ACTEC 2008 Fall Meeting Musings

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Introduction

The following are my observations from the seminars presented at the ACTEC 2008 Fall Meeting. I am not attempting to summarize all of the excellent information from the seminars, but merely highlight some of the items that were particularly interesting to me. Everyone at the meeting has his or her own personal particular interests, and other attendees would no doubt point to other things that were highlights to them.

To Distribute Or Not To Distribute: Case Studies in Discretionary Distributions, Thomas W. Abendroth, Susan Porter, Charles D. Fox, IV

1. Size of Trust Impacts Decisions. Many of the distribution decisions discussed below are impacted by the size of the trust. The trustee should run models to determine how long the trust will last, particularly if the trust is designed to provide support over a long period of time. This is often as much or bigger of a concern than issues discussed below about specific types of distributions.

2. Legal Bill for Lifting Guardianship. Can the trustee the pay a $17,000 attorney bill for lifting the guardianship of a beneficiary under a health, maintenance, and support distribution standard? Not clear. Arguably, the beneficiary's health is improved by being independent. Also, arguably, there is less cost to the beneficiary without the guardianship, so it might be justified under a support standard.

3. Informing Beneficiary. A family requests the trustee not to tell a grandson or his mother about the existence of the trust. It is possible to draft around the trustee's duty to inform. However, even if not required by law to disclose, attorneys often advised trustees to disclose. The situation looks worse if the trustee does not disclose an issue and problems arise later.

   Later Reimbursement. An Issue that may arise if beneficiaries are not advised of the existence of the trust is that when they find out about the trust, they may submit requests for reimbursement of earlier expenses. Reimbursements of earlier expenses can be justified under the trust distribution standard. Whether to reimburse depends upon the size of the trust, the needs of the beneficiaries, etc.

4. Disclosure to Parents of Minors. To whom does the trustee give disclosure if the minor beneficiary's parents are divorced or unmarried? The initial reaction is to disclose and inform the parent who is in the family line. There is little law as to whether disclosure should be given to the other parent also.

5. Preference Among Beneficiaries. If there is no provision in the trust agreement describing priorities among beneficiaries, can the trustee give priority to providing support for more senior generations, and for favoring children over grandchildren? As a practical matter, most trust officers will prefer the older generations. (The Restatement of Trusts (Third) §50 comment f says that a trustee can infer a priority for the older generation.) However, the trustee should meet with all generations and ask for appropriate information from all as to the need for distributions.

6. Conversion to Unitrust and Power to Adjust. In some states, once the trustee opts into a court approved unitrust approach, it is hard to later opt out. The power to adjust is more flexible. Exercising the power to adjust cannot just be made on a unitrust approach (e.g., distribute 4% of the trust value each year). The trustee must effectively prepare a financial plan for the beneficiary and decide the best way to proceed each year.

   The power to adjust is much more flexible, and most large trust companies preferred that over opting into a unitrust. In New York, a three-year rolling average approach must be used for a unitrust. In a year like 2008 when values are down dramatically, that means there will still be large distributions, and this is a tough environment for a trustee to raise cash for distributions.

7. Distributions for Insurance. Can a trustee purchase life insurance for a beneficiary? That is not so much a distribution issue as it is a question of whether it makes sense as an investment for the trust.

   Health insurance can be justified under a "health" distribution standard. In addition, paying for property casualty insurance is typically permissible as a means of protecting and preserving the trust assets.

8. Distributions So Beneficiary Can Make Gifts. Can the trustee pay a beneficiary's living expenses so the beneficiary is able to make large annual exclusion gifts? Part of the analysis would include whether the trustee may or must consider other resources available to the beneficiary in determining whether to make support distributions.

9. Infertility and Adoption Expenses. Can the trustee make distributions to pay infertility treatments for the beneficiary's spouse? That issue comes up fairly frequently. It helps if the trust document allows distributions for "health." Such distributions can clearly be made under an "absolute discretion" standard. What if the husband is the beneficiary? (It is not very politically correct to ask "who is in infertile?")

   Paying adoption expenses is not as clear, because they are not for the health, support or maintenance of the beneficiary.

10. Ill Spouse. What if the spouse of the beneficiary is ill? Can distributions be made for the spouse? Arguably, the spouse's poor health affects the beneficiary's mental health. Also, a support distribution standard includes persons the beneficiary is obligated to support.

11. Repaying Student Loans. Repaying student loans probably falls within the parameters of an "education" standard (as always, depending on the size of the trust, the number of beneficiaries, etc.)

12. Inter Vivos Trusts; Guidance From Settlor. These decisions are a little easier for inter vivos trusts with a living settlor. The trustee can ask the settlor what his or her intent was as to specific types of distributions.

13. Reimbursing Expenses of Last Illness. What if the beneficiary dies and the executor asks for reimbursement of expenses of last illness. Under the Restatement of Trusts (Third) § 50, comment d(5) (post-death obligations), the presumption is that the trustee has the discretion to pay these expenses. (Some trust officers think that paying funeral expenses is inappropriate under a health support and maintenance standard.)

14. Getting Beneficiary's Consent. The problem with getting the consent of other beneficiaries before making a particular distribution is that beneficiaries start to think they have veto powers. Furthermore, the consenting beneficiaries could later claim that they did not have full knowledge and still seek to hold the trustee responsible for making inappropriate distributions.

15. Substance Abuse: Decanting; Contribution to FLP; Court Modification. How can the trustee of a discretionary trust avoid an outright distribution on termination of the trust during the next year to the beneficiary that has a substance abuse problem?

    If the state allows decanting, consider that. **(Susan Porter points out that in Tennessee that is called "distilling.")**

A broad facility of payment clause may authorize the trustee to hold back assets from a trust if the trustee thinks the beneficiary is not capable of handling the assets. A Mal Moore article at a very early Miami Institute has drafting language for different scenarios.

If the trust is not in a state that allows decanting, consider moving the assets to a family limited partnership or other entity, so that the actual distribution will not be of cash and marketable securities. However, there was a Colorado case where a disciplinary complaint was drawn against the attorney for doing that. The complaint eventually was dropped as part of the settlement of the entire case.

There was a case in Pennsylvania where the attorneys sought a court extension of the trust based on unexpected circumstances and got the trust extended for the beneficiary's life. The Uniform Trust Code allows that as well.

16. Bank Advising Beneficiary About Creditor Planning. What can a bank-trustee advise a beneficiary to do to avoid creditors claims? (This is especially difficult, where there is a mandatory distribution of income.) Ethical issues arise in preventing distributions to beneficiaries to avoid creditors.

17. Beneficiary/Trustee Holding Distribution Power Not Limited by Ascertainable Standard. In some states, a beneficiary's dispositive powers will be limited by statute to the ascertainable standard. Section 814 of the Uniform Trust Code addresses this and says that a beneficiary cannot exercise a distribution power in a way that causes an adverse tax result. From a drafting standpoint, include a fail-safe clause in each trust so the beneficiary will not have a tax sensitive power. Another trustee can be appointed to make decisions about standards beyond the ascertainable standard.

18. Beneficiary Refusing to Give Financial Information to Trustee. What if a beneficiary makes requests but refuses to provide net worth statements or copies of recent income tax returns? Trustees request this type of information routinely. When a beneficiary is reluctant to provide information, the trustee should meet with the beneficiary and discuss the purposes of the trust and how flexible the trust is — to provide for immediate needs and long term needs. If that discussion occurs upfront with beneficiaries, they are not as likely to have a continued hostile relationship, but a collaborative relationship to carry out the intent. The trustee should prepare spreadsheets and show what is likely to happen in the future if distributions are made currently.

    If beneficiary does not provide financial information, they do not get distributions.

19. Consideration of Outside Resources. If the trust instrument is silent, common law says the trustee is still entitled to information regarding outside resources in part to carry out the duty of impartiality and balance the needs of future beneficiaries. That is discussed in Comment e to §50 of the Restatement of Trusts (Third).

The Rest Of The Story: Income Tax Issues Related To Transfer Tax Planning With Grantor And Non-Grantor Trusts, Randy Harris, Mary Ann Mancini, and Howard Tuthill, III

1. Section 678 Issues.

    a. Grantor Trust as to Crummey Powerholder Under §678(a)? Section 678(a)(1) says that a person is treated as the owner of the trust if he has a power exercisable solely by himself to vest corpus or income in himself. That covers a Crummey power before the power has lapsed (subject to §678(b) as discussed below if the trust is a grantor trust as to the original grantor).

        After a Crummey withdrawal power lapses, there is controversy as to whether the trust is a grantor trust as to the powerholder. Section 678(a)(2) says that if the powerholder releases the power and retains such control as would subject a grantor to being treated as the owner of the trust, the powerholder will continue to be treated as the owner for income tax purposes. Does the lapse of a Crummey power cause the beneficiary to be treated as a partial owner of the trust?

The IRS position has been clear since the early 1980s. A number of private letter rulings view the lapse as a release, and since there is no "five or five" exception in the income tax statute, the beneficiary is treated as the partial owner of the trust.

