ACTEC 2009 Annual Meeting Musings

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Introduction

Some of my observations from the 2009 ACTEC Annual Meeting Seminars in Rancho Mirage, California on March 5-8, 2009 and current developments from other recent seminars are summarized below. (The summary does not include any discussions at Committee meetings at the ACTEC Annual Meeting. The summary generally also does not include issues that I have discussed in prior "Musings."). In particular, a wide variety of current developments are summarized in my Heckerling 2009 Musings, available at the ACTEC private website (http://www.actec.org/private/default.asp) in the "New Developments" section. I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the seminars. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. I often have not identified individual speakers who made each of the comments (primarily in case I have misinterpreted any of their comments).

Items 1-9 come from a Hot Topics seminar by Chris Albright, Anne O'Brien, and Barbara Sloan and include various other recent developments.

1. Legislation Issues

a. Heckerling Musings Summary. Estate and income tax legislation issues are addressed in my Heckerling Musings 2009 (mentioned in the Introduction). A few additional developments are discussed below.

b. $3.5 Million Exemption; 45% Rate Likely Will Pass. It is unlikely that Congress will want to be more aggressive than administration proposals regarding the estate tax. Several provisions in the President's proposed budget point to a $3.5 million estate tax and GST exemption and a 45% rate. (A footnote to one table says that the "estate tax is maintained in its 2009 parameters.")

c. Portability. Portability of the estate tax exemption may have a 50-50 chance of being added at some point. Whether portability of the GST exemption would be allowed may be more doubtful; it may be viewed as a tax on the "ultra-rich." (There is an estate tax exemption portability provision in HR 498 introduced by Representative Mitchell, which also would also increase the exemption to $5.0 million, indexed for inflation, and would reunify the gift and estate tax exemption.)

d. GRAT Legislation. The likelihood of legislation limiting GRATs seems very small. If it happens, it will be because of "self-fulfilling prophecies."

e. Crummey Powers. A Joint Committee Report several years ago suggested the possibility of tightening the rules on Crummey trusts. The Treasury would like to impose more restrictions on annual exclusions for gifts in trust. However, that does not seem to have a high priority. (If a restrictive provision were adopted [for example, allowing the annual exclusion only for single beneficiary trusts], that could create substantial problems for ILITs that need continuing gifts for making future premium payments.)

f. Valuation Discounts. Restricting valuation discounts appears to have the attention of various staffers on the Hill and they are definitely thinking about it. The AICPA's legislative staff has been active in preparing a letter to Representatives Rangel and Baucus outlining objections to the valuation provisions in section four of the Pomeroy bill (HR 436).

Legal documents (such as buy-sell agreements) that refer to transactions based on "fair market value" could result in awkward situations in which transactions are legally binding for state law purposes but may not be recognized for federal transfer tax purposes.

g. S Corporation Built-In Gain; 2009 Stimulus Act. A C corporation that elects to become an S corporation is subject to the corporate level built-in gains tax on any built-in gain (i.e., gain at the time of the conversion to an S corporation) recognized during the 10 years following the conversion. The American Recovery and Reinvestment Tax Act of 2009 provides that for any built-in gain recognized during 2009 or 2010, the ten-year holding period is reduced to a seven-year holding period. (§1251(a) of the Act.)

2. Planning In Light of Decoupling and Federal Estate Exemption Increase to $3.5 Million

a. Increase to $3.5 Million Exemption. The increase of the federal exemption to $3.5 million has had a dramatic impact on the amount of state estate tax. In New York, state estate tax increases from $99,600 to $229,200 for fully funding a bypass trust (now that the exemption is $3.5 million). (Only two states have a $3.5 million state exemption. Illinois and a few other states have had a $2 million exemption, and the disparity between the state and federal exemptions in those states has just arisen this year.)

b. Use Two QTIPs To Allow More Flexibility. If the state exemption is less than the federal exemption and if the state does not recognize a state QTIP election (separate from the federal QTIP election), the basic alternatives are to pay the extra state estate tax and fully fund the bypass trust, or to underfund the bypass trust to avoid paying extra state estate taxes. An alternative approach, to allow more flexibility, is to fund the bypass trust with an amount equal to the state exemption, fund one QTIP trust with an amount equal to the difference between state and federal exemption, and to fund another QTIP trust with the balance of the estate. This gives the executor the flexibility, during the estate administration *(taking into account the law and financial conditions at the time of the first spouse's death),* to decide whether to make a QTIP election for the first QTIP trust in order to save state taxes or whether to allow the trust to become a bypass trust by not making a QTIP election (and thereby having to pay additional state taxes).

