ACTEC 2008 Annual Meeting Musings

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Introduction

Some of my observations from the 2008 ACTEC Annual Meeting Seminars are summarized below. (The summary does not include any discussions at Committee meetings.) I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the seminars. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. I often have not identified individual speakers who made each of the comments (primarily in case I have misinterpreted any of their comments).

1. Legislation Issues

a. Senate Finance Committee Hearings. There are informal reports that there will be Senate Finance Committee Hearings on the estate tax (including alternatives to the current estate tax regime) in early March and also in April (apparently, April 3). Chairman Baucus has promised vigorous hearings in 2008 with the goal to make changes in the 2009-2010 Congress. Among the witnesses who have been contacted to testify are Professor Joseph Dodge, a professor from Toronto about the Canadian capital gains tax, and another professor about replacing the estate tax with an inheritance tax. We don't expect any of those alternative regimes to be enacted (but we never know). It is likely that the Committee will find that they are complicated and administratively more complex than the current regime.

b. November Elections; Low Enthusiasm Currently for Change in House Ways and Means Committee. Some Senators have exerted more pressure to act this year (in light of possible Republican losses in the November elections that may increase the Democratic majority in the Senate, and possibly even come close to the 60 "magic" number). However, there is no indication that Rep. Rangel or Rep. McCrery with the Ways and Means Committee has the same level of interest. Rep. McCrery (the ranking Republican on the Committee) also announced his retirement and that creates more uncertainty.

Rep. Charles Rangel, Chair of the House Ways and Means Committee, controls the flow of tax legislation in the House. He has shown no intention to change estate tax currently. He told some people privately that the Republican President and Congress passed the 2001 Act. "If it was good enough for Republicans, it's good enough for Democrats, and we'll just let it play out" (resulting in a $1 million exemption and 55% rates in 2011). Most people think that will not happen, but Rangel has never favored changes to the estate tax.

No one expects a major tax bill this year, but just a few minor extenders.

c. Senate Budget Resolution. The 2008 Senate budget resolution, passed in late March, includes an amendment proposed by Senate Finance Committee Chair Baucus that would make the 2009 law permanent, with its $3.5 million exemption and 45% rate. (The amendment passed 99-1. Five other amendments offered regarding the estate and gift tax all failed; the one that came closest to passing was Senator Kyl's amendment providing for a $5 million exemption with rates ranging from 15% to 35%, which was rejected on a 50-50 vote.) However, the budget resolution just establishes a goal and is not law. Nevertheless, this may (or may not) give a glimpse as to where discussions might be heading for future possible estate and gift tax legislation.

2. FLP/LLC and LLC Model Agreement and Checklists, Randy Grove, Jerry Deener, Nancy Hughes, and Jonathan Rikoon

a. Business Planning Committee Project. This has been a project in development over several years from a subcommittee of the Business Planning Committee. The Subcommittee has produced an extensive annotated LLC Model Operating Agreement, together with a variety of very detailed and helpful planning checklists (for FLPs or LLCs), flowcharts of various planning alternatives to avoid §2036(a)(2), and a chart summarizing the 18 FLP cases that have addressed §2036(a)(1). (The Subcommittee came to the conclusion that an LLC is more flexible than an FLP and that an LLC approach is preferable to an FLP approach.)

b. Delaware LLC Structure. The subcommittee recommends a Delaware LLC structure. The extensive LLC Model Operating Agreement form gives explanations and alternative provisions with extensive footnotes. It can be used in a variety of family situations.

c. Make Sure The Shoe Fits. A central theme of this seminar is that an FLP or LLC plan will be a disaster if it does not fit the client situation. Use a family entity only if it fits the assets, objectives, and mindset of the family. Factors for consideration include the following.

    (1) Need for Control. Does the client require keeping control over estate assets? Is the client willing to cede some control to family members? (It is important to cede two powers: 1) Power to distribute; and 2) Power to dissolve the entity. If the client is not willing to give up those, it is not as clear that an FLP or LLC can achieve tax benefits.)

    (2) Willingness to Respect the Entity. The entity must be treated with respect. There should be an investment policy spelled out to all family members. Distributions should only be made pro rata to all partners. Don't even think about looking to the entity as the family pocketbook. If family does not respect the entity, the IRS won't either. (The patriarch may agree in words, but secretly think otherwise. Be sensitive to that.)

    (3) Mechanics. The client must be willing to hire an accountant to keep the books and tax records, an appraiser of any real estate in the partnership, and an appraiser of the value of partnership interests.

    (4) Fees. FLP/LLC planning is not inexpensive when done properly.

d. FLP or LLC? The LLC is more flexible. It has unlimited life. There is full creditor protection without needing a separate entity as the general partner. Single member disregarded entity treatment may be more readily applicable because a manager who is not a member can be allowed.

e. Choice of Jurisdiction. The subcommittee chose Delaware law for several reasons. Delaware has a favorable "user friendly" LLC statute. There are limited statutory restrictions which can result in greater ability to defend against §2704(b) or §2703 arguments. Also, it is helpful that Delaware is a known state in corporate context.

f. Purposes. The agreement lists general purposes. (In addition, a footnote in the Model Agreement provides a wide variety of other specific purposes that may apply in some situations.) It is important that the specific factual circumstances support the purposes.

g. Structure of LLC. The Model provides a Class A Interest with the power to appoint and remove managers, set the compensation for managers, and to vote on all LLC matters. (The Class A interests are the "control" interests in light of their power over the

managers.) Class B units will be able to vote only on "big ticket" items, such as amendment to the LLC Agreement or dissolution.

Sales or gifts will probably be of the Class B units. The parents may wish to keep some of the Class A units, but if the parents die owning all (or a majority) of the Class A units, that will impact the amount of "lack of control" discount.

Having the two classes of units does not create a problem under §2701, because of the proportionate economic rights of the Class A and Class B units.

h. Managers. One or more persons, who need not be members, will be the managers. The managers are subject to an express fiduciary obligation to the LLC and its members. Managers are entitled to reasonable compensation.

If a child of the parent is the manager, the parent may wish to keep the right to vote on successor managers. If the parent keeps a removal power, include a requirement that only persons who are not "related or subordinate" to the parent could be named as successor manager.

i. Funding. It is preferable if children (or other members) can contribute "old and cold" money. A child may not have "old and cold" assets to contribute, and the parents may loan money to the child for that purpose. In the Stone case, the parent loaned money to the child and the child put money into the entity. (However, the child in that case was actively involved in the entity.)

j. Residence. It is a bad idea to transfer the parents' residence to the FLP or LLC. The parents would have to pay full rental value to the partnership. If the partnership later sells the house, it would not be entitled to the personal residence income tax exclusion on gain.

k. Disregarded Entity for Income Tax Purposes? Planning the FLP or LLC as a disregarded entity (owned entirely by one person for income tax purposes) can be very helpful in case improper reporting occurs (because all of the income is reported on one return in any event). One alternative is for just the parents to fund the FLP/LLC and sell or give member units to grantor trusts. Only one parent could be a member and the sole donor to grantor trusts. The other parent could serve as manager or trustee of the trust. (That type of plan can make a lot of sense in a good long term marriage situation.) The LLC could then be treated as a single member LLC disregarded entity.

Advantage: Simplifies tax reporting.

Disadvantage: The client may insist on the children making their own investment. That may look more favorable if the IRS contests the FLP/LLC. Also, it might help with the business purpose exception to §2036 (if there is a §2036 issue). One speaker said that he tends to use the multiple member approach rather than a single member. It is a more typical business approach. Some cases have pointed to a pooling of assets or pooling of efforts that may assist in avoiding §2036. It can assist in providing a non-tax reason for the FLP/LLC — and a reason to motivate the parents to contribute to the entity.

l. Admission of Members. The Model Agreement requires that assignments be in writing and acknowledged by the assignees. Admission requires a vote of the existing members. The agreement describes the consequences of an assignee that is not voted in as a member. There is an exception for a transfer of membership interests to certain related family members and entities.

m. Avoiding § 2036(a)(1). This is largely an operational issue, not a drafting issue. Non pro rata distributions (with disproportionately large distributions to the parent) may reflect an implied agreement for retained enjoyment. The agreement prohibits disproportionate distributions, providing for distributions of "Available Cash". The manager's fiduciary duty to comply with the agreement may be helpful in defending an IRS claim of implied agreement if disproportionate distributions are inadvertently made despite the prohibition in the agreement.

A drafting concern is to "avoid having the senior family member retain unfettered control over the timing and/or amount of cash flow distributions to him or herself." Relinquishing control over cash flow and dissolution is also helpful in avoiding §2036(a)(2) (discussed below).

A chart summarizes the 18 FLP cases that have addressed §2036(a)(1). The chart details 8 factors that have been mentioned in some of the cases. There have only been four victories (Kimbell, Bongard (1/2), Schutt and Stone). The cases suggest both a form and a "smell test" substance approach. In planning, always assume that §2036 may arise. Over time, there have been changes in the formulation of court standards of some of the elements of §2036. Particularly damning factors seem to be transferring almost all assets to the FLP/LLC, making disproportionate distributions, and having no significant nontax purposes. One speaker reached the following summary based on factors listed in the chart:

If the plan violates factor (2) (failing to follow formalities) and/or (3) (making disproportionate distributions contrary to the governing instrument) and if the plan also violates factor (5) (transferring most assets to the FLP/LLC) and/or (6) (no significant non-tax reason; no pooling of significant assets among partners), the case is a loser.

n. Avoiding §2036(a)(2). The primary factors helpful to avoid §2036(a)(2) include the following.

(1) General Fiduciary Duty. The manager should have a general fiduciary duty, together with some circumstances providing a probability that the fiduciary duty will be enforced, such as a meaningful interest owned by a third party or subject to independent oversight.

(2) Economic and Business Realities. Factors include the existence of nontax and economic objectives, particularly if there is a going business or active investment or change from the pre-entity approach.

(3) Distributions and Liquidation. It is very helpful to restrict the donor from making discretionary distributions or participating in the decision to liquidate. Also, the donor should have no voting right to reinstate the donor's right to liquidate by amending the governing instrument. The Model Agreement gives several alternatives for accomplishing this, including having Class A units that hold these powers (or participate in selecting managers), and planning for the donor not to own those units. Alternatively, the agreement could exclude the "Senior Family Member" from voting on these decisions.

o. Parents Insist on Keeping Control. What if the parents just insist on keeping control?

Consider naming an LLC wholly owned by the donor-parent as the manager. Under the terms of that LLC, all decisions will be made by a QTIP Trust for that donor's spouse or by the spouse directly (someone who is not a member). (If QTIP Trust holds that power,

consider giving the donor-partner a removal power over trustee that meets the requirements of Rev. Rul. 95-18.)

