need not be 'exactly' for equal worth of the property purchased. Hence, perhaps any IRS 'approved' table and rate can be used. It appears that in *Dallas*, however, the discount rate used was in fact the then applicable Section 7872 rate and not the Section 7520 rate. On the other hand, it might worthwhile noting that several 'commercial' actuarial calculation programs use the 90CM Table and the Section 7520 interest rates in doing calculations with respect to SCINs."

Also, footnote 134 concludes that practitioners have anecdotally reported "that IRS actuaries use the AFR and not Section 7520 to determine the discount factor for a SCIN."

Observations From Estate and Gift Tax Committee

23. Section 6166 Lien Requirement for Prior Extensions?

The IRS is requesting comments in light of the *Roski* case for factors to consider in determining whether to require a lien. Notice 2007-90. Also, what if 6166 has already been granted and no lien was provided? The notice asks about what factors to consider for those as well. The IRS might adopt rules allowing it to go back and ask for liens later or else deny further any further §6166 extension. [After the ACTEC 2007 Fall Meeting, the IRS released ILM 200747019, which addresses when the IRS must accept the closely held stock as collateral as well as other issues regarding the lien requirements for §6166 extensions.]

24. Delaware Intentional Non-Grantor (DING) Trust Gift Tax and Grantor Trust Effect

DING trusts are designed to be non-grantor trusts even though the grantor is a potential beneficiary (with the consent of a Distribution Committee that consists of other discretionary beneficiaries and remainder beneficiaries). Non-grantor trust status is achieved by allowing distributions only with the consent of the grantor and an adverse party (i.e., another potential discretionary beneficiary), so that §§674(a) and 677(a)(1) arguably are not invoked. The trust is also designed so that the grantor is not treated as having made a completed gift to the trust (by the grantor's retention of a testamentary limited power of appointment). Is there a gift by the beneficiary if the beneficiary consents to a distribution to the grantor even though there is not a completed gift to the trust in the first place? A series of favorable private rulings have been granted, reasoning that the beneficiaries have substantial adverse interests to each other for purposes of §2514, so they do not possess general powers of appointment and distributions will not be treated as gifts by distribution committee members. A primary reason for using these trusts is for avoiding or minimizing state income tax. Some months ago, the IRS issued a notice asking for comments as to whether its conclusion was correct, or whether it is inconsistent with 1966 and 1967 revenue rulings. Notice 2007-127.

The ABA RPTE Section submitted comments. ACTEC sent a letter approving the RPPT comments. The comments concluded that there should not be a gift by the beneficiary consenting to a distribution to the grantor, in large part because the original transfer to the trust was an incomplete gift. Everyone who submitted comments reached the same conclusion except comments submitted by the NYC and NY State Bar.

The NYC and NY Bars included the following comments. (1) <u>Grantor trust issue</u>. They concluded that trusts described in the ruling WERE actually grantor trusts. The grantor of the trust, with the consent of A, could authorize a distribution to A and the grantor with the consent of B could make a distribution to B. In that respect, A and B were not adverse parties as to possible distributions to themselves. Therefore, there would be a §674(a) power to distribute without the consent of an adverse party, and no exception applies. [Query: Can the grantor be an adverse party as to distributions to A and B respectively (since the grantor is also a discretionary beneficiary), so that no distribution can be made to any particular person without the consent of an adverse party to the distribution?] (2) <u>General power of appointment and gift by beneficiary issue</u>. The Tax Section wanted to take the position that if the original transfer is incomplete for gift purposes, it CANNOT create a general power of appointment in other persons. The effect would be that the grantor and distribution committee would be making gifts simultaneously. Also when the grantor dies, the assets would be in her estate, and distribution committee members would be making gifts because they no longer have control. But the commentators couldn't find a way around it in the statute, and they conclude that this needs to be fixed by statute.

After NY has raised the issue, the IRS may ask for comments on the grantor trust status as well.

25. Patenting of Tax Strategies

The House of Representatives passed a bill that prohibits the patenting of tax strategies. The Senate is considering a bill that does not have that provision. ACTEC just sent a letter urging the Senate to include similar provisions. [A bill has subsequently been introduced in the Senate that also prohibits patenting tax strategies.] Legislative progress has been much quicker than any of us would have guessed several years ago.

How can attorneys protect themselves? One suggestion by a patent lawyer is to say in engagement letters that we will not search for patents when doing planning. However, that does not sound attractive to clients. Perhaps it makes sense for ACTEC to appoint a representative to talk to ALAS about their position of what attorneys should do to protect themselves against patent infringement attacks.