Contrary arguments: nothing in §678 says that a lapse should be treated as a release. Furthermore, the statute refers to a partial release; is a lapse a partial release? Also, the statute contemplates active participation by the beneficiary.

One speaker thinks the IRS has the better argument. Otherwise, the result could be manipulated by whether the term "lapse" or "release" were used in the instrument. That speaker believes that the annual lapse of a Crummey power is probably treated as a partial release.

Observe that this causes a complex reporting nightmare. There may be 20 Crummey powerholders, each of whom is treated as owning a portion of the trust. The IRS has issued no published rulings regarding this issue. It apparently does not know what to do about the issue either. (There are no reported cases where the IRS has gone after Crummey powerholders for not reporting trust income.)

Commercial 1041 software packages typically do not support reporting trusts as partial grantor trusts owned by various individuals. However, the Lackner software may do so.

b. <u>Original Grantor Trumping as to Grantor Trust Treatment, §678(b)</u>. A possible way of avoiding these problems, at least temporarily, is if the original grantor is treated as the owner under §678 (b). However, § 678(b) talks about a power over income, and a Crummey withdrawal power is the power to withdraw principal. However, the definition of income in the §678(b) regulations refers to taxable income, so perhaps it is not inconsistent to apply to §678 to Crummey powerholders despite the reference to "income" in the statute.

The IRS has taken a position in a number of recent private letter rulings that §678(b) does apply to treat the original grantor as the owner rather than the Crummey powerholders.

What happens when original grantor trust status ceases? Do we have a complex trust at that point, or a trust owned by 20 different Crummey beneficiaries? Just reading the statute says the lapsed powers come roaring back to life — and the trust is treated as owned by the Crummey power holders. There have been only two private rulings (and they arose out of one ruling: 9321050, revoking 9026036 on the §678 issue). The IRS initially ruled that the beneficiary would be treated as the owner. Several years later, the IRS revoked that position and said the beneficiary would not be treated as the owner-with no further discussion.) Perhaps the IRS was saying that no one could figure this out. Practically, the IRS apparently does not want to treat all of the Crummey powerholders as the owners, but cannot justify that position under the statute.

2. <u>Section 67(e) and AMT Consequences</u>. Section 63(d) defines "itemized inductions" to mean deductions other than (1) deductions allowed in arriving adjusted gross income and (2) the deduction for personal exemptions. Therefore, if an investment advisory expense "flunks" §67(e), it is an "itemized deduction." Section 67(b) says that "miscellaneous itemized deductions" includes all "itemized deductions" other than 12 specific deductions listed in §67(b), none of

which covers investment advisory expenses. In computing alternative minimum taxable income, §56(b) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b)." Therefore, if an investment advisory expense does not come within the §67(e) exception for trusts and estates, all of the expense (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

The AMT affect can be much larger than the effect of not being able to deduct expenses that do not exceed 2% of adjusted gross income. For example, assume a trust has $100,000 of investment advisory expenses, and $100,000 of adjusted gross income. Despite the 2% rule, the trust can still deduct $98,000 for taxable income purposes, resulting in negligible "regular" income tax. However, for AMT purposes, no deduction would be allowed; after reduction for the $22,500 AMT exemption, the 26% tentative AMT tax is roughly $20,000.

The AMT affect is carried through to beneficiaries who receive trust distributions. Although the beneficiary will not have any taxable income if the trust has $100,000 in gross income and $100,000 in deductions, the K-1 to the beneficiary will report the $100,000 as an adjustment that must be added back for AMT purposes on the beneficiary's tax return.

3. Section 1014(e); Denial of Basis Step-Up If Decedent's Property Passes Back to Original Donor Within One Year of Gift. Section 1014(e) was enacted in 1981 and it is a poorly drafted statute. There was an initial regulation project that was abandoned. Generally, if someone gives property away, and the donee dies and gives the property back to the original donor within one year of the gift, there is no basis step up. One ruling (PLR 9026036) says that if property passes into a trust giving the original donor a mandatory income interest, only the value of the remainder interest qualifies for a basis step up. Arguably, this is not the correct result; receiving back "the property" is not the same as receiving back *an interest* in the property. No ruling has addressed a situation in which the original donor merely has an interest under a discretionary distribution standard (either an ascertainable standard or a totally discretionary standard).

   A possible way to bolster the taxpayer's argument is to have the decedent's estate sell the assets before distributions are made, so that the same "property" is not returned to the original donor.

4. Making a Trust Beneficiary the "Grantor" for Grantor Trust Purposes.

   a. QSST Election. The trust might contribute all of its assets to an S corporation and the trust beneficiary might make the QSST election. (There can be only one beneficiary, and all income must be distributed currently.) All of the S corporation income is taxed directly to the beneficiary, who is treated as an owner under §678.

      While the trust must distribute all of this income to qualify for the QSST election, having the S corporation own all of the trust assets filters the income to be distributed, because only dividends from the S corporation would be treated as trust "income" to be distributed.

      If the trust has multiple beneficiaries, it would not qualify for the QSST election. In that case consider decanting to a similar trust with only one beneficiary.

   b. Section 678. Under §678, a beneficiary is treated as a substantial owner of the trust for grantor trust purposes if the beneficiary "has a power exercisable solely by himself to vest the corpus or income of the trust therefrom in himself." A beneficiary-trustee's distribution power would have to be limited by an ascertainable standard to avoid inclusion in the beneficiary's estate under §2041. Does a distribution power subject to an ascertainable standard qualify as being exercisable solely by the beneficiary for purposes of

§678? There is no published ruling. Private rulings from the IRS have been inconsistent. Compare Ltr. Rul. 8211057 (trustee-beneficiary with discretionary principal interest for "support, welfare and maintenance" taxable on income under § 678) with Ltr. Rul. 9227037 (trustee-beneficiary with discretionary principal interest for "health, support and maintenance" held not taxable under §678). See also Ltr. Rul. 8939012 (trustee-beneficiary not taxable as owner of trust under §678; however exact distribution standard not clearly set forth in ruling).

There is one reported case that has addressed this issue after the adoption of §678, and it adopts an ascertainable exception approach (so that the beneficiary under an ascertainable standard is not treated as the owner of the trust). U.S. v. DeBonchamps, 278 F.2d 127, 130 (9th Cir. 1960) (held that grantor trust rules applied to determine tax effects of holder of life estate; life tenant did not have unrestricted power under state law to distribute corpus to self, but only for "needs, maintenance and comfort"; held that undistributed capital gains not taxed to life tenant).

Many attorneys use a beneficiary as sole trustee and take the position that causes the trust income to be taxable directly to the beneficiary under §678. However, there is no direct case authority for trusts, and there are conflicting PLRs. The issue has been around for a long time, and the IRS has shown no eagerness to address this issue or to confront it — witness the almost total absence of cases.

c. Crummey Beneficiary Treated as Owner. Richard Oshins, Oshins & Associates, LLC, Las Vegas, Nevada, discusses using a Crummey trust created by a client's relative, giving the client a Crummey withdrawal power. The IRS position is that the Crummey powerholder is treated as the owner of the trust for income tax purposes, even after the withdrawal power lapses (as long as the trust is not a grantor trust as to the original grantor). The trust assets would not be included in the beneficiary's estate under Code §§ 2036 or 2038, because the client never makes any gifts to the trust. The only inclusion in the beneficiary's estate under §2041 would be to the extent that the withdrawal powers have not lapsed out. The client may be able to build the value of the trust substantially by taking advantage of business opportunities in the trust. The client might also sell assets to the trust (with no gain recognition) for a low interest note. (The client might need to guarantee the note to the extent that the trust does not have adequate "seeding" to justify the sale.) The trust should not be subject to the beneficiary's creditors under traditional spendthrift trust principles, because the beneficiary is not a settlor of the trust.

5. Stepping Up Basis of Grantor Trust Assets. The grantor of a grantor trust may purchase back low-basis assets before the grantor dies for cash or other high basis assets, so that the low basis assets will receive a basis step-up at the grantor's death. That can be done shortly before the grantor dies. If it is not possible to swap out assets, the trustee might sell appreciated assets before the grantor's death. The income will be reported on the grantor's final income tax return and the income tax paid will reduce the grantor's estate tax.

(Some attorneys have reported having a grantor borrow substantial amounts from a bank to accomplish this purchase. The income tax savings can totally swamp the interest expense.)

6. Income Tax Reimbursement Provisions; Negate State Law Reimbursement Rights. Under Rev. Rul. 2004-64, if the grantor has an absolute right to be reimbursed for income taxes, that would cause estate inclusion under §2036. If state law says the grantor has the right to be reimbursed, there needs to be language in the trust instrument NEGATING the reimbursement right. That

provision should be included in all trusts, because the draftsman does not know if the trust situs might be changed in the future.