Control over distributions and dissolution creates problems. Maybe the client will go for being able to control all other things (investment decisions, etc.).

One speaker described a situation where the client agreed to relinquish control-but when it got around to signing documents, the client would not sign and give control to a third party over distributions.

Even with keeping control, one speaker indicated having moderate success if everything else is done "correctly" (only proportionate distributions, proper bookkeeping, etc.).

p. Annual Exclusion (Hackl Issues). Hackl involved a partnership that would provide no income for many years, so other FLPs/LLCs may be distinguishable from the Hackl case on that basis. The Model Agreement includes a provision giving each member a right to sell, but subject to right of first refusal. The agreement could also give a limited redemption right for a 30 or 60 day period. (This is not an issue if the parent does not intend to make gifts of member units intended to qualify for the annual exclusion.)

q. Communication With Clients. Proceed as though the plan will be scrutinized by the IRS. An article in the January 2008 issue of *Probate & Property* discusses five aspects of privilege. But in planning, just assume it will all be disclosed to the IRS.

r. Get Copies of Income Tax Returns. The planner who is monitoring the operation of the FLP/LLC must get copies of the partnership income tax returns for review. Reviewing the returns can inform the planner of transfers of partnership interests of which the planner was unaware. Also, if the planner is aware of transfers that are not reflected in revised percentages of the interests of the partners on the tax return, the tax returns can be corrected promptly.

3. FLP Planning; Observations About *Rector*

The *Rector* case (by Judge Laro) is a "bad facts" case. It reaches the right result (i.e., inclusion under §2036) but has interesting twists.

a. Partnership Consisting Only of Decedent and Decedent's Revocable Trust. Is it a valid partnership where the decedent and her revocable trust were the only partners initially? Like most cases, the facts were stipulated, and the parties stipulated that the partnership was validly formed, so the court did not reach this interesting issue.

b. Small Discount Does Not Assure Breeze Through Audit. The parties only took a 19% discount. They probably assumed the IRS would never contest it.

c. Key Bad Facts. The key bad facts were that so many assets were transferred to the partnership that there was an assured cash flow shortage. In fact, many living expenses were paid out of the partnership.

d. Why Not Include Bypass Trust As a Partner? The decedent's assets and assets in a revocable trust were contributed to the partnership. There was also a bypass trust and a Marital Trust for the decedent created by the predeceased spouse. If the purpose was management, why didn't they put the assets in the bypass trust into the partnership. One respected speaker said that he does that regularly.

e. Bona Fide Sale Exception. There must be a legitimate and significant nontax reason for the partnership. Judge Laro continues to add the word "business," despite failing to

convince a majority of the Tax Court of the existence of a business purpose test in *Bongard*. There does not have to be a business purpose, but there does need to be a significant nontax reason.

One speaker observes that if a judge starts talking about the exception first, it will probably apply. If judge starts talking about the existence of a retained interest first, the court will say that a retained interest exists and that the bona fide sale exception does not apply either. (The courts often apply the same standard for determining the existence of an implied retained interest and the applicability of the bona fide sale exception.)

f. Age. Judge Laro mentioned, among many other factors in finding an implied agreement of retained enjoyment, the decedent's age and her health when the partnership was created. At what age do we have to tell clients they can no longer set up FLP? Age should have nothing to do with it. But the longer the FLP lasts before the decedent dies, the better.

g. Family Lawsuits Over FLPs. One speaker mentioned being involved in a case where the FLP was created 30 years ago. Children want to terminate and take their pro rata part of the partnership assets. The parents responded by seeking to rescind the partnership because they are not getting the intended tax benefits (because they kept too much control). In effect, the parents want to undo the partnership to keep the children from getting assets.

h. Malpractice Actions Regarding FLPs. Unfortunately, malpractice cases are arising regarding FLPS. Attorneys have been sued for creating an FLP, and other attorneys have been sued for not creating an FLP.

4. Return Preparer Penalties, §6694

a. Reasonable Basis — 20-25% Likelihood of Success. Under §6694, if a preparer discloses an issue, and if there is a "reasonable basis" for the position, no penalty will apply. Prof. Mitchell Gans has indicated that he believes that equates to a 20-25% likelihood of success.

b. Notice 2008-13 Disclosure. Notice 2008-13 provides interim guidance. It makes clear that the final regulations may not be as lenient to preparers. The Notice gives various ways to protect preparers from penalties even when disclosure on a Form 8275 is not made. One of the exceptions applies if there is "substantial authority" for the position (meaning around a 40% likelihood of success) if the preparer advises the taxpayer of the different penalty standard for taxpayers and preparers and contemporaneously documents in the client's files that the advice was given. Professor Gans and Jonathan Blattmachr summarized planning opportunities under Notice 2998-13 in the February 4, 2008 issue of the Daily Tax Report, and included a sample detailed statement and taxpayer and preparer penalties that could be inserted in engagement letters.

c. Notice 2008-13 Reliance On Third Party Information. Another helpful provision in Notice 2008-13 is that a preparer "may rely in good faith without verification" on information supplied by the taxpayer or by third parties. However, the Notice says that the return preparer "also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete." One speaker said he interprets that to mean that a preparer can rely on appraisals without further due

diligence work into the appraisal as long as the preparer reads it and it does not appear incomplete or appear wrong on its face.

d. Notice 2008-13 Addresses Conflict of Interest Between Preparers and Taxpayers. Many of the special exceptions in Notice 2008-13 seemed designed to reduce the conflict of interest between preparers and taxpayers based on the different penalty standards that apply to each.

e. Regulations Are Being Finalized Soon. There are informal indications that the regulation project is proceeding quickly and that regulations may be issued soon.

f. Circular 230 Yet To Be Amended. Circular 230 has not yet been fully amended to conform to the changes to §6694, but it will be.

g. More Than Dollar Penalties At Stake. The basic preparer penalty is increased to the greater of $1,000 or ½ of the preparer's fee with respect to the return. (One speaker pointed out that accountants may begin allocating more of their fee to planning and less to return preparation.) (The $1,000 amount is increased to $5,000 in the case of a willful or reckless understatement.) There is more at stake than just the dollar penalty, however. There will be a mirror provision in Circular 230, §10.34 (which can involve more serious sanctions against the preparer).

h. One Speaker Thinks Concerns Overstated. One speaker expressed the belief that there has been an overreaction to the increased "more likely than not" standard in §6694. He said that careful planners do not take positions on returns that they do not think are correct, and that should satisfy the "more likely than not standard." (He suggests that the *Walton* case is an example of a contrary situation, where the return preparer would have been required to file a Form 8275R to reflect that the return was taking a position contrary to an existing regulation.) He points out that Revenue Procedure 2008-14 describes a number of things that do not require filing a Form 8275.

The speaker indicated that the changes to §6694 this will not change his practice at all. He doesn't file a return where he thinks it is not the correct position, and he thinks that is "more likely than not."

i. Prior Gift Tax Returns. Can the preparer who has not filed previous gift tax returns rely on gifts reported on prior returns without making efforts to determine if there are any unreported gifts that must be reported to be able to file a correct current return? One speaker expressed that the statement in Notice 2008-13 about being able to rely on information supplied by the taxpayer should apply in that context (unless the preparer is on notice specifically that prior returns have not been filed or has been told that no prior returns were filed because the gifts were covered by annual exclusion, but the preparer finds that the trust agreement that received prior gifts does not contain a Crummey clause).

5. Forms and Discussion of Tax and Non Tax Aspects of Trusts, Including Distribution Provisions, Bruce Stone and Susan House

a. Excellent Resource. The forms were collected from various Fellows, and build on the Gallo/Hilker forms project twelve years ago. Even aside from the actual forms, merely reviewing the various subjects covered by the forms provide an excellent checklist of alternatives to discuss with clients in planning trusts.

b. <u>Plain English vs. "Lawyer English"</u>. A balance is required between drafting in a manner easy for clients to understand with being precise. "Imprecision and oversimplification leads to unanswered questions." The draftsman should consider who is the audience for language in a specific provision in a trust — the client? the courts? or the fiduciary?

c. <u>Settlor Intent</u>. Some simple forms merely specify whether the lead beneficiary or remainder beneficiary is favored. A popular provision is to provide guidelines for distributions (beyond just health, education, support and maintenance). There are several longer forms providing a more detailed discussion of the settlor's life philosophy.

One of the forms includes the following topics: Family Statement, Disqualification (of a beneficiary who is "unsalvageable for a life of basic decency"), Alternative Financial Resources, Tax Effects of Distributions and Benefits, Excessive Lifestyle, Education, Health, Support, Special Activities and Events, Matching Funds, Business Ventures, and Distributions to Beneficiaries. That clause states that the trust provides a basic safety net for the beneficiary, but the beneficiary should not expect to have all education and medical expenses paid from the trust.

In preparing an intent clause, consider whose words are used. This is the ideal place to use the settlor's words as much as possible.

d. <u>Revocable Trusts-Distributions for the Benefit of Others During Settlor's Lifetime</u>. One form provides that the trust may permit the trustee to make distributions after the settlor's incompetence to provide for the settlor and the settlor's spouse and dependent children. Various forms are included for gifts. One approach allows the trustee to make distributions directly to a donee consistent with the pattern of gifts made while the settlor was competent. The trustee can go beyond those if the gifts will reduce taxes and are consistent with beneficiary directions at the settlor's death.

Another approach allows gifts only to a specified class of people, with a "5 or 5" safe harbor if that person is also a trustee holding the power to make gifts to himself or herself, but with a direction not to upset the ultimate per stirpes division under the trust.

Yet another approach authorizes the trustee to deliver assets to an agent under a durable power of attorney who requests trust funds for the purpose of making gifts authorized in the power of attorney.

e. <u>Irrevocable Trusts; Grantor Trust Trigger Powers</u>. Forms include a grantor nonfiducicary power to reacquire assets, and a power of a Protector to add charities as beneficiaries. There are several comprehensive clauses granting a number of trigger powers including substitution of assets, additional beneficiaries (by a Protector), borrowing of assets, and payment of insurance premiums, with a provision that allows the termination of any of the powers.

There is concern with using a grantor substitution power in light of the inclusion in the 2007-2008 IRS "business plan" of whether such a clause will result in estate inclusion under §2036. One speaker said that he stopped using grantor nonfiduciary substitution power years ago because of fear of that result at some point (although he thinks that they should work in most cases without estate tax issues).

One of the "power to add beneficiaries" clauses grants the power to a Protector (in a non-fiduciary capacity) rather than being given directly to the Trustee. The concern is that a trust may be hard pressed to exercise the power to add beneficiaries in light of his fiduciary duty to the trust beneficiaries.