c. Source of State Tax Payments. Will the state estate taxes be paid from the bypass trust or the marital share? State estate tax qualifies for a deduction from the federal estate tax, so it can be paid from the marital share without creating additional federal estate taxes. However, the answer may be different for state estate tax purposes. In some states, there is no deduction for the estate tax, and apportioning estate tax against the marital share in those states would require an interrelated formula to calculate the estate tax. For example, in New York, the state estate tax will be $229,200 for fully funding a $3.5 million bypass trust if the estate taxes are paid out of the bypass trust. If the estate taxes are paid out of the marital trust, the state estate tax will increase to $254,911. Each client in a similar taxing state will need to decide whether the additional $25,000 (approximately) of state tax is worth keeping the bypass trust intact, unreduced by the $254,911 of the state tax.

d. State QTIP Election. A handful of states allow a state QTIP election, which recognizes the QTIP election for state purposes but not federal purposes. In these states, it is possible to fully fund the bypass trust with the amount of the federal exemption, but avoid paying state estate tax at the death of the first spouse. In some states, this election is allowed in an administrative directive rather than in a statute.

3. Built-In Gains Discount Taking Into Consideration Anticipated Future Appreciation and Lack of Control and Marketability Discounts, Litchfield

a. Basic Facts. This case addresses discounts for a real estate corporation and a marketable securities corporation, including the built-in gains discount. Estate of Litchfield, T.C. Memo. 2009-21 (Judge Swift). The estate owned minority stock interests (43.1% and 22.96%) in two corporations, one that primarily owned farmland and securities and another that owned marketable securities. Both companies elected S corporation status one year before the decedent died (so still had nine years to run on the 10-year period of built-in gains after conversion from C corp to S corp status).

b. Built-In Gains Discount. There are two general approaches for calculating the built-in gains discount. First, a dollar-for-dollar approach is allowed in the 5th and 11th Circuits. (Estate of Dunn, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke III, 507 F.3d 1317 (11th Cir. 2007), cert. denied (2008). Second, other courts have applied a present value analysis, considering when the corporation might sell appreciated assets and determining the present value of the additional corporate level capital gains costs. Both experts in this case applied the present value analysis. The court emphasized that it was not deciding which of the two approaches was most appropriate, observing that the estate's expert did not ask the court to apply a full dollar-for-dollar valuation discount. "Therefore, we need not decide herein whether such an approach would be appropriate in another case where that argument is made."

The court was more persuaded by the taxpayer's expert as to the turnover estimates, including conversations with management and discovery that there were many elderly shareholders concerned with paying estate taxes, and that management had addressed selling assets to be able to provide liquidity to the shareholders' estates. A key distinction between the approaches of the parties is that the taxpayer's expert considered an amount of assumed appreciation in the assets during the holding period and took into consideration the additional capital gains taxes attributable to that appreciation in some manner.

There is no consistency in the cases as to whether future appreciation should be considered. On one hand, the corporation is being valued as of a particular valuation date, and arguably neither increased liabilities nor increased asset values should be taken into account. On the other hand, a purchaser buying a corporation with appreciating assets will have to incur a second level capital gains tax on future appreciation that a purchaser of directly owned assets will not have to bear. As a result, prospective purchasers presumably will pay less for the corporate interest that would be subject to the additional tax on future appreciation, and an adjustment should be made in some manner with respect to the built-in gains tax attributable to future appreciation. The court agreed that an adjustment should be considered with respect to the additional level of capital gains taxes on future appreciation.

> "On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller."

The court observed that one of the IRS's own experts in another case acknowledged that he would take into account holding-period asset appreciation in calculating appropriate valuation discounts. (Estate of Dailey, T.C. Memo 2001-263). In addition, Estate of Borgatello, T.C. Memo 2000-264, included capital gains taxes on estimated holding period asset appreciation in determining the amount of built-in capital gains discount. In contrast, the Tax Court in Estate of Jelke did not include post-death appreciation in determining the built-in gains discount. The built-in gains discounts allowed in Litchfield were not "dollar-for-dollar," but were very substantial.

Practical Planning Guidance. In the 5th and 11th Circuits, claim a dollar-for-dollar built-in capital gains discount. Outside of those circuits, there is no certainty. If the taxpayer's expert uses a present value approach, the second level of corporate capital gains taxes on the appreciation during the holding period should be considered. In determining the estimated holding period before assets are sold, consider historical data, recent data, and actual conversations with management about anticipated plans.