Slicing and Dicing Duties of Trustees — Dennis Belcher, Peter Gordon

1. More FDIC Coverage For Trust Accounts Than Estate Account. Funds held in an FDIC insured ***estate*** account are only insured to $250,000. Funds held in an FDIC insured ***trust*** account, including an account in the name of a revocable trust that has become irrevocable as a result of the death of the grantor, however, are insured to $250,000 ***per beneficiary***. That is a factor that might favor using a funded revocable trust estate plan for a client that is concerned about FDIC coverage.
2. Trustee Selection is Critical. "The real key is who is in control — a good estate plan and bad trustee results in a failure." Consider the trustee's duties, and then consider who is best to carry out those duties.
3. Splitting Up Trustee Functions. Some trusts split out the functions of a trustee among various parties: custodianship (recordkeeping, communicating with beneficiaries reporting, etc.), investment, and distributions. The instrument should specify who coordinates among those. For example, what if the distribution trustee was to distribute $500,000, but the investments are all locked up?
4. Delaware Being Used for Directed Trustees and to Avoid Informing Beneficiaries. Peter Gordon, a Delaware attorney, indicates that he is seeing a big increase in the number of trusts being moved to Delaware. Ninety percent of the trusts he is seeing now have directed trustees (i.e., a third party gives directions regarding certain decisions). He is also seeing Delaware trusts being used in various situations where the settlor wants to avoid informing beneficiaries of the trust's existence.
5. Delegation. A trustee that delegates some duty of the trustee is generally still responsible for that function. However, statutes in many states have adopted specific delegation procedures, under which the advisor (rather than the trustee) is primarily liable if the requirements of the delegation statute are followed. In summary, make sure that the state law procedures are followed. Monitor the agent to make sure that the agent is not violating the terms of the trust. Make sure that there is not a total exoneration of liability of the agent.

   Fiduciary administration is process oriented. Fiduciaries are not guarantors of performance and can avoid liability by following the right process.
6. Directed Trustees. The trust instrument may specify that the trustee is required to follow the directions of some third party with respect to specifically designated issues. (Good resources are: Nenno, Directed Trusts, Can Directed Trustees Limit Their Liability?, 21 Probate & Property 45 (Nov. Dec. 2007); Clarke & Zeydel, Directed Trusts: The Statutory Approaches to Authority and Liability, 35 Estate Planning 14 (Sept. 2008).) There are several types of directed trustee statutes.
   a. Delaware. "Except in cases of *willful misconduct or gross negligence* on the part of the fiduciary" the fiduciary is not responsible for losses resulting directly or indirectly from following directions as required in the trust instrument. Various other states have adopted statutes that are more protective of directed trustees than either the Restatement or Uniform Trust Code approaches. (These states include Colorado, Delaware, Georgia, Idaho, Indiana, New Hampshire, Ohio, Oklahoma, South Dakota, Tennessee and Wyoming.)
   b. Uniform Trust Code, §808. If the terms of the trust confer on a third person the power to direct certain actions of the trustee, "the trustee shall act in accordance with an exercise of

the power unless the attempted exercise is *manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty* that the person holding the power owes to the beneficiaries of the trust." (States following this approach include Alabama, Arkansas, the District of Columbia, Florida, Kansas, Maine, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, Oregon, Pennsylvania, South Carolina, Texas, Virginia, and Wyoming.)

c. Restatement (Second) of Trusts, §185. The trustee must follow directions given by a third party pursuant to the terms of the trust "unless the attempted exercise of the power *violates the terms of the trust or is a violation of a fiduciary duty* to which such person is subject in the exercise of the power." If the third party's direction power is held *personally*, the directed trustee must follow the directions and the trustee's only duty is to verify that the exercise does not violate the terms of the trust. However, if the third party holds the direction power in a *fiduciary* capacity, the directed trustee must verify that the exercise of the power does not violate a fiduciary duty that the powerholder has to the beneficiaries of the trust. This approach is followed in Indiana and Iowa.

d. Florida Recent Statute. Florida recently adopted a directed trustee statute that permits a directed trust only if the person giving the direction is also a trustee.

e. Draftsman's Job. The draftsman's job is not necessarily to protect the trustee against all liability. The goal should be to place the liability where it belongs. A third party with responsibility over certain functions should be liable for those functions.

f. Clarify Communication Lines. The Duemler case in Delaware highlights the importance of getting lines of communication clear as to when and how directions will be delivered. In that case, the investment advisor argued that it had faxed instructions to sell a specific bond, but the trustee said that it never received the faxed instruction.

7. Lawsuit Settlements While Banks Are Undergoing Mergers. In one of the directed trustee cases, there was a settlement. Some have suggested "The bank paid because they were going through a merger." Banks want to clear everything up before a merger; that is a very good time to settle lawsuits against a bank.

8. Transfer of Trust Situs. If the trustee is concerned that it is not adequately protected even if there is a direction provision in the document, consider transferring the situs of the trust to a state that has a more protective law. For conflict of laws purposes, directed trustee laws are viewed as being as administrative (not regarding the validity or construction of the trust), and the state where the trustee resides generally governs administrative laws. If a trust instrument says that the trust is governed by the law of a particular state, and there is a subsequent change in situs to another state, the conflict of laws rules kick in. Do not automatically assume that moving the trust situs to Delaware or South Dakota achieves the desired result.

9. Planning Where There Is No Direction Provision in Trust Instrument. If the trust instrument does not have a directed trustee provision, but the parties believe that a directed trustee situation would be the best approach, look to the trust instrument to see if it permits appointing a trustee in another jurisdiction. If so, appoint a trustee in a jurisdiction that has a good directed trustee statute. Seek a reformation action in the jurisdiction where the new trustee resides to add a directed trustee provision into the trust. If the instrument requires local jurisdiction, a petition in the "pitching" jurisdiction must be filed seeking to have a new trustee appointed. Also file a petition in the "catching jurisdiction" acknowledging jurisdiction, and reforming the trust.

Another possibility is to use a decanting statute. Change the trustee to a state that has a directed trustee statute and a decanting statute. The trustee can then decant the trust to a new trust with direction provisions. That should be done with confirmation by the court.

10. Forms. An outline by Peter Gordon has excellent forms including

- Special Holdings Direction Adviser Language
- Investment Direction Advisor Language
- Consent Adviser Language
- Direction Adviser Language
- Trust Protector Language
- Administrative Trustee Language

Planning For Post-Election Income Tax Changes — Turney Berry & Richard Robinson

1. Overview. Income tax rates are likely to go up in the next administration. However, in light of difficulties in the economy, some people think the rates may be changed but the effective date will be delayed.

   In considering this issue, there is the math question (will less overall tax be paid, taking into account present values?) and the business decision question (what is the effect on the overall rate of return of the taxpayer if money must be borrowed to pay the extra income tax currently?)

   There was a very short time frame to do planning when the 1986 Tax Reform Act was passed. Consider planning alternatives now — and give clients the option of doing something in 2008 depending upon what the client thinks the future may hold.

2. Wages and Bonuses.

   a. Current Situation. There is a 35% maximum income tax rate on earned income. The FICA tax is 12.4% (6.2% employer and 6.2% employee) up to a $102,000 wage ceiling for 2008. The Medicare tax rate is 2.9% (1.45% employer and 1.45% employee) with no wage ceiling.

      Itemized inductions are phased out at higher incomes. At one time, the cut back was limited to 80% maximum. In 2008 and 2009, the cutback is just one third of the cutback previously.

   b. Possible Changes.

      - Ordinary income tax rate over $250,000 — increase to 39.5%.
      - Employment taxes; there are proposals to increase employment taxes over $250,000 by amounts from 2% up to the 6.25% rate that now applies. (Apparently those amounts would be doubled for self-employed individuals that pay both the employee and employer share.)
      - Itemized deductions; there are proposals to completely reinstate the phase out of itemized deductions if the taxpayer's income is over $250,000.

      For employees, the maximum combined income tax and employment tax rate for amounts over $250,000, could increase from the current 36.45% (35% +1.45%) to 49.15% (39.5%+6.2% +1.45%). For self-employed individuals, it appears that the combined rate could increase to 54.8% (39.5% +12.4% +2.9%). These are huge potential rate increases.

c. Possible Situations To Consider Accelerating Income.

- Wages and net earnings from self-employment.
- Exercising non-qualified stock options (some would rule out exercising non-qualified stock options this year because the stock is going down so much. Furthermore, if the option is exercised now (generating ordinary income) and the stock goes down later, when the stock is sold, there will be a capital loss.)
- Making §83(b) elections or taking other steps to remove a substantial risk of forfeiture for non-vested restricted property. (The §83(b) election must be made within 30 days of the receipt of property.)
- Deferred compensation: vesting benefits causes immediate employment taxes, but the benefits do not have to be reported for income tax purposes until paid. Vesting deferred compensation benefits in 2008 may generate only very slightly additional employment tax. If the client is already above the FICA wage base, the only additional employment tax is the Medicare tax (1.45% if just paying one side, 2.9% if paying both sides). That makes sense for the client if the company is solvent and can pay the deferred compensation in the future.