The power to relinquish trigger powers is sometimes given to a Protector as well (rather than the trustee). Some have questioned why a trustee would ever relinquish a trigger power if doing so harms the beneficiaries of the trust.

f. Distributions of Tangible Personal Property. An initial concern is how to describe the "stuff" that the settlor wants to be distributed to specific individuals. A simple reference to "tangible personal property" may not accurately reflect the settlor's intent. If there is a list of the types of items included, does the list include what the client really owns?

Interesting aside: No one ever says on their deathbed: "I should have bought more crap."

The importance of making specific bequests of these items is in part to avoid having distributions of these types of items carrying out distributable net income to the beneficiaries.

Issues to address include insurance, packing and shipping expenses and tax allocation. The clause must also address how to allocate assets among beneficiaries. Alternative approaches include specific allocation by the settlor, trustee absolute discretion, a round robin selection process, a private auction, or a lottery approach.

g. Net Income Distribution. Alternatives include a simple distribution direction, granting a beneficiary the right to withdraw income, and the right of the spouse to direct the trustee to convert unproductive assets. For marital deduction qualification purposes, the agreement does not have to mandate the distribution of trust income (from a marital trust). It is sufficient that the income is *available* to the spouse. If this approach is used, the spouse should have a continuing right to withdraw the net accumulated income at any time.

h. Private Unitrust Distribution. Some simple forms are provided as a starting point. One clause provides a unitrust amount to the surviving spouse that is designed to qualify for the marital deduction. (If state law in the settlor's state does not have a statutory unitrust option that permits rates from 3%-5%, which would be recognized under Reg. §1.643(b)-1, the trust should provide that if the trust has net income in excess of the unitrust amount in any year, such excess should be distributed to the spouse annually.)

An alternative approach provides for a fixed payout with unitrust supplement or unitrust cap. (That form was prepared for an ultra-wealthy client who thought that the distribution of all income was "too much" for the surviving spouse. The clause provides for the distributions of monthly installments of a reasonable amount that the client really wants the spouse to receive, and gives the spouse a right to withdraw a 3% unitrust amount (with the withdrawn amount being treated as an advance of any monthly installments due during the rest of that calendar year). Again, that would be permissible only if the state has adopted a statutory unitrust option that is recognized under Reg. §1.643(b)-1.)

A similar alternative approach is to use a §2056(b)(8) trust having the surviving spouse and charity as the only beneficiaries. Independent trustees could be given the power to allocate distributions between the spouse and charity. That arrangement provides for more flexibility than a QTIP. For example, the spouse's discretionary interest could be terminated in the event of remarriage. One planner recently obtained a favorable private letter ruling where a relatively low minimum amount was guaranteed for the surviving spouse.

Very detailed comprehensive unitrust forms with annotations (prepared by Robert Wolf) are attached to the outline.

Practical issues to consider in preparing unitrust distribution provisions include what type of smoothing provision to use, the effects of multiple funding events, what percentage payout to use, and QTIP qualification requirements.

i. Discretionary Distributions. One approach is to give the trustee absolute discretion. Various HEMS (i.e., health, education, maintenance and support) approaches include permitting distributions for HEMS, requiring distributions for HEMS, or allowing HEMS distribution in the absolute discretion of the trustee. Another approach is to authorize a beneficiary-trustee to make distributions within a HEMS standard but to allow an independent trustee to make distributions for the best interests of the beneficiary.

Discretionary distribution clauses may provide guidelines as to what the settlor would expect based on facts known to the settlor at the time the trust is prepared.

The clauses also address whether outside resources may (or shall) be considered. One approach allows the trustee to rely on the beneficiary's oral or written statements as to other financial resources without any duty of inquiry or verification. Several of the clauses provide a number of choices regarding the consideration of outside resources. One form addresses the trustee's duty to inquire into the beneficiary's resources, but does not require that the trustee get income tax returns or financial statements from the beneficiaries.

Other miscellaneous clauses include coordination with the beneficiary's guardian, maintaining the settlor and spouse at home, and "welfare" or "best interests" distributions (with extended discussions of what those standards would include, such as expressing a philosophy that the settlor wants the beneficiary to lead a productive life).

If distributions are permitted to others than the beneficiary-trustee, require the use of a reasonably definite standard by the beneficiary-trustee. Also, be wary of satisfying a beneficiary-trustee's support obligation. The HEMS standard exception in §2041 only covers payments directly to the trustee.

It is not clear whether an "absolute discretion for HEMS" standard is within the §2041 exception.

The trust may allow discretionary terminating distributions upon reaching specified ages. Various forms provide for discretionary terminating distributions at various ages rather than mandated distributions at those ages.

j. Incentive Clauses. These types of clauses are not commonly used any more. There have been many examples of horrible things that may go wrong (such as when the real estate developer gets all of the trust and the other child who is a medical researcher with relatively low income gets little from the trust). The preferred approach is to give the trustee broad discretion with some general guidelines.

One form has a matching funds clause, but it does not provide for income matching. Instead, it describes a general concept of making adjustments such as increasing the income level of a researcher to that of a private practice doctor.

k. Disincentive Clauses. One approach is a straightforward clause dealing with substance abuse concerns. Alternatively, there is long detailed substance abuse provision that one of

the speakers drafted with help of a doctor who deals with substance abuse. It also addresses gambling and incarceration. (If a beneficiary is incarcerated, it is not a good idea to make big distributions — for fear of what will happen to the beneficiary if jail mates find out he or she has a lot of money.)

l. Continuing Access to Family. A clause may provide for travel expenses for the beneficiary to visit other specified family members.

m. Delayed Distribution Clauses. Various clauses (a short, medium, and long version) allow the trustee to delay otherwise required distributions. Important issues are the criteria for delay, who determines the need for delay, and the length of delay.

n. Trust Protectors. Possible powers of trust protectors include a veto power over investments, removal and replacement of trustees, and powers over tax sensitive issues. It is interesting that West coast lawyers rarely use trust protectors, but they are often used on the East coast. The clause must address whether the protector acts as a fiduciary. The preferred approach is that someone be responsible for every decision for the trust, and if only the protector has responsibility for certain actions, the protector should act in a fiduciary capacity as to those activities. There may be a desire to shift responsibility from the trustee, but what if no one is responsible? When is the protector really the trustee? "Can there be a rose garden with no roses at all?"

o. Directed Trust. The trustee is typically exonerated for following directions of specified persons as to specific activities. Alternative forms provide for a committee, specified individuals, a family council, or family advisors to give directions.

(A proposed directed trustee statute [written by Bruce Stone and Diana Zeydel] is being considered in Florida. It adopts the UTC provision — the trustee does not have to follow directions unless doing so results in a serious breach of trustee duty. That approach may provide little comfort to the trustee, but the Florida proposed statute permits a trustee to provide for a co-trustee who can do certain things excluding other trustees who must follow directions and will be exonerated from liability. Under that approach, there is another person who is fully accountable.)

p. Decanting. A form allows independent trustees to make distributions to another trust for the same beneficiary.

q. HEET Trust. A sample clause is included for a simple trust provision for charity and a GST exempt health and education trust (sometimes referred to as a HEET). (The form survived an IRS audit. It provides for distribution of all income annually to a foundation and gives the trustee discretion to distribute principal for the foundation or for the health and education of descendants.)

r. Supplemental Needs Trust. A New York clause and a non-state specific clause is included.

s. Investment Clauses Directly Bearing on Distributions.

(1) Residences. There are several alternatives for holding personal residences and directing how the residence can be used be specified beneficiaries. There is a very detailed clause providing continued use of a residence by a companion — operating much like a lease with options.

(2) Closely Held Businesses. Various detailed clauses are included. The clauses address the extent of protection of the trustee for retaining the closely held company interest. (There is concern after the *Dumont* case, however, whether the

duty to act prudently may override the waiver of the duty to diversify. The law of some states [such as Delaware] may more clearly recognize the validity of such directions than in other states.)

(3) Agricultural Property. It is important for the draftsman to have a working knowledge of the issues associated with agricultural property (or other special assets).

(4) Total Return Management Philosophy.

t. Pet Trusts. The selection of the trustee or recipient of the gift (to be used to take care of the pet) is crucial. Watch for state law limitations.

u. Defining Beneficiaries. Typically spouses of beneficiaries are not included. If the trust does make provisions for spouses, carefully define who a spouse is. For example, if a divorce is pending, the spouse is typically no longer included.

v. The New Biology. There are several alternatives, dealing with adoption out of wedlock and posthumously conceived children. Issues include whether a posthumously child can obtains benefits as a beneficiary of the genetic parent's trust, or as a beneficiary of trusts created by persons other than the genetic parent.

6. Preventing Malpractice Claims in an Estate Planning and Administration Practice, Dom Campisi, Aurora Cassirer, Dan Smith, and Pamela Bresnahan

a. Types of Potential Claims. Malpractice plaintiffs often proceed under five or six causes of action, including:

- malpractice for failing to implement the intent of the testator/settlor;
- malpractice to failure to meet technical requirements (such as a missing Crummey power, failure to make tax elections, and claims that the attorney failed to detect lack of capacity or undue influence);
- conflicts of interest;
- failure to disclose;
- breach of fiduciary duty;
- aiding and abetting a breach of fiduciary duty.

b. Failure to Disclose and Aiding and Abetting Breach of Fiduciary Duty. An example of this type of claim is *In re John Hanes, Jr.* (E.D. Va. Bankruptcy 1999). This involved post mortem planning for a family. Two sons restructured the family assets, using an FLP to borrow funds using estate assets as collateral to invest in various business ventures. Eventually, bankruptcy ensued. The attorney was sued for breach of fiduciary duty, and judgment was entered against the law firm for failure to disclose and aiding and abetting a breach of fiduciary duty. The court reasoned that giving advice just to one son and expecting him to pass the advice on the other family members is under the required standard of care. There was a $9 million judgment against the law firm.

Schrock v. Markley et al., 142 P.3d 1062, (Or. 2006) said that "to hold a lawyer liable for substantially assisting in a client's breach of fiduciary duty, the third party must prove that the lawyer acted outside of the lawyer-client relationship." The opinion cited other cases pointing out that the lawyer must render "substantial assistance" to the breach of duty, not merely to the person committing the breach, and that the lawyer knew of the breach and actively participated in it.

c. Malpractice Insurance Coverage Questions.