26. FLP Audits; Practical Update of What's Going on in FLP Audits and Litigation Issues

(This discussion was led by John Porter and various attorneys reported their experiences as well.)

a. <u>More intrusive audits</u>. There have been a lot of cutbacks at the IRS. One recent report is that there are 170 agents and 27 supervisors still in estate and gift at the IRS — down significantly from several years ago. While there may be fewer audits, the audits that we do have are being much more intrusive than before.

b. <u>More national coordination</u>. There has been much more national coordination on FLP matters. Agents typically say — "we have talked with someone in National office about this, and…" General Counsel are even being brought into audits, especially if questions arise about privilege.

c. <u>Focus</u>. The focus in FLP audits has been: (1) Valuation and amount of discount; (2) Sections 2036 and 2038; and (3) Indirect gift under Senda. (This is not the old gift on creation argument, but an "integrated transaction-indirect gift of hard assets" argument if gifts or sales are made quickly after the FLP is formed.)

d. <u>IRS appraisals during audits</u>. More and more, agents are getting outside appraisals of FLP interests. That is rather surprising, and it delays the process significantly. A requisition must be approved. Getting an outside appraisal adds six to nine months to the audit process. It has happened several times recently. Sometimes the agents get in house appraisals. That is waste of time. Appeals officers will not give much weight to in house appraisals and if the case goes to court, the IRS will get an outside appraisal.

e. <u>Audit preparation begins at estate planning level</u>. Preparation for the audit begins at the estate planning level. 95% of the documentation that examining agents look for was created before the date of death. Anticipate the potential audience of the IRS and Tax Court judge when sending out correspondence and memos. The <u>Schutt</u> case is one where contemporaneous communications helped a great deal in the audit.

f. <u>IRS seeking same information for gift audits</u>. The IRS is looking at this type of background information in gift tax audits as well. Why, when §2036 does not apply? The old lack of economic substance argument still floats around. Even in gift case cases, if the IRS can find documentation about gift and estate tax discounts, agents use that to try to hammer a better settlement.

g. <u>Privilege</u>. Requests are potentially subject to the attorney-client privilege, attorney work product privilege, and tax practitioner privilege. But despite those privileges, the IRS is clearly trying to get into attorneys files. In every estate tax audit about §2036, the IRS wants communications about the reasons for creating the entity. The attorney must decide whether to assert the attorney client privilege. There is no bright line case of when to waive the privilege. In <u>Schutt</u>, the attorneys decided to waive the privilege and produce documents, and that was helpful to the taxpayer in that case.

The attorney may decide to assert the attorney client privilege at the audit level, but waive if the case goes to court.

In one case, Jay Goldenberg (agent in Orange County — who led the charge for summonses) was trying to get 88 documents. He dropped 80 of them, and went to court over eight of them. They involved communications of accountants and third parties with the lawyers that were necessary to render legal advice, so the summonses were quashed.

Privilege is potentially waived if the information is shared with anyone else. (If so, the client cannot assert the privilege, and must disclose requested information.)

h. <u>Medical records</u>. The IRS is regularly looking for medical records in estate tax audits. Under federal law, there is no doctor-patient privilege. The agent will send a release form which the attorney or client can give to the doctor. John Porter offers to coordinate that with the IRS. He likes to see the document flow. If the IRS does not agree, he calls the doctor's office, and asks the office to send him a copy of anything the doctor sends to the IRS. John wants to know everything the examining agent knows. (If the IRS wants to meet with a doctor, suggest that the doctor respond that he or she wants to meet in a setting where the estate's attorney is also present.)

The IRS is usually accommodating if the attorney wants to be there. John had one case where the examining agent said no. But the IRS Manual does suggest that if the taxpayer wants to be present for third-party interviews, they can be there. In that audit, the agent finally agreed, but stuck the attorneys in two folding chairs at the back away from the interview table.