3. Choice of Entity.

a. Employment Tax Impact. There is a difference in the self-employment tax treatment of S corporations versus the treatment of partnerships and LLCs.

S corporations: Pass through income is not subject to self-employment tax (except in certain situations when the IRS can recharacterize the income is wages).

Partnerships and LLCs: Truly passive investors (limited partners of a partnership and certain members of an LLC) are not subject to self-employment taxes. However, the pass-through income for active owners is self-employment income.

If the self-employment tax increases by 15.3% (12.4% +2.9%) for amounts over $250,000, structuring the business to avoid self-employment income can be quite significant.

b. Mechanics of Converting. Under the check the box rules, there is no necessity of creating a new corporation. The entity can "check the box" to treat the entity as an S Corporation. Be sure to file the S election as well.

4. Ordinary Income and Deductions.

a. Short Term Gains and Ordinary Income. Consider accelerating short term gains and ordinary income to 2008 to avoid higher rates in the future.

b. Charitable or Business Deductions. Deferring deductions is more questionable. The uncertainty of the timing of rate changes makes this dubious. If tax rates go up, there will be an interaction with the phase out of itemized deductions so that more deductions in future years may be lost. Also, there is the lost time value of the earlier tax payment.

c. 65 Day Rule for Trusts. The 65 day rule for trusts allows additional flexibility as to the timing of the recognition of income or payments generating deductions.

5. Carried Interests.

a. Taxing Hedge Fund Owners. Hedge fund owners make their money largely through carried interests, generating capital gains. There have been various proposals to treat "people in Greenwich" running hedge funds "the same as the rest of the country."

b. Carried Interests Are Also Powerful Tools for Owners of Small Businesses. The carried interest is an ownership interest in a partnership (a partnership profits interest) that entitles the owner to a share of the *future* income, gain, and appreciation in the partnership, but not any portion of the *existing* partnership capital on the date the carried interest is issued. Receipt of a profits interest is generally not a taxable event, whether or not it is vested, if the requirements of Rev. Proc. 93-27 are satisfied. Contrast that with the receipt of options or restricted property, for which there will be ordinary income at the time of exercise or when restrictions lapse. However, a profits interest is entitled to the future share of income and increasing capital value, and much of the gain reported to the profits interest owner may be capital gain as it is recognized by the partnership.

Carried interests can also be helpful in family entities, but be sure that the value of the profits interest is equal to the value of service provided, and be sure to structure around §2701.

c. Proposed Legislation May Impact Most Partnerships. The proposed legislation is aimed at hedge fund managers who receive huge profits with capital gain treatment even though the profits represent compensation for their services. Various bills have been introduced in Congress, some of which impact in a special way any partnership interest that is an "investment services partnership interest". For that partner, all K-1 pass-through income is ordinary income (even if the K-1 would otherwise show capital gain income). Also, a sale of the partnership interest generates ordinary income, not capital gains. If there is a distribution of property, the partnership recognizes gain and a partner has ordinary income on receipt of the property. Under one proposal, an "investment services partnership interest" is a partnership interest if the partner provides substantial services to the partnership in connection with advising on securities, commodities, real estate and certain other assets. In one bill, services must be provided to third parties, but in another bill, there is no requirement of providing services to a third party. Under that approach, if a family limited partnership invested in marketable securities, and the parent provides advice as to the sale of securities (or for a real estate partnership, the parent provides services regarding real estate investments) those partnerships could be within a broad definition of an "investment services partnership interest."

If that result were to occur, the effective date of the legislation would be critical. There may be a need to liquidate FLPs before the effective date to avoid the ordinary income treatment.

6. Qualified Dividend Treatment — 15% Tax Rate. Qualified dividends are currently taxed at 15%; that may be changed to 20% (or even 28% or higher). Transactions that a client might consider completing this year to take advantage of the 15% rate include redemptions that might not qualify for capital gain treatment under §302. Examples include:

- Client will eventually be redeemed;
- A child owns an interest in a family business but does not participate in the business and wishes to be cashed out; and
- An owner is nearing retirement, at which time his or her interest will be redeemed

Examples of situations that might flunk the §302 test, so that redemption proceeds would be treated as dividends, include the following. (In each of these, dividend treatment may result in the same 15% tax as a capital gain transaction, as long as the owner has a very low basis in the stock.)

- Dad wants to be redeemed but wants to continue as president of the company; family attribution cannot be waived if dad continues as president.
- Two siblings will receive stock from the estate of a parent who has died; a §302 redemption is not possible because estate-beneficiary attribution cannot be waived.

Redemption for a note in a dividend transaction. If the redemption is for a note and if the redemption is treated as a dividend transaction, the full present value of the note is treated as a current dividend.

7. Capturing the 15% Rate for Sales and Liquidations. Selling appreciated securities just to take advantage of the low current capital gains rate probably does not make sense unless the owner is confident that the security will be sold within the next 4-5 years in the event. Methods of securing the benefit of the 15% rate include:

- Selling securities currently (but that may be difficult as a practical matter, because of the market timing aspects of the sale);
- Real estate sales (but remember that there are portions of real estate taxed at ordinary rates, including depreciation recapture [portion at 25% and portion at 35%]); and
- Sell for an installment note and elect out of the installment method.

Getting Into The Clients (Testator's) Head: A Lawyer's Guide To Diminished Capacity And Use Of Medical Experts — Margaret G. Lodise, Dr. James E. Spar, Adam F. Streisand (All From Los Angeles)

1. Humorous Prior Georgia Statute. George replaced its testamentary capacity statute a decade ago (on a split vote). The prior statute was rather humorous.

   Georgia Title 53-4-12(b):

   > "The amount of intellect necessary to constitute testamentary capacity is that which is necessary to enable the testator to have a decided and rational desire regarding the disposition of his property. The testator's desire must be decided, as distinguished from the wavering, vacillating fancies of a distempered intellect, and rational, as distinguished from the ravings of a madman, the silly pratings of an idiot, the childish whims of imbecility, or the excited vagaries of a drunkard." [The speaker noted, "only morons appear to be left out."]

2. Psychiatrist's Approach to Client Interview; Converse Before Test. Dr. James Spar is a geriatric psychiatrist who does a significant amount of work involving capacity testing in court situations. His approach to interviewing a patient: Guided by the relevant statutory standard for capacity, directly assess the patient's ability to know, recall, understand and appreciate specified information: e.g. "what do you own? to whom are you leaving what, and why? how will this contract affect you and the others involved?", etc. He will have a 30 minute discussion with the subject about that. Only then will he administer some tests. The testing is just ancillary. He typically decides if the patient is competent after the 30 minute informal conversation. Some psychiatrists will just do the testing. That is not ideal.

   To measure the patient's best performance:

   - Eliminate distractions
   - Ask questions and give instructions clearly and slowly
   - Allow ample time for responses

3. Most Retain Capacity. Most wildly impaired people retain capacity. The person does not have to know what year it is or who the President is. The person just has to know that "I own a shack and who I want to leave it to."

4. Attorney Approaching Client About Being Evaluated. Attorneys do not have an ethical responsibility to determine if a client has capacity; attorneys are not qualified to make that determination. Sometimes, however, the attorney will have concerns about whether a client has capacity or if there is some undue influence. The attorney may feel uncomfortable approaching the client about involving a geriatric psychiatrist, but it is a way to protect the client (and to protect the attorney.) Also, it sometimes "smokes out" a problem. For example a client wants you to represent his mother and says she understands everything but just can't communicate. When the attorney suggests that the person see a geriatric psychiatrist, the client may never call back — because she really is incompetent.

5. Charm vs. Capacity. A speaker once worked with an actress who is disabled, but can charm people. She charmed police into giving her guns back after they had taken them for her protection. Adam asked the psychiatrist if that is a common problem in evaluating patients. He said he is not persuaded by charm. There is a difference between charm and capacity.

6. Retrospective Evaluation of Capacity. If the patient is deceased or if one's capacity at an earlier time is being evaluated, a patient interview is not possible. The evaluation depends primarily on medical records. The examiner examines medical records [best if there are any on the day in question or about same time], attorneys' records, productions of the testator/settlor, declarations and testimony of disinterested observers. The evaluator must estimate the degree of impairment at the critical moment.

7. Test Scores. Competency rule of thumb from MMSE scores (a common test) to evaluate capacity:

   Mild impairment (MMSE 20+) = almost always retains capacity.

   Moderate impairment (MMSE 10-20) = may or may not have capacity, depending on the specifics of the decision and pattern of deficits

   Severe impairment (MMSE less than 10) = almost always lacks capacity.

   Many impaired people are in the moderate category.

8. Significance of Delay from Time of Records to Time of Event. If there was an evaluation a year later and a year before the relevant time, the one a year before is better than a year after. Degenerative dementias progress gradually, losing about three MMSE points per year, and interpolation is possible. Cerebrovascular dementia (from strokes) progresses in steps and interpolations are much less reliable. (The patient can get much worse overnight.)