(1) Going Naked. One speaker represented an attorney who had been sued who did not have any liability insurance, figuring that "if I do not have a policy, no one will sue me." Indeed, the plaintiff in the case eventually moved on to the next target. But the speaker strongly recommends against that plan. The attorney in that case had many sleepless nights. (Other malpractice plaintiff's attorneys view the failure to maintain malpractice insurance an act of bad faith and will not drop the defendants in such cases as a matter of principle.)

(2) Notice to Carrier. Whenever the attorney is put on notice of a possible claim, give notice to the insurance carrier as soon as possible. When an attorney gets a letter from a client saying that the client is unhappy and wants to meet to discuss claims, the attorney must notify the carrier immediately, even though he or she may never get sued. Otherwise the attorney runs the risk of not having coverage. Notify everyone (if there are multiple policies). If the attorney has an umbrella policy, notify that carrier also.

(3) Reservation of Rights. When an attorney is sued, the insurance company often will send back a letter saying that they will defend, but maintain that there is not coverage of liability under various defenses. "We will defend you under a reservation of rights." For example, if there are claims of aiding and abetting, intentional torts, punitive damages, etc., they are often not covered. Typically, the carrier will settle under the covered portion of the policy — typically negligence.

(4) Coverage For Serving as Fiduciary. If at least a portion of the fiduciary fees are paid to the attorney's firm, there is typically coverage under the firm's malpractice policy. Fiduciary riders assure that the policy covers claims for services as a fiduciary.

(5) Director Liability. If the attorney serves as a board member, make sure the company has a D&O policy. For closely held corporations, it is not particularly expensive.

(6) Claims Made Policies. The policy covers claims made during the period of coverage. Most policies are claims made policies. This creates a problem for attorneys moving to new firms, particularly if the old firm goes out of business. If a claim is made against an attorney who is in a new firm, the old firm will typically also be sued and they will have their own coverage. If the old firm is out of business, and if the attorney does not have a policy, the attorney is then naked. The speaker recommends tail coverage in that situation.

(7) Retiring Attorneys. If an attorney retires from the practice of law but wants to dabble, there may still be coverage. Most policies say that a retired attorney is still covered up to 50 hours a month. So the policy of the attorney's prior firm may cover the retired attorney.

d. Arbitration Clauses. Speakers differed on arbitration clauses. One speaker (who does a lot of defense work) clearly does not like arbitration clauses. They are not less expensive. Most arbitrators run panels as a business. Electronic discovery is very expensive. Generally, there is no right to appeal (although the clause can be drafted to permit a right to appeal). Clients end up spending millions in arbitration, and will be stuck with what the panel decides.

Another speaker feels a little different. Arbitration cases originally were often one day discussions and one line opinion. They are now a long drawn out process. However, the speaker prefers arbitration in a high profile case where a client prefers not to be in the newspapers on a daily basis during a long trial.

Another advantage of arbitration clauses is the ability to get an arbitrator who has experience in the subject matter. Even in a very complex case, a probate judge may not permit a 20 day trial and may have no experience with the issue. In such a case, the existence of an arbitration clause may give leverage to settle the case. (An arbitration clause can be crafted to limit the panel to experts in the field.)

Arbitration clauses in engagement agreements are enforceable in a number of states. <u>E.g.</u>, *Larson v. Speetjens*, __ F. Supp.2d __, 2006 WL 2567873 (N.D. Cal. 2006). Put the arbitration clause in bold print. The engagement letter should say in bold print that the client can get other counsel to review the engagement letter.

e. <u>Jury Waivers</u>. Speakers generally do not favor jury waivers. If there is a bench trial, the judge will often deny pre-trial motions to limit evidence or issues, reasoning that he or she "will settle it all out later." The trial ends up being about a broader number of issues. One speaker prefers to wait to waive a jury until after getting past pre-trial motions.

f. <u>Engagement Letters; Assess Potential Malpractice Risk</u>. The process of accepting a new client must include an assessment of the potential for a future malpractice action. Estate planning attorneys, tax attorneys and corporate attorneys are problem solvers. They think they can work problems if they can get everyone in a room. At some point, self preservation needs to kick in and the attorney needs to assess whether to "spin off" clients to another firm for certain activities.

Will the client turn out to be a "wacko?" Is there a conflict between a beneficiary and the testator. Are there conflicts among beneficiaries? Is the client favoring one beneficiary over another? Those are all situations that have a higher potential for a future malpractice action.

Assess what kind of retainer agreement is needed?

In drafting engagement letters, be very specific. Don't use plural if the agreement really means the singular. Don't say "us" if "me" is really intended. Don't just refer to general estate planning services. That will become interpreted as being very broad. The attorney will be presumed to be an expert in all things that might potentially be covered.

g. <u>Make Totally Clear Who Is Being Represented</u>. Clearly define who the client is. That is critical. In 75% of the malpractice cases, it is not the client who is suing (but, for example, a beneficiary). If a person *thinks* you're his or her lawyer, they will get past pre-trial motions.

During the representation, constantly ask yourself, who is my client here? That's not always easy. We also have to ask — in what capacity is this person my client? (Personal or fiduciary). Constantly consider "Can I show that everyone in this room understands who I represent and who I do not?" If that is clear in writing at the outset, they cannot come back later and claim something different.

One way to make sure that people know they are not your clients is to send a simple "I am not your lawyer" letter. "Dear B: I represent A and I do not represent you. If you want someone to look out for your interest, you need to hire a lawyer."

That is especially important in a family representation matter. A client's son and daughter may also become clients as to certain matter (i.e., their personal estate planning), but not as to the estate planning for mom and dad. If mom and dad want to disinherit the son, the attorney wants to be clear that the attorney owes no duty to son as to that matter (even though the attorney represents son on other matters).

Once you tell someone they are not your client, don't treat them as if they are. Don't give them free legal advice. If the son calls about dad's will, tell him to call dad.

If mom pays you to do estate planning for son, the attorney still must remember who the client is. Don't communicate with mom about it.

h. Conflicts of Interest.

(1) Very Damaging to the Case. Conflicts of interest claims are especially deadly claims. One plaintiff's attorney told a speaker: "I just love conflicts. I don't care about proximate cause and damages, I just need to see the guy sitting there with a conflict. It is just jury heaven for me. When a client comes in, I look first for conflict. A conflict puts the defendant in jury hell."

The public actually hold lawyers in high regard, but gets very upset if it sees a conflict of interest.

(2) Punitive Damages. The existence of a conflict of interest often opens up the possibility of punitive damages.

(3) Conflict Waiver. Any conflict waiver must be in writing. "An oral waiver is not worth the paper it is not printed on." The client legitimately will forget what was said orally. The waiver must be in writing and signed by the client. Think: "Will I be able to show 17 yrs from now that I disclosed this conflict?"

(4) Vet the Waiver With Someone Else. Vet the conflict waiver with the expert in the firm who is experienced in that. The attorney being engaged lacks experience and objectivity. The third party may say, "you can do this, but maybe you shouldn't."

(5) Don't Invest With Clients. Don't invest with clients. Doing so moves the attorney from being someone who has a privilege to someone who is a deep pocket.

i. Joint Representation. Attorneys deal with this all the time. At the outset of the representation, put in writing what the conflicts are. The attorney must disclose the risks of joint representation, and the attorney must get informed consent notwithstanding those risks. For any joint representation, the attorney must address how to handle confidential information. One speaker thinks the only way to handle that is with a "no secrets with anyone" policy. As a practical matter, it is not possible to keep secrets in different parts of the brain.

What is the exit strategy if a conflict arises later? For example: "If a conflict later arises, I am out, and all of our privileged conversations may lose privilege." Alternatively, the agreement could say that if a conflict later appears, the attorney will continue to represent just A and can use confidential information from B against B. That is not enforceable in all states, but it is in some states.

j. Poor Economic Times: Suing to Recover Attorney's Fees. The statistics show that 85% of fee cases result in a counterclaim. A standard folklore is not to sue for a fee unless the fee is at least four times the malpractice policy deductible. Often, fee disputes arise because the client is angered for other reasons and does not pay.

Before filing a fee case, someone else should review the bills and make a determination if the full amounts are collectable. For example, every single act that a first year attorney puts on the bill may not be appropriate for the client to pay. Bill entries are often not supervised. There must be a balance between explaining work and listing things that people won't pay for. Scrutinize not only associates' work, but how they describe their work.

Disgorgement of fees is not covered under malpractice policies.

k. Ethical Breaches. In a malpractice case, experts can testify about a breach of an ethical rule. That is typically allowed in evidence, and it is damaging testimony to the jury. So be very careful about conflicts, over billing, not representing zealously, and not making proper disclosures. All of those can be breaches of ethics rules. In many states, that raises a presumption of negligence.

l. Statute of Limitations. A statute of limitations defense has two components. 1) Discovery rule in most jurisdictions — the client knew or should have known that the negligence injury or act occurred. 2) Continuous representation rule — the statute of limitations does not start to run if the representation has not been completed.

Put the scope of services in the retainer letter. When a particular service is completed the statute of limitations can start to run on that particular service.

m. Termination Letter. For example: "We have finished this assignment. Here's your will. We will not do anything more on this until you contact us." In a big firm, the letter may say, "our policy is that we can't do any more for you until we have a new engagement letter setting out the scope of the new engagement." That means that the statute of limitations will start to run. Also, it converts the client to a former client, so it solves the problem of not being able to be adverse to a current client.

n. Causation. Lack of causation is a common defense. There may have been a mistake (or a conflict of interest), but that did not cause the damage. The courts have applied two different tests: a) "Substantial factor" test — it is easier for a plaintiff to get past that test; or B) "But for" test — the injury would not have happened but for the negligence. Whenever there are multiple representations or third party beneficiary issues, consider the causation defense. BUT juries don't care about causation. A much stronger argument is that the engagement letter is clear on scope of the representation and the asserted actions are outside that scope of representation.

o. Defense to Failure to Identify Lack of Capacity Claim; Witness; Videotape. Under ethics rules, an attorney cannot represent a client to sign a will if the client lacks capacity. If the attorney has some question about capacity but believes the client understands salient facts, do the instrument and keep a good record. A witness (from the office or a family member who is not interested or a caregiver) or videotape can be very helpful in establishing that the client understood what was being done. Most cases that have ruled on the issue have said lawyers do not have to preserve evidence of capacity.

Beware of problems with videotaping will signings. Videotape is often used to attack attorneys. Older people have foibles and don't look good on videotape. When a witness signs the form that the testator was competent, the witness will not remember that the testator stammered. That appears on videotape.

It is not possible to stop the videotape. For example: "My nephew…" The testator couldn't remember his name for four minutes. It looked terrible (even though everyone draws a blank on names from time to time).