Can HIPAA be asserted when IRS is requesting medical records? John thinks not — §7602 would likely override that.

i. <u>Discovery is at audit level</u>. Most discovery in FLP cases is at the audit level. It is under oath, so treat it as a deposition. John Porter wants a court recorder (and the taxpayer has to pay for it). Otherwise, the district counsel just takes notes. He had a case where her recollection was different than the witness. She pulled out her notes and said, "Now didn't you say this…"

j. <u>Request agent's written report</u>. At the conclusion of the audit, always request a copy of the examining agent's report. Once the case gets beyond the audit, request to see the agent's file. The IRS is typically accommodating. That allows the attorney to see the examining agent's files (if the attorney can read the agent's handwriting). The conclusions of the examining agent are not really relevant (just the examining agent's report), but they give a roadmap to the IRS thinking process.

k. <u>Burden of Proof</u>. The IRS's determinations in a deficiency notice are presumed correct, but the burden of proof may shift to the IRS with respect to a factual issue relevant to tax liability if the taxpayer introduces credible evidence, has complied with Code requirements to substantiate items, and has maintained records and cooperated with reasonable requests by the IRS. §7491(a). A prerequisite in the legislative history (not in the statute) is that the taxpayer must exhaust administrative remedies. John used to skip appeals and just go straight to the Tax Court. In the *Karmazin* case, the IRS argued that the taxpayer did not exhaust administrative remedies because he did not go to appeals. (The attorney did not go to appeals because the statute had expired on being able to do so.)

John follows up every response to the agent with a written letter. In *Bongard*, John had a big stack of everything he had produced, and it became fundamentally clear that he had cooperated with the agent at the audit level.

Will the IRS argue that the taxpayer did not reasonably cooperate because the attorney asserts the attorney client privilege to avoid producing some of the requested documents? The IRS urged that in *Kohler*, T.C. Memo 2006-152. The court said the taxpayer had a good faith belief that the documents were privileged. When the court determined they were not privileged, the taxpayer promptly turned them over. The court said the taxpayer did reasonably cooperate, and court held that burden of proof did shift to the IRS.

However, John says there are some Tax Court cases that have imposed a negative inference when the taxpayer asserts the attorney-client privilege.

l. IRS document requests. Exhibit 1 attached to John's outline is a typical request. See Item 5A. That is in every audit request that he gets. (For example, it requests any correspondence regarding creation of the entity.)

m. IRS examines prior disbursements and deposits. The IRS will look at every cancelled check of FLP — to see if there have been any distributions to taxpayers. Some attorneys have had this arise with FLPs that have been around for a while. Taxpayers often discard records after seven years. That has caused some problems. If the taxpayer has the burden of proof, how does the taxpayer carry the burden if it can't produce the records? The IRS sometimes asks for an explanation for every deposit, even in long existing FLPs.

n. Evidence to substantiate capital contributions. The IRS wants to see if parents made gifts to kids that are immediately contributed back to the partnership. In the *Schutt* case, that was an issue, but the court said there was no obligation for the family members to do contribute the assets to the FLP.

o. Minutes. There is no obligation for an FLP to keep minutes under state law. However, if a reason for the FLP is to serve as a family investment vehicle, it is good to have regular family meetings to discuss investments and strategy going forward.

p. Good formation facts are essential. Make sure the documentation trail is such that there is a clear paper trail for contributions, proper crediting of capital accounts, and allow some time to proceed before gifts are made. (In *Holman*, the IRS is arguing that there was indirect gift of assets in the partnership where gifts of limited partnership interests were made eight days after the partnership was created.) (Indirect gift on formation — gift of capital contribution.)

q. Affidavit of non-tax reasons. The IRS sometimes asks the attorney to give an affidavit of all non-tax reasons for the FLP. That is clearly privileged, as communications between the taxpayer and attorney. But John would rather produce an affidavit than answer rapid fire questions in an interview.

r. Need to understand boilerplate in documents. The IRS often digs to see if any requirements in the partnership agreement have not been met. Do everything the partnership agreement requires. In some audits, the agents just go through the agreement, and ask if everything has been done.

s. Sometimes easier to settle at audit level. In some cases, it is easier to resolve discount disputes at the audit level than at the appeals level. The IRS national office coordinates FLP settlements at the appeals level. The IRS tries to slot discounts into *McCord/Lappo/Perrachio* line of cases, asserting discounts for marketable securities of 22-37%. Those were three cases decided by only two judges, but Appeals officers say "my hands are tied." Attorneys report experiences with Mary Lou Edelstein bouncing discount agreements reached with appeals officers.

t. Defined value clauses yield better settlements. Attorneys report getting better settlements if the facts include a transfer with a defined value clause. In one case, the taxpayer claimed a 43% discount and got 41% for marketable securities partnership — where there was a defined value clause. IRS did not want to pursue that.

u. Defined value clause with excess value pouring over to Marital Trust. Jonathan Blattmachr uses a general power of appointment trust rather than a QTIP trust for the pour-over receptacle. There is no authorization in the lifetime QTIP regs for a protective QTIP election, so he uses a general power of appointment trust. If the IRS argues that there is excess value that passes to the Marital Trust, then there is no necessity of having made a QTIP election.

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