9. Depression vs. Incapacity. Severe depression can look like incapacity, but treatment can help. Psychiatrists can determine the difference between severe depression and dementia.

10. Practical Steps for the Attorney If Capacity is in Doubt. If the attorney has mild concerns about a client's capacity, what can the attorney do in the execution ceremony that would help later?

    - Do not ask yes or no questions. "Do you know what year it is? Yes."
    - The more that's in the record the better.
    - Ask general questions and let the client talk. Write down what is said.
    - The more the better.
    - If you have the temptation to videotape, DON'T. It's not a good idea.

What's New From Washington? — Ron Aucutt and Cathy Hughes

1. Recent Legislation.

   a. Residence Gain Exclusion for Surviving Spouse. The 2007 Mortgage Debt and Relief Act amended §121 to provide that a surviving spouse now has up to two years (rather than just one year) to sell the residence and still take advantage of the deceased spouse's exclusion from recognition of gain, as long as the spouse has not remarried by the time of the sale. The Emergency Economic Stabilization Act of 2008 impacts whether both spouses' exclusions can be used. If there has been any period of non-qualified use, that will reduce the amount of the exclusion.

   b. Charitable IRA Rollovers Extended. The Emergency Economic Stabilization Act of 2008 (often referred to as the bailout act) permits the use of charitable IRA rollovers, as allowed in 2006 and 2007 under the Pension Protection Act of 2006. IRA owners and beneficiaries age 70 ½ years and older can make qualified charitable contributions of up to $100,000 in a calendar year. The extension permits rollover for all of 2008 through 2009. (For married couples, each spouse can make qualified distributions of up to $100,000 each if both have IRAs and are both 70 ½ years of older.)

   c. Other Extensions. Some of the other extensions included in the Emergency Economic Stabilization Act of 2008 include (a) the option to claim an itemized deduction for state and local general sales taxes instead of the itemized deduction for state and local income taxes, and (b) the above-the-line deduction for qualified tuition and related expenses for higher education paid during the tax year.

   d. AMT Relief. The Emergency Economic Stabilization Act of 2008 provides some relief for 2008 only. The act increases the maximum AMT exemption amount over its 2007 level by $3700 (to $69,950) for married taxpayers filing joint returns, and by $1850 for unmarried individuals (to $46,200) and married persons filing separately (to $34,975). After 2008, the exemptions drop to the levels in the year 2000 unless Congress acts to provide a further fix in the future.

   e. More Detailed Reporting of Securities Transactions After 2010. Starting with stocks, bonds and several other financial instruments bought after 2010 (a later date applies to some specialized securities), brokers must include in reports of sales transactions a customer's adjusted basis, and whether a gain or loss on the transaction was short term or long term.

   f. Expatriation; HEART Act. The Heroes Earnings Assistance and Relief Tax Act of 2008 (referred to as the "HEART" Act), includes generally (1) a special income tax "mark to market" rule when someone expatriates after June 17, 2008, and (2) a new succession tax on anyone who receives a gift or bequest from an expatriate after June 17, 2008. (There are special rules and exceptions to these rules, some of which are summarized below.) Some of the provisions of the HEART Act potentially affect every client.

      The new provisions apply to a "covered expatriate" who is a U.S. citizen who relinquishes citizenship and any long term resident (i.e., a lawful permanent resident or green card holder for eight out the 15 years prior to expatriation) who terminates U.S. residency if the individual meets one of three categories. (Those categories are that the individual (1) has an average income tax liability for the last five years over $124,000 [adjusted for inflation after 2004], (2) has a net worth of $2 million or more [not indexed], or (3) fails to certify that he or she has complied with all U.S. tax obligations for the prior five years.) There are several exceptions to who constitutes covered expatriates.

Mark-to-Market Tax. Section 877A is an income tax provision, requiring a mark to market tax. A covered expatriate is deemed to have sold his or her property on the day before expatriation occurs. There are various exceptions, including (a) the first $600,000 of gain, (b) eligible deferred compensation agreements (for which the gain is recognized only as funds are paid out), but this exception does not apply to IRAs, and (c) Section 529 plans.

Interests in grantor trusts are subject to the mark-to-market tax. The mark-to-market tax does not apply to interests in non-grantor trusts at the time of expatriation, but there is a 30% withholding requirement on the trustee on the portion of any distribution that is made to covered expatriates that would have been includible in the gross income of the expatriate if he or she continued to be subject to tax as a citizen or resident of the U.S. Furthermore, if a non-grantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the expatriate at its fair market value.

Persons who expatriated before June 17, 2008 are subject to continued taxation under the former special tax regime in §877 for 10 years, but that will run out in 2018.

Succession Tax. Section 2801 is a transfer tax provision, imposing a transfer tax on the recipient who is a U.S. citizen or resident of a gift from a "covered expatriate" or a transfer directly or indirectly by reason of the death of a an individual who was a covered expatriate immediately before death. Therefore, planners must ask every client if any "upstream" relative has expatriated. There are several exclusions from this tax: (1) property shown on a timely filed gift or estate tax return of the covered expatriate; (2) property for which a marital or charitable deduction would be allowed under §§2055, 2056, 2522, or 2523; and (3) annual exclusion gifts and other gifts exempt under §2503(b). (Observe, an expatriate loses all benefits of a unified credit; the recipient qualifies for the $13,000 annual exclusion, but gifts above that are subject to the transfer tax.) The tax is the highest marginal rate of tax specified for gifts or estates, respectively [currently 45%].

If the transfer is made to a domestic trust, the tax is due from the trust. (What if the bequest is made to a charitable remainder trust, and taxes cannot be paid from the charitable remainder trust?) If a transfer is made to a foreign trust, the succession tax is not imposed in the year of transfer but is imposed on any distribution from the trust (whether from income or principal) attributable to such covered gift or bequest. However, a foreign trust can make an election to be treated as a domestic trust and pay the tax at the trust level. Otherwise, the foreign trust and beneficiary must act together; the portion of a distribution attributable to a covered gift must be reported by the distributee.

The recipient of a transfer from a covered expatriate must file a report and pay the tax, but if property received by a US resident is shown on a timely filed gift or estate tax return, then the recipient does not have a reporting requirement. This creates considerable confusion until the IRS issues guidance. (There have been rumors that there will be guidance from the IRS in the fall on this Act; Cathy Hughes has indicated that a lot of people are working on guidance and it is a priority.) The statute does not provide when the report must be filed. It must be reported after the receipt of the property, but is that the date of death or the date the bequest is funded? How will the recipient know, if the transfer has been shown on another person's gift or estate tax return (which may not be due until the same day the report would be due by the recipient)?

The special taxes regime that has been imposed on expatriates over the last several years (in particular beginning with the American Jobs Creation Act of 2004) has dramatically reduced expatriation. Some planners say that this new tax system will devastate expatriation; it is such an onerous tax that the primary application will be just for accidental expatriation.

2. Priority Guidance Plan 2007-2008 Projects.

a. Section 67(e) Regulations. Proposed regulations apply the same harsh test as adopted by the Second Circuit in Rudkin (i.e., only expenses "unique" to trusts and estates qualify for the §67(e) exception). That approach was rejected by the Supreme Court in Knight, but there is language in Knight suggesting that the statute was "somewhat ambiguous" which liberates the Treasury Department to write reasonable regulations. Under accepted deference principles, any reasonable regulations adopted by the IRS would be recognized by the Supreme Court.

Notice 2008-32, said that the IRS would finalize regulations consistent with the Supreme Court decision, but would not apply unbundling to 2007. There was a warning that for 2008 and beyond, unbundling would be required.

The IRS hopes to get further guidance out quickly, so that planners are not in the same situation as last year when they knew there would be a Supreme Court decision early in 2008 and did not know how to file returns. The goal is to adopt regulations that would be administrable and fair. The IRS hopes to have regulations issued by the end of the year.

b. Ordering Rule for CLTs. Proposed regulations provide that ordering provisions in charitable lead trusts (saying that the "worst" income comes out first, when it is distributed to charity) will not be respected, unless the ordering provision has economic effect. A comment filed with the IRS by Conrad Teitell argues that ordering provisions do have economic effect, because they impact the amount of future distributions to charity (by reducing the amount of taxes that must be paid by the trust).

c. Alternate Valuation Date. Proposed regulations provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate within the first six months following the date of the decedent's death due to market conditions, but not due to other post-death events. The term "post-death events" includes a reorganization of an entity in which the estate holds an interest. Therefore, reorganization may occur that is outside the control of the decedent's estate, but the example says that is treated as a post-death event that would be ignored in determining the value under the alternate valuation date method. In addition, distributions of minority interests or undivided interest between the date of death and the alternate valuation date are treated as post-death events that are ignored for purposes of the alternate valuation method. (The IRS is concerned that a control interest might be turned into minority interests for valuation purposes by distributing a minority interest during the first six months, leaving the estate with a minority interest at the six month alternate valuation date.)