But videotape sometimes can be useful. Video works great for a person who is very articulate and can explain why they are disinheriting someone. One speaker had a case where the testator stared at the camera and said "I'm disinheriting Jimmy because he is evil." The speaker got the judge to issue an injunction to prevent the evil son from suing the lawyers and the good brother. The videotape was very helpful.

Another speaker has used home videos to get rid of a lawsuit very early. Mom says very clearly on a home video that she is giving the estate to one son. The family saw what she really wanted and dropped the lawsuit.

p. Holding Client's Documents. Does continuing to hold the client's documents constitute continuing representation of the client? The speakers are not aware of any cases saying that. But in one reported case, the court included the fact that the attorney held 35 boxes of the client's information as one of the factors in determining that the former client was in fact a current client and that the attorney could not take an unrelated case that was adverse to that client. Mere possession of a client's will not be enough, but it may be a factor that is considered with other factors.

q. Newsletters. Do not begin a marketing newsletter with "Dear Client…" That might be used to bolster an argument of continued representation. The fact that newsletters have been sent to another state is sometimes used to get jurisdiction in that other state.

r. Words of Wisdom.

"If you have enough work to do, don't overwork. When you have too much work, something gets neglected."

"People sit in judgment under a higher standard than they operate under in their every day experiences."

7. Donors Restrictions on Charitable Giving, Turney Berry, Ed Beckwith, and Carolyn Clark

a. Basic Underlying Tension. Charities want total flexibility to use assets as needed over time. Donors sometimes want to direct the use of their funds. Tension arises. There is policy tension as well: the policy conflict of allowing donors to direct charitable funds vs. the public policy of allowing the use of charitable funds to be flexible and shift as society's needs change.

b. Gift Policy Statement. An attachment to the outline is the Gift Policy Statement from the University of Vermont. All charities should have this kind of policy. It describes the kinds of property the charity will accept and the kinds of restrictions it might accept. The key is that the charity should determine what types of restrictions are within their mission and are acceptable and those that are not — and gifts with unacceptable restrictions should be turned down. Having the policy causes the university to carefully consider any proposed restricted gifts under a formal process for review.

c. How Do Restricted Gifts Arise?

(1) Written Agreement. There may be a written agreement between the donor and charity. If gift is over $10,000 with any restrictions, there should be a written gift agreement — one writing that describes the intent of all the parties.

(2) Actions by the Charity. Legal restrictions can arise from solicitation materials. For example, a museum wants to buy a certain painting that will cost $5 million and conducts a fundraising campaign. What if only $3 million is raised? Or $10 million? Solicitation materials should clarify if the donations are restricted and can only be used for that purpose. Campaign materials may give the donor the option for the charity to keep the money if it does not raise enough or if it raises too much.

Another example is of American Red Cross fundraising after 9/11. The Red Cross raised money to help victims of 9/11, but the website said the purpose was to raise money not only for the specific disaster but to raise funds for future disasters. However, that was not made clear to the public. The public perception was that the funds were being raised only for victims of 9/11. When the more general purpose was realized, some attorney generals thought the public was being cheated. The Red Cross raised over $1 billion, so they said that was too much money for the particular cause. Due to public outcry, the Red Cross caved in and agreed to use all the money for 9/11 victims. Now, the Red Cross is having problems because there are no reserves for future disasters. The Red Cross will make clear in all future fundraising campaigns that it is raising money for the particular disaster and retains the ability to maintain a reserve for future disasters.

(3) Resolution by Charity's Board. In *Authors Club v. Kirtland*, the board passed a resolution that funds would be used for a particular purpose. Based on that, the donor gave more to the fund. The court held that the fund was restricted. However, *Leftowitz v. Cornell University* illustrates that a simple board resolution that becomes known will not permanently restrict a fund. Generally, restrictions will not be implied.

(4) Public Relations May be More Important Than Legal Niceties. From a charity's standpoint, public relations and community view are more important than the legal niceties. One speaker told of a situation where a charity wanted to tear down a building that had been named for a donor. The attorney advised the charity that the restriction could reasonably be interpreted to last only as long as the building lasts, even if the agreement said "in perpetuity." The charity's response was: "Counsel, that is an interesting analysis, but if I take the donor's name off this building, I will not raise another dime in this community, because no one will believe me."

d. Construction of the Gift: Is There a Restriction and If So What Does It Really Mean; *Robertson v. Princeton*? Sometimes the gift arises after a donor's death when there is no ability to negotiate the terms of the gift, and an issue arises as to whether the gift actually imposes an enforceable restriction. The general rule is that restrictions will not be implied. Courts generally favor flexibility for the charity and construes limitations as precatory desires but not legal restrictions.

An example of how problems can arise from the meaning of a restriction is the *Robertson v. Princeton* case. In the 60s, the donor gave $35 million to a fund at Princeton to support funding of education of graduate students to be trained for government service, especially in internal relations, by funding a School at Princeton. The board of that fund is controlled by Princeton, but it has Robertson family members on it. The arrangement worked while the older generation was alive. The situation began to fray when children

came onto the board. It appears that the communication is not the same as when the donor was alive. The parties just aren't talking to each other the way that the donor and Princeton did. There was been a deep dispute over the fund that has now grown enormously, and the case is scheduled for trial in October.

One of the basic issues is the construction of the restriction. Was the money to fund the education of students in government service or was the purpose to fund the Woodrow Wilson School at Princeton to train people for public service? It is a very simple dispute when you reduce it to that. But one gets the sense that the problems have been exacerbated because there has not been the same communication with the next generation as there was at the beginning.

e. Standing to Enforce the Restriction. The law differs from state to state. (Cy pres and standing rules are very state oriented.) Uniform Laws are now exhibiting a trend to change the traditional rule.

The general rule has been that the state attorney general can enforce restrictions, as well as co-trustees and beneficiaries with a special interest. Amazingly, there is no consensus as to whether the donor has standing to enforce restrictions. A 1997 Connecticut case (*Herzog Foundation*) held that the donor did not have standing. Uniform Acts responded to the *Herzog* case. For example, the Uniform Trust Code grants a donor standing to enforce a charitable trust. Speakers indicated that this change is good; there is no reason that the donor should not have standing to sue to enforce restrictions.

Every gift agreement should reserve standing for the donor and his or her successors. There may be a question as to whether that is legally effective. In the *Barnes* case (involving a Pennsylvania non profit entity with many restrictions in the bylaws and governing documents), the donor restricted a gift in accordance with the documents, and purported to give standing to any citizen who brought a legitimate case that the foundation was not abiding by all of the restrictions. The court said that standing is more jurisdictional in nature and cannot be conferred by agreement or in the trust. Nevertheless, put it in the agreement. (It may at least be a waiver by the charity to object to standing.)

f. Cy Pres and Deviation to Relax or Remove Restrictions. The New York statutory law allows the charity to ask a court to release restrictions if the circumstances have so changed as to render impractical or impossible the accomplishment of the charitable purpose. That is a standard application of the cy pres rule.

Be very careful in advising a charity considering going to court to remove or change a restriction. Make sure there is a very persuasive case. There is a risk that the charity may prove that circumstances have not so changed, but just that the particular charity cannot do it. The court has the authority to give the funds to another charity that can accomplish the stated purpose. (An example of that is *In re Estate of Buck,* in which the Community Foundation lost a $400 million fund.)

The standard is changing. *In re Estate of Buck* involved a gift to provide for care of the poor and needy in Marin County, California (one of the wealthiest counties in the country). The fund was worth $350 million when the decedent died and grew to $400 million. The foundation argued that the change of circumstances requiring a change in the restriction was the increase in value. The foundation lost the cy pres case, because it could not show that it was impractical or impossible to use the funds for the stated use. The

issue was really that the use of the funds for that purpose in Marin County was wasteful and inefficient. As a result of that case, articulations in the Restatement and UPMIFA change the standard for cy pres and articulates the test as whether it is "impossible, impractical, inexpedient, or wasteful" to apply all or any part of the fund." (If the Uniform Act had been in effect, the result in *Buck* may have been different.)

g. Charity Prefers Gift Agreement With Restrictions to Come From Donor; Enforceable Pledges. One speaker prefers on behalf of charities that the gift agreement come from the donor to the charity and not vice versa. 1) If it becomes necessary to construe the agreement, it will be construed against the drafter. 2) The charity often wants the contribution promises to be enforceable pledges. The easiest way to make it a binding pledge is to be signed by the donor.

   Sometimes, it is not appropriate for the agreement to provide a binding pledge. For example, a donor advised fund or private foundation is not allowed to use funds to satisfy a disqualified person's binding pledge. (In that situation, a typical way of addressing the issue is for the gift agreement to say "I or my private foundation or donor advised fund will collectively give…") The charity's gift policy and acceptance form should acknowledge that donations will come from various sources. They will want to facilitate gifts from private foundations or donor advised funds. The charity should not insist on having binding pledges if that constrains getting donations.

h. Choice of Law. A charity understandably does not want to have to learn the law of 50 states. It is often reasonable to negotiate to apply the law of the donor's state, but the charity will have to hire an attorney in that state to review the agreement. (State law varies widely on all of these issues regarding gift agreements.)

i. Insist on One Agreement. The charity will want to insist on one written agreement that contains all aspects of the agreement, so that informal statements of charity employees cannot be used later to impose restrictions.

j. Excess Funds: Charity Will Want Flexibility. What if the fund greatly increases or decreases? The charity will want language allowing flexibility to use excess funds for related or similar purposes or if using the funds for the stated purpose becomes impossible (e.g., there are not enough students who want to be interns in the program for the specified limited purpose).

k. If Problems Arise, It is Often Years Later. The cases often arise years after the gift is made, even after the donor generation is gone.

l. Who Is the Donor Trying to Benefit; Should a Separate Foundation Be Used? If the donor primarily wants to benefit the charity, the donor should be willing to provide flexibility. However, if the primary purpose is not to benefit the charity but to further a certain cause, perhaps the donor would be better off creating his or her own foundation to support that cause.

m. Trend Away From Long Perpetual Funds. The current trend of thinking among large philanthropists is not to have long perpetual funds. (For example, the Gates Foundation and Warren Buffet do not have perpetual funds.) A very large recent foundation was designed to last for only one generation after the donor's death. Who's to say in 25 years how the restriction will be interpreted? The trend is to accelerate the philanthropy to do some good currently. The best advice to the donor may be not to worry about 75 years or

even 25 years from now. Go on with what you want to provide — and spend it over a reasonable period of time.