The IRS received various comments to the proposed regulations, suggesting that the IRS overreacted with some of the harsh positions taken in the regulations. Apparently, the IRS is rethinking some of its positions in light of comments received. Final regulations are expected by the end of the year.

d. <u>Family Owned Trust Companies</u>. Notice 2008-63 addresses some of the tax effects of trusts that have a family-owned trust company as the trustee, where family members that created the company are grantors or beneficiaries of the trust. The Notice describes a proposed revenue ruling, which is rather unusual, and reflects the desire of the IRS to "get it right." A proposed revenue ruling approach is used, because the IRS believes that it is especially important to get the input of planners who have dealt with the minutia of these issues in private practice.

The preamble states that the goal is to prevent taxpayers from doing indirectly (through using family owned trust companies) what cannot be done directly. The general approach is to impose the restriction of a discretionary distribution committee that would have firewalls to "wall off" the interested members of the committee from participating in distribution decisions.

The proposed revenue ruling addresses two situations. Situation one involves a state statute with various restrictions. (It is likely that a lot of state statues in the future will have provisions looking exactly like the facts in situation one. At this point, no states have a statute like this.) Situation two addresses a case where there is no state statute and limitations are hardwired into the governing documents of the trust company. (Since the Notice was issued, it has become apparent that there is a legitimate concern that the requirement that certain provisions be irrevocable may not be enforceable under local law. The IRS is looking for ways to avoid that problem short of requiring a state statute.)

e. <u>Sections 2036 & 2039 Treatment of GRATs</u>. The final regulation under §2036 finalized this year, dealing with the amount included in the gross estate of the grantor of a GRAT who dies during the GRAT term, made clear that the amount included in the estate did not depend upon whether the annuity was for a fixed term or for the life of the individual. Interestingly, it did not directly address "Walton GRATs" and there is no plan by the IRS to do so. The 2008-2009 Plan will address graduated GRATS, discussed below.

f. <u>Others</u>. Various other projects were finalized this year, including among others: (a) CLUT sample forms (annotations reference restrictions on ordering provisions in the proposed regulations); (b) Division of CRTs (addressing pro rata divisions of a CRT into new separate CRTs; in fact, many CRT divisions are made on a non-pro rata basis, but the revenue ruling dealt only with pro rata divisions, because otherwise the IRS income tax group would have had to deal with the <u>Cottage Savings</u> issue of the income tax effects of a non-pro rata division); (c) grantor substitution powers; and (d) restricted management accounts.

g. <u>GST Late Elections</u>. Proposed Regulation 26.2642-7 provides new features for making late GST exemption allocations pursuant to §2642(g)(1). The new system will replace Notice 2001-50 that allowed relief under Regulation §301.9100-3. There are more factors to be considered under the new proposed regulations than under 9100 relief, which was totally discretionary with the IRS. This guidance project came out partly because of a change announced by the IRS about a year ago in the standards that it was using to analyze these requests. By taking the system out of 9100 relief and putting it into regulations, everyone is bound by the regulations. For example, the proposed regulations say that whether or not the statute of limitations has run on the collection of transfer tax on the original transfer will not by itself prohibit a grant of relief. Furthermore, the combination of the expiration of the statue limitations on additional taxes with the use of the valuation discount will not by itself prohibit a grantor relief.

Cathy Hughes indicates that the standards in the proposed regulations may look like tougher standards than those required under the 9100 relief system. However, her understanding is that the provisions in the proposed regulations are very close to how the IRS has been addressing 9100 relief for GST exemption allocation extensions. The IRS does not view this as a shift.

h. Contingent Claims Deductibility Under §2053. The §2053 final regulations will be issued soon. Apparently, the IRS has finished its work on them.

3. Priority Guidance Plan 2008-2009 Projects.

a. Uniform Basis Rules for Trusts. If the income beneficiary and remaindermen of a trust join in selling the entire trust to a third party, each gets a pro rata share of basis in the trust assets under §643. IRS is taking another look at those rules. They were enacted before §664 regarding charitable remainder trusts. The IRS is looking at whether the uniform basis rules should apply to split interest trusts (apparently, planning to address some abusive "tax shelter" types of transactions that they have seen.)

b. Adjustments to CLT Sample Forms. The IRS is considering needed adjustments. For example, annotations to the new CLUT forms reference the ordering rules that were issued after the CLAT forms were published last year. In addition, the IRS is considering whether to include a sample form using formula clauses in testamentary CLTs.

c. Graduated GRATs. The §2036 regulation that was finalized this year did not address graduated GRATs (in which the annuity amount increases by 20% each year), but that issue is on the Priority Guidance Plan for this year. The IRS has been working on this issue with IRS actuaries, and a proposed regulation should be issued in the near future. "It is pretty far along."

d. Protective Claims for Refund. This is an outgrowth of issues that arose from comments to the §2053 proposed regulations. More guidance will be provided about the details for filing and pursuing protective claims for refund. One issue that may be addressed is whether the entire return can be considered, even though the statute of limitations has run on the return, as an offset against the protective claim.

e. Effect of Guarantees and Present Value Concepts. This is also another outgrowth of comments to the §2053 proposed regulations. One comment asked whether a guarantee would be treated as a contingent claim by a family member, where there is a presumption that the claim is not bona fide.

The project will also address when present value concepts should be applied to administration expenses and claims. Under current law, administrative expenses may be deducted fully, as of nine months after the date of death, even though the claim is not paid until years later. Under a present value approach, taxpayers might only be allowed to deduct the discounted value. When contingent claims are actually paid, there may be a superficial parity: the discounted value would be deducted, which would generate a tax refund, and interest would be allowed on the tax refund. If the interest on the refund is calculated at the same rate as the discount rate, there would be parity. However mismatches may occur — including the income tax that would be paid on the interest.

Furthermore, the present value concepts may be addressed for all administration expenses (including attorneys fees, Tax Court litigation expenses, etc.), not just contingent claims. Tax litigators often tell clients that the IRS pays 80% of their litigation expenses in the Tax Court (including the estate tax refund from the additional administration expense deduction and interest on the refund). This project may change their result. Cathy Hughes said "that is a fair reading of what we might be looking at."

Graegin Notes. Current law permits deducting the full amount of interest paid on Graegin notes, even though the interest is paid years after the date of death. Graegin notes might also be on the radar screen. Cathy Hughes: "They certainly are in the scope of what we are looking at."

f. Section 529 Plans. An Advance Notice of Proposed Rulemaking describes the IRS's current thinking. Difficult transfer tax issues are raised. Cathy Hughes has spent a lot of time on these proposed regulations.

g. Updating Mortality Tables, §7520. The mortality tables will be updated to reflect the 2000 census data. The tables must be revised every 10 years to reflect updated census data.

h. Further Section 2704 Regulations. Guidance under §2704 regarding restrictions on the liquidation of interests in a corporation or partnership, first appeared in the 2003-2004 Priority Guidance Plan. This relates to the statutory authority to issue regulations regarding the effect of "other restrictions" that have "the effect of reducing the value of the transferred interest for purposes of this subtitle, but [do] not ultimately reduce the value of such interest to the transferee." §2704(b)(4). The statutory language is very broad, authorizing regulations that would disregard restrictions impacting valuation other than just the restrictions now addressed in §2704. Cathy Hughes said there has been a lot of action of these regulations, and she anticipates they will be issued by the end of the year. These regulations may be a HUGE DEVELOPMENT when they are issued. They could potentially substantially impact FLP discounts (and the effective date provisions will be of great interest).

4. Disregarded Entities Must Pay Their Own Employment Taxes Next Year. This issue was not discussed in the seminar, but beginning with wages paid in 2009, regulations require "disregarded entities" to pay their own employment taxes and file their own tax reports. An employer identification number will be needed for the entity. The entity is liable to income tax withholding, as well as FICA and FUTA taxes. The disregarded entity continues to be disregarded for other federal tax purposes. Reg. §§1.1361-4(a)(7), 301.7701-2(c)(2).

When Worlds Collide — T&E vs. M&A, Ed Manigault and Richard Lang

1. Overview. Estate and gift tax issues addressed by trust and estate attorneys can have a dramatic impact on corporate and real estate transactions. The presentation addresses: the "secret" federal estate tax lien; dealing with transactions when fiduciaries, trusts, or deceased or incapacitated individuals are parties to the transaction; and S Corporation issues.