There is some thought that the future trend of the laws may be to say that as time goes on, it makes less sense to enforce restrictions literally.

n. Advisory Committee. How can the donor be assured that the Advisory Committee will represent his or her views years into the future? Having an Advisory Committee is fine from the charity's standpoint, as long as its purpose is just to advise. Be careful about obligating the charity to pay the expenses (travel expenses) of the Advisory Committee. Be very careful about providing any benefits back to the donor or the donor's family or an Advisory Committee.

o. Direct and Indirect Expenses; Endowment Fund. The gift agreement should address how direct and indirect expenses of carrying out the restriction will be provided. If there is a gift of tangible personal property, make sure the donor is creating a sustainable model. If there is not enough money to go around, the charitable purpose will not be workable, so courts and civic leaders will try to mess with the charitable purpose. Endowment of cash is a very important aspect that many donors ignore.

If an endowment fund is provided, be aware that UPMIFA has removed the requirement that the fund must maintain the historic dollar value. As an aside, in poor economic times, a number of institutions have not maintained historic dollar value of their endowment funds. A gift in July, 2007 is probably underwater at this time. Are institutions revising their spending rate as a result? Many probably are not.

p. Enforcing the Restriction. The gift agreement should address how the restriction will be enforced. The agreement may provide that if the charity is not abiding by the restrictions, someone has the ability to take the funds away from the charity and transfer them to another charity. From a charity's standpoint, giving that power to an Advisory Committee is problematic. As discussed above, the agreement should at least purport to give court standing to whoever is designated to be able to enforce the restriction.

q. Summary.

(1) Be clear on how, when, and how much is contributed and if it is an enforceable pledge.

(2) Identify if the gift will be a component part of the charity or a separate entity.

(3) Verify that the restriction is consistent with the mission of the charity.

(4) Nothing is forever. Civilization moves on and evolves. Try to be as flexible as possible.

(5) If the donor wants the restriction to be enforced, build in a variance power that is clear. Be clear on standing to enforce the restriction.

(6) Be clear when the triggering event will occur.

8. Investment Planning in Estate Planning, Donna Barwick, Ralph Heckert, Jeffrey Call

NOTE: As stated at the beginning of this summary, I have not attempted to verify the information in this summary. It is particularly important to understand that Bessemer Trust has made no attempt to verify the summaries reached in this section.

a. <u>The Cycle of Market Emotions</u>. Optimism, excitement, thrill, euphoria [point of maximum financial risk], anxiety, denial, fear, desperation, panic, capitulation, despondency [point of maximum financial opportunity], depression, hope, relief, optimism.

b. <u>Long Term Outlook</u>. A key to successful investing is having a long term outlook and appropriate asset allocation over the long term. There is much truth in the cartoon: "We're expecting stocks to rally but we don't know which ones or when."

Warren Buffet: "Successful investing is about capturing the long term return the market is trying to give you while ignoring the short term noise along the way."

Warren Buffet: "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight or inside information. What's needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework."

c. <u>Hedge Funds Proliferation</u>. 50% of the stock market volume daily is from the hedge funds.

d. <u>Key Factors to Successful Investing</u>. What really counts in investing? Asset allocation, controlling fees and taxes, controlling volatility.

e. <u>Importance of Asset Allocation</u>. A study written in 1986 says that 90-92% of the return comes from asset allocation — not timing, selection of managers (very humbling for managers), not security selection, or other factors. "Determinants of Portfolio Performance," Grinson, Hood & Beebower, <u>Financial Analysts Journal</u>, July-August 1986.

f. <u>Allocation to Stocks, Domestic and Foreign</u>. The key to stock returns is return over a long period of time. One year returns are up and down. However, the five-year annualized returns for the 75 five-year periods from 1926-2006 are gains except for only 10 periods. The 15-year returns are positive for all of the 65 15-year periods in that time span.

Adding non-US stocks increases returns and reduces risk level. But increasingly, markets are not as decoupled as they were 20 years ago. In 1970, the U.S. stock market was 68.0% of the global stock capitalization. At the end of 2006, U.S. stock market was 36%.

How much should be allocated to foreign stocks? Some managers recommend having 25-30% total exposure to foreign stocks, but that includes foreign exposure through domestic portfolios (which can be substantial). For example, "ADRs" can add substantial foreign exposure.

g. <u>Market Timing Does Not Work</u>. $1 invested in 1926 would have grown to $3,077 at the end of 2006 assuming the return of the S&P 500 Index (assuming reinvestment of income, but not taking into account fees and taxes). However, the S&P Index over that same time span, minus the best 40 months (out of the 960 months in that 80 year period) only grow from $1 to $18.23.

It is also important to stay diversified and not try to time asset classes. Investors are often drawn into "hot" asset classes — too often resulting in a "buy high, sell low" philosophy. Asset class performance is random and unpredictable. Good advisors may know when assets are undervalued, but they don't know when the market will realize that.

For example, many investors are afraid to invest now in these uncertain economic times. A speaker was asked if he would recommend a 70% allocation to stocks now. The

speaker said that is appropriate — this is the time to invest. "Returns in periods following bear market are much larger than losses during bear markets."

h. Reducing Volatility and Risk. A primary goal is to reduce risk while not reducing returns in the same proportion. For example, as discussed above, adding some degree of non-U.S. stock exposure reduces risk without diminishing returns.

The key to reducing risk over time is to diversify across asset classes, within asset classes (large cap, small cap etc.), across investment management styles (growth, value), and by global markets. The key benefit of diversification is the reduction of risk over long periods. The goal is to limit the chances of loss over long periods of time.

There are an increasing number of asset classes. The choices used to be cash, bonds or stocks. Many of the current asset classes were not around 25 yrs ago.

i. Integration of Investment and Estate Planning. A marriage of good investing and estate planning involves the integration of risk management policies taking into consideration each generation's goals.

j. Rebalancing and Reallocation. The portfolio will be monitored on an ongoing basis. As market movements cause the asset allocation to shift, the portfolio will periodically be rebalanced to bring it back into line with the Investment Policy Statement (discussed below). The concept of rebalancing is to engage in a buy-low, sell high discipline that maintains asset class weightings within percentage tolerances. When the allocation is 5% out of line in any asset class, rebalance.

A case study showing the effect of a simple 5% rebalancing strategy from 1970-2002 for a diversified portfolio indicates that the returns are almost the same, but the volatility of the portfolio is considerably lower (over 33 years: 10.4% vs. 12.2% standard deviation).

k. Investment Policy Statement. Implementing an investment strategy begins with having an Investment Policy Statement. It includes:

- Investment objectives
- Investment guidelines (asset allocation, diversification, risk position, tax positioning, income yield)
- Procedures for selecting money managers and/or mutual funds
- Procedures for reviewing the managers or funds

(Most attorneys know about investment policy statements, but VERY few have one for their own investments.)

The investor must have realistic goals for the investment portfolio. That is part of the advisor's job — to help the client have realistic goals.

l. One Approach to Selecting Advisors. There will be a more robust selection approach for clients with larger portfolios. Begin with a questionnaire to get information from advisors. Use the same questions for every firm you're looking at to get information that can be compared. Narrow the field to five firms or less.

Arrange interviews, giving each firm one hour — 40 minutes to go through the questionnaire and 20 minutes for the client to ask questions. Have the same time for each firm.

Get a full disclosure of all fees, including 12(b)(1) fees on mutual funds, hedge fund fees, and bond trading fees. (There are markups on bond portfolios and the amount depends on

the firm. Markups on bond trading can be as high as 3-4% on the way in and on the way out. For example, it might be possible to negotiate that the maximum trade cost on a bond would be 50 bps.)

Issues to address include the following.

- How do they address asset allocation?
- How do they rebalance?
- How do they select managers? How do they change managers?
- How do they implement security selection?
- Do they believe in market timing? ("Strategic asset allocation" may be another form of market timing.)
- How do they approach tax efficiency (this is especially important for hedge funds, which usually are not very tax efficient)?
- Alternative investment opportunities (what can they access that the typical investor cannot)?
- How do they coordinate with other advisors?
- How do they report portfolio performance? Ask for a sample report.
- How do they benchmark? That is very important. You want to see if there is excess return over an index return.
- Actual performance over 3, 5, and 10 years for different portfolios.
- How many years of experience? For a portfolio over $10 million, you want over 10 years of experience.
- Educational experience? Professional credentials?

Eventually narrow the field to two firms. Have an additional interview with each. The second meeting is to check initial impressions. Explore what differentiates each from the other advisors who are being considered. The investor should have a good idea about the strengths and weaknesses of each. Try to keep the process objective. Personal connection should be the last element. Look at other factors first. If other factors are basically even, then let subjectivity enter into the selection process.

Another issue: Age of advisor vs. client. A 65 year old client probably does not want a 65 year old advisor; they will want someone younger who will be around for the next generation.

m. Foundation Endowments. There have been recent research papers about the remarkable returns of endowments of foundations. Investment Policies for large foundation endowments have been more liberal as to alternative investments (sometimes 20-30%). Also, they were more or less encouraged to emphasize non-US stocks (when valuations were very attractive in the 70s and 80s). Also, they got the big returns of hedge funds back in the early years when hedge funds had huge returns.

n. Tax Efficiency. Can investment advisors give statistics on after tax returns? That is a challenge at times. That has been difficult because of the assumptions in constructing the returns. Different firms do it differently; there is no industry standard. There are AMIR compliant standards. The best standard one speaker has seen is sponsored by Deloitte and Touche.

o. Treasuries. After taking out tax and inflation adjustments, the return is negative. The studies generally assume that all income is reinvested. That why the charts show a positive

return. But after adjusting for inflation, the return from Treasuries is negative. In the last 15 years, we have experienced the lowest interest rates since the Eisenhower administration.

p. Delegation From Trustee to Investment Advisor. Someone asked how often the investment manager takes the risk from a trustee who delegates the investment management function to the advisor? Apparently, not often.

q. Multiple Advisors? Do you sometimes have two advisors? The speaker likes the client to narrow to one advisor. If there are two advisors, it is very important for someone to coordinate with both advisors. Many advisors do not want to give the performance results to another advisor to coordinate the two. An overall manager may be needed to coordinate.

r. Financing Wars; Will We See Tax Rate Increases? Statistics show that we finance our wars 15 years afterward by an increase in tax rates.

9. Trachtman Lecture — It's Not Your Father's Buick Anymore, Prof. Jeffrey Pennell

a. Background. Two of the three legs of the estate planning practice are fiduciary and tax planning. The third is one we've given less attention to — the people aspect, including the people aspects of dispositive provisions. Planners tend to look for solutions in our toolbox of estate planning techniques — and we have not been expanding into areas that are not as comfortable. Ever since Jeff graduated from law school in 1975, there have been many statutory changes, and we have been responding to an agenda that has occupied our attention that was largely written by Congress. Tax changes occurred with regularity since the mid 70s. Planners have tended to devote much of their effort to responding to the tax agenda that Congress has drafted for us.