The outlines by Ed Manigault and Richard Lang are tremendous resources on these topics. I have approached Ed about turning his outline of why and how T&E lawyers need to be involved in transactions being handled by transactional attorneys in their firms into a Probate & Property *article that can be widely distributed to transactional attorneys. In the meantime, Fellows may want to consider distributing the five or six pages of these Musings summarizing Ed's comments in Items 2-4 below to the transactional attorneys in their firms (which will likely scare the* *"bejeebers" out of them). Richard's discussion of S corporation issues addresses various practical problems connected with ownership of S stock in trusts that I have not been aware of previously.*

2. Estate Tax Lien.

   a. Scary Example. A big corporate client bought the assets of an LLC several years ago, following the death of the founder of the LLC. The client recently received a letter from the IRS saying that it will foreclose on all assets purchased from the LLC in order to pay the founder's estate taxes — because the estate is now insolvent. The client complains to the attorney, "We had your help in this transaction and don't remember you mentioning a lien. We did a lien search and found nothing. We paid full value. Why aren't we protected as a bona fide purchaser for value?" Unfortunately, there may be no BFP protection, the IRS may be able to foreclose, and the corporate client may not have recourse against anyone.

   b. Scope and Elements of Estate Tax Lien. Section 6324 says that on the death of an individual, the estate tax lien attaches to every asset in the gross estate, and it lasts for ten years. The lien is not recorded, and there is no notice to third parties. Indeed, the IRS Manual says that if the agent is in a jurisdiction where there is a forum for filing the lien, the agent is not supposed to record notice of the lien. The lien lasts for up to 10 years unless taxes are paid or become unenforceable due to the lapse of time. The lien can be foreclosed on, even if other assets of the estate are available; the IRS is not required to pursue other estate assets first.

   c. Example of Application of Lien. The First American Title Insurance Co. v. U.S. case illustrates that the "scary example" discussed above is realistic. 2005-1 USTC ¶60,501 (W.D. Wash. 2005), *aff'd* 520 F.3d 1051 (9th Cir. 2008). Title insurance companies are sophisticated parties, but this illustrates they can still get caught by this special lien. The decedent died in 1981, owing several major assets, including Frisko Freeze that runs hamburger joints. The decedent's daughter filed the estate tax return and paid part of the estate tax and received an extension on the excess. The estate distributed three houses to the daughter, which she subsequently sold to three purchasers who each obtained title insurance. The IRS revalued Frisko Freeze and assessed more estate taxes. The daughter and estate filed for bankruptcy. The IRS sent letters to the purchasers of the homes threatening foreclosure, unless the taxes were paid. The title insurance companies paid the increased taxes and sued the government for refund, arguing that the sale proceeds were used to pay taxes so the estate tax lien should be divested. The title insurance companies lost that argument because they could not "trace" the use of the proceeds to the payment of taxes, and even if they could, the court held that the payment had not been approved by the court as required by §6324(a)(1). The title companies were left "holding the bag."

   d. Practical Problems and Lessons in Dealing With the Estate Tax Lien.

      (1) Last Minute. Invariably, the estate tax lien issue comes up last minute in deals.

      (2) Hard to Spot; Transferee As Seller. The seller may not be a decedent's estate, but the child of decedent, who within the prior 10 years received assets from the estate.

      (3) Hard to Spot; Disregarded Entity. If assets were purchased from an LLC that either is or was a disregarded entity previously owned by a decedent, the IRS may take the position that the LLC is disregarded for all tax purposes and that all assets of

the LLC are subject to the estate tax lien, even if the LLC *at the time of the sale* was taxed as a partnership.

(4) Practical Problem of Obtaining Sensitive Information. The attorney for a prospective purchaser may approach the estate. "I cannot identify my client, but I need to know information about when the decedent died, the assets of the estate, the amount of the estate taxes, when estate taxes have been paid, etc." What is the likelihood of receiving that information until the transaction has proceeded far down the line? In some situations, sellers may be unwilling to share sensitive estate tax information with counsel for the purchaser or perhaps even with the corporate attorney handling the sale transaction for the seller.

(5) IRS Will Not Accept Wire Transfers. As discussed below, it may be possible to get a release of lien by payment of the estate taxes from the purchaser (i.e., the purchaser may pay part of the purchase price directly to the IRS in partial payment of the estate taxes), but the IRS only accepts checks. It will not accept a wire transfer. The transaction may have to be delayed several days until the check clears. This is particularly difficult when the lien issue arises, as it often does, at the last minute.

(6) Drafting Cannot Solve the Problem. Just adding representations and warranties in the sale documents does not solve the problems. The documents will say that the seller is getting marketable title, and that estate taxes are paid or provided for. However, if taxes in fact are not paid, the purchaser of the asset may still be responsible.

(7) Due Diligence. The purchaser should ask for a copy of the Form 706 if the asset is being sold by an estate. However, even that will not necessarily highlight problems. In the First American Title case, the purchaser was primarily interested in the houses, but the estate tax problem arose over the closely held corporation in the estate. It is hard for the purchaser to know what is going on with all of the other assets of the estate. Even if the advisor is comfortable with assets shown on the estate tax return, what about assets that might have been omitted?

(8) Joint and Several Liability. As a result of the inherent uncertainties, sale agreements generally put all sellers in the position of being jointly and severally liable for the taxes. Therefore, all beneficiaries would be on the hook if there is an estate tax problem.

(9) Escrow for All Proceeds? It is not surprising that funds may need to be placed in escrow in order to obtain the release of the estate tax lien. However, the transactional attorneys may be quite surprised to find that the IRS may require all, not just a portion, of the sale proceeds to be placed in escrow before the IRS grants a certificate of discharge of the lien.

(10) Consider Owning Assets in Revocable Trust or Entity. As discussed below, there are fewer restrictions on the lien if assets are held in a revocable trust or entity.

e. Release of the Estate Tax Lien. There are various methods of releasing the lien, but often they take time and may not be helpful in a time-sensitive M&A deal.

(1) Release of Lien from IRS. The IRS may release the lien entirely or as to specific assets. §6325. The IRS has discretion to issue a certificate of discharge if it is otherwise protected (meaning that other assets subject to the lien are twice the tax

liability (§6325(b)(1)), or if an amount equal to the IRS interest in the property is paid to the IRS, or if the proceeds are held in escrow. The escrow approach is often required in the context of business transactions, but negotiating the agreement can take considerable time. Ed Manigault was recently involved in a case where three months was required to negotiate the arrangement with the IRS — and all of the proceeds were placed in escrow, not just 45% (because the lien attaches to all of the asset).

(2) Payment of Estate Expenses. The lien is released if (i) proceeds of the purchase are used to pay charges against the estate or administration expenses, AND (ii) those expenses are allowed by a court with jurisdiction. (The First American Title Insurance Company case discussed above, emphasizes the importance of both the tracing and court order requirements.) This method has limited utility in many corporate deals because of the time requirement of obtaining a court order. (This method applies to both probate property and non-probate property.)

(3) Discharge Under §2204. If the executor has been discharged from personal liability under §2204, a transfer of property to a purchaser for full consideration, or a holder of the security interests will divest the lien from the transferred property. §6323(h)(6), 6326(h)(1). (Instead, a substitute lien is placed on the consideration received from the sale. §6324(a)(3).) (This method applies to both probate property and non-probate property.)

(4) Non-Probate Property Exception for Bona Fide Purchasers. A transfer of non-probate property to a purchaser or holder of the security interest divests the lien from the transferred property. §6324(a)(2)(first sentence). However, a lien is then placed on all of the property of the transferor (not just the consideration received in the transfer). §6324(a)(2); Rev. Rul. 56-144.

(5) Exception for Purchasers of a "Security". If someone pays full value for a "security", they receive the security free of the estate tax lien; that sounds like BFP protection. However, an important concern is that this exception only applies to stock or other securities, not to a partnership or LLC interest. Also, it does not apply if the purchaser had "actual knowledge or notice" of the existence of the lien. In light of the uncertainties surrounding the "actual notice or knowledge" requirement, purchasers cannot rely on this exception.

f. Mitigating the Lien Using Revocable Trusts or Entities. If there will be substantial sales after an individual's death, various steps can be taken to mitigate lien problems that may arise in making sales.

(1) Revocable Trusts. Assets in revocable trusts would be non-probate assets that could be sold to a purchaser for full value divested of the estate tax lien.

(2) Assets in Entities. In Beaty v. U.S, 937 F.2d 288 (6th Cir. 1991), the estate sold its partnership interest to the partnership in return for land owned by the partnership, and the land was distributed beneficiaries. The estate tax lien did not attach to that land. Under the reasoning in this case, the estate tax lien only attaches to property included in the estate, i.e., the partnership interest and not the assets in the entity.

3. Transactions With Fiduciaries. If a fiduciary is a party to a transaction, most transactional attorneys know to coordinate with the T&E attorney because there are different rules for fiduciaries.

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

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

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

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

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

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

Ed Manigault's outline includes a *terrific* chart of all 50 states, listing state statutes dealing with third-party protection, certification of trusts, and broad trustee powers.

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

d. Summary of Approach to Dealing with Trusts Involved in Deals.

(1) What Law Applies to Administration of the Trust. The attorney for a purchaser often asks the attorney representing the fiduciary to give an opinion on what law applies to the administration of the trust. (That should just be a short opinion.)

The attorney can then review the statutes of that state regarding the protection for third parties, trust certification, and broad trustee powers.