There has been a legislative hiatus in the tax area in the last several years. (Jeff thinks Congress will not act this year. He thinks the hearings this year are just for the political theater. He thinks it will be the end of 2009, just before repeal for a year, that we get legislation, and maybe early 2010 with a retroactive effective date — to avoid the "throw mama from the train" scenario. He thinks the ultimate result will be modest extensions of where we are today.)

In 2001, Congress made major changes. The unified credit has ratcheted up the amount of the tax that is free of tax from $600,000 to $3.5 million by 1/1/09. Jeff thinks Congress will freeze the exemption at $3.5 million. At either a $2 million or $3.5 million exemption, less than 1% of the decedent population is taxable. Furthermore, at those levels, for many traditional plans, most of the estate will pass to the non-marital (bypass) trust at the first spouse's death.

We routinely draft the non marital trust the same as what he learned 35 years ago. Jeff wonders if that is still appropriate.

b. Jeff's Thesis. We need to rethink "traditional" dispositive patterns. Current drafting is much the same as 35 years ago for the GI Generation, and that planning may not be appropriate for the Silent Generation or Baby Boomer generations.

For example, the non-marital trust that most attorneys draft is what Jeff's father's generation wanted for his mother's generation for surviving spouses. (He uses those genders because in those days, the husband was typically the bread winner and most assets were in his name.) Estate planning was drafted for H to provide for W. The general

philosophy behind the approach was that husbands didn't trust surviving wives with control over wealth.

Maybe that was appropriate for Jeff's mother's generation. But he wonders if it is still appropriate. (Furthermore, many more surviving spouses in the future will be husbands.) Jeff thinks that perhaps attorneys are still drafting as a holdover of planning that was done for the GI Generation. Our assumptions of what is appropriate may need to be changed.

c. Generations. The GI Generation was born before 1927 (i.e., they were 18 before the end of World War II). The "Silent Generation" was born between 1927-1945 (during the depression and war years). (They are referred to as the "Silent Generation because there is no identifying cause; Jeff refers to them informally as the "Elvis generation.") The Baby Boomers were born between 1946-1964. Often, they are children of the GI Generation. (Baby Boomers are really different from their parents.)

We now generally represent the Silent Generation. Are they more like Jeff's parents or more like Baby Boomers? According to census data, there are not many married couples still in the GI Generation. Most men have died. Surviving widows are now dying off. Only about 25% of the Baby Boomer generation has yet become an orphan — and traditionally children only receive assets from parents after the surviving spouse's death.

This year, the oldest Baby Boomers became old enough to retire and receive Social Security. Jeff thinks there will be a wave of estate planning over the next several years.

Perhaps our planning boxes haven't changed yet because our primary client base is the Silent Generation and they may be more like the GI Generation than the Baby Boomers.

Now, ACTEC is largely in the Silent Generation and Baby Boomer generation (about 55% Baby Boomers) — "with a few GI Generation holdouts."

d. We Bring Our Own Preconceptions. Planners come to this endeavor with our own preconceptions. We are good at asking the question that will evoke the answer that we want. "You do want per stirpes distribution don't you — that is standard for most people."

e. The New Biology. So far, there have been five cases, which are remarkably similar. (The latest case is *Khabaaz v. Commissioner of Social Security Services*, 930 A.2d 1180 out of New Hampshire.) This is the general scenario: H is diagnosed with cancer. If H survives, he will be left sterile. They were hoping to have a family, so H banks sperm. H dies, and within a year, the surviving widow decides wants to have a legacy of her predeceased husband. So she goes to sperm bank and "gets out the turkey baster." (In many of these cases, she ends up having twins.)

Are the DNA offspring of the deceased H, that were conceived and born post mortem, treated as descendants of H for the purpose of receiving social security survivor benefits? The federal court remands the case to the state level, because the issue turns on state law — are the DNA offspring considered heirs of the decedent, even though they were conceived and born posthumously. In three of four cases with this scenario, the state court said yes. (That is not remarkable — the entitlement is coming from the federal government so why would a state court stand in the way?) Bigger factor: The decedent made a conscious decision to bank his sperm and DNA. (The recent *Khabaaz* case did not follow that approach.)

Analog: In old days, if I adopt a child, it is treated as my child by reason of the adoption.

The much harder case is *In Re Martin B*. (Jonathan Blattmachr was involved in that case.) Grandfather created a trust for C, with remainder to C's descendants. The surviving widow produces more "little Jeffries." The issue is whether H's wife can make more beneficiaries of H's father's trust. Jeff puts this on a personal note: Would Jeff's father want Jeff's surviving spouse to have the ability to make more beneficiaries of dad's plan after Jeff is dead?

One study shows that less than 7% of estate plans that were reviewed addressed this issue. Jeff does not know what the answer is. This is not something that is susceptible of a Uniform Law.

Estate planning attorneys should explore this issue with clients. To put it bluntly — "Are the client's children going to leave stuff in the freezer and how do we know that as planners?" Estate planning attorneys should ask clients: 1) If your son died leaving sperm in the bank and your daughter-in-law wants to produce more offspring, would you want them to be included? Jeff thinks the majority of clients would say yes. 2) If your daughter was to die having left eggs and your son-in law wanted to find a surrogate mother to incubate the baby, would you want your son-in law be able to produce more descendants of your daughter? Jeff thinks the favorable response would be lower.

f. Drafting the Non Marital Trust. Jeff thinks this is more controversial. We tend to draft the non-marital trust to provide for the surviving spouse and descendants, in the discretion of a third party as trustee (the spouse may be a co-trustee, but to avoid tax issues, distribution decisions are typically made by an independent trustee).

For a $2.0 million estate (or a $3.5 million estate in 2009), the entire estate will be held in a trust like this. How many surviving spouses would find this palatable? Jeff thinks most surviving spouses are far less passive about their entitlement to "our wealth" than was Jeff's mother. Jeff strongly believes that we will need to address the terms of non-marital trusts to make them more palatable to spouses.

Possible alternatives: 1) Make the spouse a co-trustee. But will Baby Boomer spouses be satisfied with that or will they push back? If so, what planning is appropriate? 2) Do not change the non-marital trust, but make it more difficult for the surviving spouse to elect the elective share.

From a tax perspective, Jeff likes the non-marital trust to be QTIPable so he would prefer providing a mandatory income interest to the surviving spouse from the non-marital trust.

g. Drafting for Spouses of Children. How many attorneys commonly draft trusts for the settlor's son for life, and then for the son's surviving wife for life? Only a dozen hands went up. He finds it bizarre that the case law so far gives the surviving wife a blank check to make more beneficiaries of the parent's estate plan, but the draftsman thinks the parents were not willing to make son's spouse a beneficiary of the estate plan.

Would the thinking be different about providing for a deceased daughter's surviving husband?

A child's spouse may be used to living on the income from the trust when the settlor's child is alive. Yet when child dies, the surviving spouse is cut off, and her (or his) lifestyle would change dramatically. Why do we disinherit the surviving spouse of the child — often the surviving parent of the client's grandchild?

We typically don't want a surviving spouse taking the family assets to a new spouse, but the trust could provide support until death or remarriage or until "shacking up."

Most plans (Jeff said about 80%) provide for outright distributions to children at certain ages. If that is the case, it is not as important to consider spouses of children. Jeff thinks it may be better to use a power of appointment approach and include the child's spouse as a potential appointee (in case the child dies before receiving the distributions).

Suggestion from one Fellow: Give a power to appointment to the child to appoint to the child's spouse, but the appointment must be in trust with a corporate trustee.

h. Marital Trust. A tax efficient plan is to allow flexible distributions from the Marital Trust to permit the surviving spouse to make lifetime gifts to the descendants. How many plans allow that? The issue turns on whether the client trusts the spouse to withdraw from the Marital Trust and turn around and make gifts to whomever he or she wants.

1) Jeff asked the ACTEC audience: Would you personally trust your spouse with this provision? (Most hands went up — [many of their spouses were sitting next to them].)

2) Then he asked: Do you routinely draft Marital Trusts that give surviving spouses this authority? (There were many fewer hands. Why is there a difference between what we do would personally do and what we do for clients?)

Jeff asked this question with spouses sitting next to many of the ACTEC Fellows in attendance. Attorneys will typically ask this question in estate planning conferences when both spouses are sitting there. Would there be a different answer if the spouses were asked separately? (Then the attorney would be left with the conundrum of whether to share all relevant secrets. Jeff thinks that a "share all secrets" approach was ok in his father's generation, but he thinks it is corrosive in the Baby Boomer generation and perhaps in the Silent Generation as well.)

The trustee cannot condition the distribution on the spouse making a gift. (That might endanger the marital deduction.) That means the client must really trust the spouse by permitting large distributions to the spouse from the Marital Trust and trusting the spouse to make gifts.

i. Several Issues Not Related to Changing Demographics.

(1) Terminating Distributions At Relatively Young Ages. Estate plans typically distribute a share of the estate when a child reaches a specified age of maturity. Many form books say 30 or 35. But most all of us become orphans at 50-65. Jeff thinks the 30-35 ages are kind of goofy, but about 80% of plans are drafted that way. The alternative is to give the beneficiary a power of withdrawal at that age. If the beneficiary is busy with a career or wants investment assistance, why not allow the beneficiary to just leave the assets in the trust? Why do we force the money out rather than using a power of withdrawal?

Giving a right of withdrawal to a child gives up the asset protection that trusts could provide for children. The planning considerations are really rich and varied, and there is certainly one not approach that is appropriate for everyone. Jeff doesn't regard asset protection very high in the list of priorities. For example, Wilmington Trust and J.P. Morgan report that they have experienced a much smaller embrace of asset protection trusts than Jeff would have thought. However,

for some children (for example children who are professionals and who are concerned about potential liability), it is more appropriate for the planning to take into consideration asset protection issues.

(2) Equal Distributions to Children At Death. Most clients want assets to pass in equal shares to their children AT DEATH. That's a funny notion. We hardly ever deviate unless there is a black sheep child or a disabled child. But during lifetime, well over 70% of lifetime transfers are not equal. Jeff's dad told him that he'd always treated all three children equally. (Jeff told him, "Dad, you're a communist.") Jeff realized that what his dad meant by that was that he gave to each child what that child needed, but did not necessarily make equal transfers to others. Why do clients default to equal distributions when they die? (Jeff indicated that there are social studies looking into this dissonance. They are testing different hypotheses but are not coming up with clear answers.)

Jeff's sense: There is nothing in the literature about whether distribution in equal shares really makes sense.

j. Other Issues Related to Demographic Changes.