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

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

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

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

5. S Corporations.

a. Trusts as Qualified Shareholders. Trusts that can be qualified shareholders include:

- Grantor trusts;
- Qualified Subchapter S Trusts [QSSTs] — (1) all income must be distributed to the income beneficiary, (2) the trust must provide only one income beneficiary during the life of the beneficiary, (3) any corpus distributed must be to that beneficiary, (4) the income interest must last until the termination of the trust, (5) at termination, all assets must be distributed to that beneficiary, and (6) the income beneficiary must make the QSST election;
- Electing Small Business Trusts [ESBTs] — (1) there can be multiple beneficiaries and beneficiaries can include individuals, estates or charitable organizations, (2) no interest in the trust may be acquired by purchase, (3) the trust cannot be one for which a QSST election is in effect for any S corporation, a tax-exempt trust, or a charitable remainder trust, and (4) the trust must make the ESBT election.

b. Landmines for Grantor Trust Qualification. Grantor trust status may depend upon the relationship of the trustee to the settlor, and trustee changes may impact that result. The trust must be a wholly grantor trust, as to both income and corpus.

c. Landmines for QSST Qualification.

- The beneficiary cannot be a nonresident alien.

- The trust cannot be a foreign trust.
- The income distribution requirement may present problems. The instrument does not have to require mandatory income distributions, but they must be made in fact. Even though the QTIP regulations allow distributing undistributed income at the death of the surviving spouse to remaindermen, under UPIA, undistributed income must be paid to the estate of the income beneficiary; therefore, if the instrument merely does what the marital deduction rules allow, the income requirement may not be satisfied.
- Clayton QTIP trust — if the trust says that different provisions will apply if the QTIP election is not made, the QSST election may not be possible until the beneficiaries are certain, and that may not occur until the QTIP election is irrevocably made, which will not happen until the expiration of time to file the Form 706. (Filing the Form 706 early does not help.) However, this is usually not a problem, because an estate may be a qualified shareholder for two years following the shareholder's death.

d. <u>Landmines for ESBT Qualification</u>.

- The beneficiary cannot be a nonresident alien.
- The trust cannot be a foreign trust.
- The remaindermen of the trust cannot include a disqualified individual or trust. If the trust passes at termination to another trust, look through to the beneficiaries of the trust. For example, if a pet trust is a remaindermen, that would blow ESBT qualification.
- If a beneficiary (such as the surviving spouse) made the QSST election for another S corporation owned by the trust, the ESBT cannot be made for the trust (even though the QSST election has not been made for the particular corporation at interest).

e. <u>Overview of Tax Effects</u>.

For a QSST, the beneficiary who makes the QSST election is treated as the owner of the trust, and reports flow-through income on his or her return directly. The trust accounting purposes, any distributions from the corporation are treated as trust accounting income that must be distributed to the beneficiary.

For an ESBT, income tax on the S income is paid by the trust at the highest bracket for trusts (currently 35%). The S income includes the trust's share of pass-through items and gain or loss on the trust's disposition of its S stock. There is no deduction for a distribution to the beneficiary for trust accounting purposes from the "S portion" of the trust. The net after tax income of the trust is the fiduciary income that must be distributed to the beneficiary.

On the surface, it appears that the two regimes can produce the same net benefit if the trust and beneficiary are in the same bracket. However, anomalies can result. For example, some state UPIA acts allocate partial liquidating distributions to principal. That may mean that the income beneficiary would pay income tax on those amounts, but if allocated to principal, they would ultimately pass to the remaindermen unless they are distributed to the beneficiary under liberal discretionary principal distribution standards.

There is an excellent detailed discussion in Richard Lang's outline of the detailed tax effects of either QSST or ESBT treatment, and of differences that may result for QSST vs. ESBT trusts as a result of the way that the state allocates undistributed income between income and principal of the trust, including a discussion of the new §505 of UPIA.

f. Factors That Favor One Regime Over the Other. The flexibility of choosing either QSST or ESBT treatment is often available only for QTIP trusts, because other trusts typically have more than one permissible beneficiary. The following discussion assumes the trust is a QTIP trust and the income beneficiary is the surviving spouse.

(1) Spouse in Lower Bracket. If the spouse is in a lower bracket than the trust, QSST is better.

(2) Adjusted Gross Income. The spouse sometimes desires to have a higher adjusted gross income (for example to have a higher charitable deduction limitation); in that case, QSST treatment would be better. However, the spouse sometimes desires a lower adjusted gross income (for example, for purposes of the 2% limit on deducting miscellaneous itemized deductions or for purposes of deducting medical expenses); in that case the ESBT approach would be better.

(3) State Income Tax Considerations. Richard Lang's outline: "If the trust is resident of a state with a high state income tax and the spouse is resident in a low or no income tax state, then a QSST will save the state tax that the ESBT would pay, and vice versa should the ESBT not be subject to state income tax and the surviving spouse is."

(4) Charitable Contributions by S Corporation. Charitable contributions by S corporations are passed through to the shareholder's returns. For QSSTs, the deduction would be reported on the spouse's Form 1040. For ESBTs, a strange rule applies. The regulations create a fiction that distributions are made pursuant to the governing instrument, so a charitable deduction would ordinarily be allowed to the trust. However, §681 denies a charitable deduction under §642(c) to the extent that it is paid out of "unrelated business income" calculated as if the trust were a tax-exempt trust. Therefore, if the S corporation has UBIT income, ESBT treatment will cause the loss of a significant portion of the charitable deduction.

g. Conversions. Even though some tax elements may favor each regime, the trust must be one or the other. The regulations allow a conversion only once every 36 months (from QSST to ESBT or vice versa). The consent of the income beneficiary and trustee is required. Timely conversions may yield the best tax result. For example, make the QSST election when the spouse expects to make a large charitable direction and needs a large adjusted gross income or if the corporation makes a charitable contribution of UBIT income.

Avoiding additional state income tax to the surviving spouse would favor ESBT treatment. As a practical matter, most QTIPs are QSST, but if state income tax planning is important, consider moving the trust to a "no-income tax state" for trusts and make the ESBT election.

h. Failure of Spouse to Make QSST or ESBT Election May Trigger Buy-Out of S Stock. If S stock passes to a QTIP trust following the death of the shareholder, with the surviving spouse as trustee of the QTIP trust, a failure by the spouse to elect either QSST or ESBT treatment would cause the trust not to be a qualified S shareholder. Under most S corporation buy sell agreements, that would trigger a purchase of the stock by the corporation or other shareholders. How can an S shareholder who wants to leave his or her S stock to a QTIP trust avoid the possibility that the surviving spouse would sabotage the S election by refusing to make the QSST or ESBT election? One alternative may be to give someone other than the surviving spouse the authority to make the ESBT election. Another possibility is for the shareholder to create an inter vivos QTIP marginally funded with S stock, and make the ESBT election. The ESBT election has no effect as long as the trust is a grantor trust, but when the grantor dies, the estate distributes the rest of the S stock into the QTIP trust and the ESBT election would apply to the trust. Revocation of the ESBT election in that case would require the consent of the Commissioner. (Using inter vivos QTIP trusts is discussed below as well.)

i. Effects on S Status And Tax Liability At Death of Surviving Spouse After QTIP Created. If the QTIP trust is a QSST, it may continue as a qualified S shareholder for two years after the surviving spouse's death. (The QSST election treats the trust as a grantor trust as to the spouse, and at the surviving spouse's death, there is a two-year exception for estates and former grantor trusts. §1361(c)(2)(ii). Reg. §1.1361-1(j)(7)(ii) & 1.1361-1(j)(8).)

On the other hand, if the QTIP trust is an ESBT, there is no two-year grace period and the trust ceases to be an ESBT on the first day it fails to meet the ESBT qualification rules, for instance, because it has an ineligible beneficiary (such as a nonresident alien beneficiary). In that case, steps must be taken to qualify the trust immediately on the death of the surviving spouse. (The statute allows what is in effect a retroactive fix for an ESBT that finds itself with an ineligible beneficiary, because if the ESBT disposes of its S stock (by sale or distribution) then any person who first met the definition of a potential current beneficiary within the one-year period ending on the date of disposition is not a potential current beneficiary. Reg. §1.1361-1(m)(4)(iii).)

There may be differences in allocation of tax liability for QSSTs and ESBTs, depending on the state principal/income allocation statutes.

j. Inter Vivos QTIP Trusts. If a "moneyed" spouse wishes to make gifts of S stock to his or her "non-moneyed" spouse to be able to utilize the non-moneyed spouse's full estate tax exemption if the spouse dies first (and more clients will be considering this in 2009 when the estate tax exemption jumps by $1.5 million to $3.5 million), using an inter vivos trust is a good alternative. Because the grantor's spouse can receive distributions, the trust would be a grantor trust and a qualified S shareholder.

If the donee spouse dies first, the trust may continue to qualify as a grantor trust depending on the other terms of the trust, such as whether it has a substitution power.

If the donor spouse dies first, the trust will qualify as a former grantor trust with a two-year grace period. The QSST election should be available after the two years. Alternatively, the QTIP trust could make the ESBT election initially. That would have no effect while it is still a grantor trust, but if the donor spouse dies first, the donee spouse could not sabotage the S qualification by refusing to make the QSST or ESBT election.