(1) Skipping Child Generation. There is an interesting dichotomy in the consideration of the age at which people are orphaned and the proper age for distribution. If distributions are delayed until the children are orphaned, should you just skip the child's generation? We've discussed this from a tax perspective but not from a demographic perspective.

(2) Single Parent Households. There has been an extraordinary increase in single parent households. How does that impact planning decisions?

(3) Supporting Adult Children and Parents. Many clients in the Baby Boomer generation provide at least some support for adult children as well as for their parents. How should that impact planning decisions?

(4) Divorce. The Silent Generation "stayed for the benefit of the kids and divorced when they became empty nesters." If a spouse remarried, there was a likelihood that the new spouse was much younger. There are now many blended families, many including children who have grown up together. Blended families alter the classic dynamic in dealing with children by prior marriages and addressing children born to the new marriage. We could draft plans that do what the spouses did when alive: Treat all of "our" kids as if they were common to this marriage. (There is still the tension of what is appropriate if one spouse has much more assets than the other.)

(5) Grandparents Raising Grandchildren. There is an increase in grandparents who are raising their grandchildren. How will that change day to day planning?

k. Comments From Fellows.

(1) Civil Unions. What if a couple in a civil union adopt a child? The GI Generation may not feel the same about children of same sex unions, but to a large degree it does not matter what they think because their planning is "in the can." What's more important is what the Silent Generation and Baby Boomers think because we

are drafting for them. (Most in the audience thought that parents would be ok with including adopted children of a same sex union.)

(2) Dynasty Trusts. Jeff said he can't imagine drafting a trust today that would still be viable in 360 years. That is like drafting a trust for George Washington's grandfather. We need to discus ways to make that kind of trust viable, but realize that there may be thousands of beneficiaries. [Some Fellows suggested giving each a generation a broad testamentary power of appointment, perhaps to anyone other than that beneficiary's estate or the beneficiary's creditors.]

(3) Community Property. Jeff commented that things work better in many ways for community property states, including the availability of a full step-up in basis at each spouse's death. He wonders why more states have not opted for the community property approach.

(4) Outright to Spouse or Trust With Spouse as Trustee. One Fellow commented that he is seeing more and more "outright to spouse" plans. Also, many spouses are happy to have a trust and to be sole trustees with an ascertainable standard, and perhaps also a "5 or 5" withdrawal power. Jeff agrees with using a "5 or 5" withdrawal power for the non-marital trust because it can result in a bigger previously taxed property credit.

(5) Regional Differences. One Fellow observed that there are regional differences. In Texas, the surviving spouse is usually the sole trustee with a broad special power of appointment, so if a child objects to the way the parent is spending the money, the parent can eliminate the child from the plan which takes away standing. The approach gives spouse tax protection, creditor protection, and control. (One reaction: "That's what my parents did, and I've got to tell you, that is not very palatable to the next generation." Response: But we are representing the parents.)

10. Hot Topics, Susan Bart, Skip Fox, Lou Mezzullo

a. 529 Plans, Advance Notice of Proposed Rulemaking.

(1) Proposal: Trusts and Estates Cannot Be Account Owners. It is not clear how this would limit abuses. Individual account owners can withdraw money from 529 plans at any time. If a trust or estate withdraws from a 529 plan, the money would still be in the trust or estate. So having trusts and estates as account owners would actually seem to limit abuses as compared to having individuals as account owners.

Trusts should be able to take advantage of the same investment opportunities as an individual. Section 529 allows gifts (which could not be utilized by trusts), but also allows a special investment option that should not be denied to trusts. It is possible to draft workable rules to allow trusts to be account owners.

(2) Proposal: Successor Account Owner Has No Basis in the Account. The proposal to treat a successor account owner as having no basis in the account, so that all withdrawals would be taxed (even including the amount contributed to the account) seems draconian. For example, if grandmother established a 529 account for her granddaughter, then dies and names her daughter as the successor account owner, the daughter would have to pay income tax and penalty on the full amount that she might withdraw from the account. She would not be able to reduce the

income realization by the amount of the contributions made by grandmother. That is a natural non-abusive situation and the proposed tax result seems patently unfair.

(3) Proposal: Tax Effect If Change Beneficiary. If the beneficiary is changed to a new beneficiary in a lower generation, the current rules treat the prior beneficiary as making as a gift to the new beneficiary. The proposal is to treat naming a new beneficiary in a lower generation as a distribution to the account owner followed by a gift to the new beneficiary. If an account is created by grandparent for granddaughter, if grandparent dies naming daughter as the successor account owner, and if the beneficiary is later changed to a great granddaughter, why does daughter have to use her annual exclusions just because she is the account owner, and use her GST exemption because the assets are passing down two generations?

(4) Five-Year Election. What if client puts in five times the annual exclusion amount but forgot to file gift tax return to make the election? The proposal says the client can file a late return making the election (as long as it is made on the first gift tax return filed by the donor after the due date).

The proposal does not indicate if a making a five-year election for a contribution that does not fully use up the annual exclusions precludes making a second election within the first five-year period.

(5) Prospective Except as to Anti-Abuse Rule. When the new regulations are issued, they will be prospective, except as to new anti-abuse rules that will be promulgated.

b. Section 67(e). Notice 2008-32 stipulates that taxpayers "will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2% floor under §67 for any taxable year beginning before January 1, 2008, but the taxpayer "may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2% floor." That rule does not apply to amounts paid by the fiduciary to third parties for expenses subject to the 2% floor — those amounts are subject to the 2% floor on 2007 returns.

The Advance Notice specifically indicates that final regulations may contain one or more safe harbors with respect to bundled fees and expenses. The IRS is seeking comments as to safe harbors that might be appropriate.

c. Patenting Tax Strategies.

(1) Legislation. On September 7, 2007, the House of Representatives passed the Patent Reform Act with a provision that prohibits granting patents for a "tax planning method." A tax planning method is a plan, strategy, technique or scheme that is designed to reduce, minimize, or defer taxes, but does not include tax preparation software or other tools related to the calculation of tax or preparation of returns. Negotiations are continuing about including a similar amendment prohibiting patents of tax planning methods in the Senate version of the Patent Reform Act. If the Patent Reform Act does not pass, there will be efforts to introduce separate "stand alone" provisions to ban patents of tax planning methods.

(2) Business Method Patents. Tax strategies are patented under the general doctrine allowing the patenting of business methods. The Federal Circuit has agreed to hear a case that will reconsider business method patents. *Bilski*.

(3) *Comisky;* Denial of Patenting a System for "Mandatory Arbitration Involving Legal Documents Such as Wills or Contracts". *In re Comisky*, 449 F.3d 1365 (Fed. *Cir. 2007*) denied a patent on "obviousness" grounds for a method and system for "mandatory arbitration involving legal documents, such as wills or contracts." The court reasoned that that a business system that depends entirely on the use of mental processes cannot be patented.

d. Section 6166; Stock or LLC Interest As Collateral. Internal Legal Memorandum 200747019 addresses when the IRS must accept stock of a closely held business as collateral for a §6166 deferral. ILM 200803016 addresses when an LLC interest must be accepted as collateral.

The ILMs generally provide that the IRS must accept the business interests themselves as collateral if three requirements are met. 1) The stock must be expected to survive the deferral period. (Why is that important? If the company is sold, the tax is accelerated.) 2) The interest must be identified in the written agreement with the IRS. (That is just a mechanical easy-to-satisfy requirement.) 3) The value of the business interest as of the agreement date must be sufficient to pay the deferred taxes plus the required interest. One speaker responds: "Give me a break." With a 45% tax rate, the business interest must be 100/45, or 2.22 times the amount of the deferred tax.

e. Interest Rate on Underpayments Declines for First and Second Quarters, 2008. The interest rate on underpayments went down from 8% to 7% percent for the first quarter of 2008, and will go down from 7% to 6% for the second quarter of 2008.

f. *Jelke*, Effect of Built-In Gains Tax Liability on Valuing C Corporations. In *Jelke*, the Tax Court reduced the $51 million built-in gain tax liability to a present value at the date of death of $21 million (assuming that the tax would be paid over 16 years). The 11th Circuit allowed a full dollar for dollar reduction in value. The IRS requested an *en banc* rehearing, which was denied on February 28, 2008. The IRS has 90 days to decide whether to appeal to the Supreme Court.

Some have questioned why the company was not valued on a going concern approach, which would not necessarily result in a reduction for the built-in gains tax liability as compared to valuing the company on a liquidation approach. However, the parties had stipulated that the company would be valued on the basis of a liquidation approach. That might possibly weaken the case as future precedent for situations in which the parties do not agree that a liquidation approach is the correct way to value the company in question.

g. *Kohler* Non Acquiescence. In *Kohler v. Commissioner*, the closely held company was valued at $47 million, and the IRS asserted the value was $146 million and imposed a $10.5 million accuracy related penalty. One of the issues in the case was that the IRS tried to argue that reorganization of the company before the alternate valuation date was a disposition or sale, which precluded using the alternate valuation date. However, the court permitted using the alternate valuation date. The IRS recently nonacquiesced. In the future, if a reorganization occurs before the alternative valuation date, the IRS will likely again take the position that precludes using the value on the alternate valuation date.

h. *Christiansen* Formula Disclaimer That Operated As a Defined Value Transfer. Some nationally prominent speakers have opined that this is the most significant case to come down in the last year in the estate and gift tax area.

i. GST Late Elections. There have been rumors that the IRS has taken the position informally that it will not grant 9100 relief for GST late exemption allocations if 1) the original gift involved a discounted asset, and if (2) the statute of limitations has run on the original gift. In Letter Ruling 200746006, gifts were made of discounted FLP interests, which were reported on a gift tax return, but for which the accountants inadvertently forgot to make the GST exemption allocation. The gift tax statute of limitations had not yet run on the gifts. The IRS denied 9100 relief to make a late GST exemption allocation without stating a specific reason (except stating generally that the taxpayer did not meet the requirements of Treas. Reg. §301.9100-3.)

Query whether the IRS is requiring BOTH that the original gift did not involve a discounted asset AND that the gift statute of limitations has not run before it will grant 9100 relief.

11. Interesting Quotes

a. Waiver of Conflict of Interest. “An oral waiver is not worth the paper it is not printed on.” — Daniel W. Smith, Attorneys’ Liability Assurance Society.

b. On Buying “Crap”. No one ever says on their deathbed: “I should have bought more crap.”

c. Silent Jonathan. Jeff Pennell describes the “Silent Generation” as being persons who were born between 1927 and 1945. One Fellow observed: “Do you find it ironic that Jonathan Blattmachr is a member of the *Silent* Generation?”

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