Is it possible to admit testimony that buyers typically reduce the purchase price because of the built-in gains tax liability when purchasing interests in corporations? The difficulty is that the built-in gains tax factor is merely one factor considered in the negotiation process, and it is hard to say how much discount is allowed specifically for that factor. Furthermore, some judges have refused to allow that kind of general testimony.

c. Lack of Control Discount. The court adopted the taxpayer's expert analysis, which used a weighted average for the lack of control discount attributable to the farmland and securities. (The government expert just used an average of the lack of control discounts attributable to those different types of assets, without weighting the average based on the relative values of those different types of assets.) The court allowed 14.8% and 11.9% lack of control discounts for the interests in the two corporations (the higher discount being applied to the corporation holding substantial farmland as part of its assets).

d. Lack of Marketability Discount. The court did not agree with the estate's marketability discount, partly because the combined marketability and minority discounts would be too high. The court also observed that the estate's expert used some outdated data related to restricted stock discounts and applied discounts higher than those reflected in benchmark studies that included all components of a lack of marketability discount. Very interestingly, the court observed that the estate's expert, in another valuation report prepared for gift tax purposes, stated that the estate's same stock interest was valued with a lower marketability discount. The court allowed marketability discounts of 25% and 20% for the interests in the two corporations.

e. Combined Discounts. The seriatim discounts allowed for the interests in the two corporations, taking into account all three discounts, were 52.25% and 53.8%.

4. Defined Value Transfers, Formula Disclaimer, Christiansen Appeal

The estate has elected not to appeal Estate of Christiansen, 130 T.C. No. 1 (2008), which refused to recognize the validity of a disclaimer of assets that passed into a charitable lead annuity trust, having the disclaimant as a beneficiary of the CLAT. *Practical Planning Pointer*. There are no prior cases regarding whether a disclaimant (other than a surviving spouse) can disclaim assets into a CLAT of which the disclaimant is a beneficiary. There were strong arguments on both sides of the issue in the Tax Court. Planners should avoid the issue, and plan for the person to disclaim only the portion for which the disclaimant is willing to disclaim all interests, including his or her interest in any split interest charitable trust to which the disclaimed assets will pass.

The government has filed a notice of appeal with respect to the portion of the opinion that approved a formula disclaimer of assets that passed to a private foundation despite the government's argument that the disclaimer should be invalidated on public policy grounds. The government asked for an extension twice before filing its brief. For some reason, the Solicitor General delayed in authorizing the government to file a brief in the case.

One attorney informally reports that he has recently settled a case involving transfers of FLP interests using a defined value clause. The IRS appeals officer recognized the validity of the defined value clause. In that situation, the additional 1% of value that passed to taxable beneficiaries under the defined value clause was not sufficient to require payment of gift taxes.

5. Delays in FLP Audits

A number of attorneys have expressed that they are experiencing delays in FLP audits. There have been relatively few settlements over the last six months, and a number of FLP audits seem to be getting further backlogged. An interesting dichotomy is that the IRS has been adding to the staffs of estate and gift tax field agents in some parts of the country.

6. Late GST Exemption Allocations for 2008 Gifts

For gifts made in early 2008, a late allocation may be preferable to be able to allocate based on current values — after the market meltdown. A late allocation could only be made on a late return; that is not elective. The donor must wait until after the gift tax return filing date (including the extended date if the income tax return is extended to October 15, because Form 4868 automatically extends the gift tax return filing date as well) to make a late allocation. If a late allocation is desired, make sure that there is not automatic GST exemption allocation to the transfer. It may be necessary to file a timely return to elect out of automatic allocation, before filing the late return after the filing due date.

7. Recent Grantor Trust Letter Rulings

a. <u>Power to Lend Without Adequate Security</u>. In Letter Ruling 200840025 the non-adverse trustee had the power to make loans to the grantor, with or without security. The non-adverse trustee could release the power for any separate trust by written notice to the grantor and the current beneficiary of the trust. Unless otherwise provided in the release, any such release would apply to that trustee and all successor non-adverse trustees. The ruling concluded that the power of the non-adverse trustee to make loans to the grantor, with or without security, caused the trust to be a grantor trust under §675(2) so long as the grantor is alive and the non-adverse trustee has not released the power with respect to a particular trust.

Under the trust instrument, a beneficiary may withdraw assets upon reaching a specified age. The ruling concluded that the grantor would continue to be treated as the sole owner of the trust, even after the beneficiaries reach those specified ages, so long as the grantor is alive and the non-adverse trustee has not released the lending power. The ruling acknowledged that the withdrawal powers held by the beneficiaries would otherwise cause them to be treated as the owners of the trust under §678 after they reach the age for making withdrawals.

Practical Planning Pointer: Instead of requiring terminating distributions as the beneficiary reaches specified ages, instead give the beneficiary a power of withdrawal. This gives the beneficiary the flexibility to keep the assets in trust to maintain the grantor trust treatment.

b. Modification of Trust to Add Non-Fiduciary Grantor Substitution Power. In Letter Rulings 200848006, and 200848015-200848017, the IRS held that if a trust is modified in accordance with state law to add a non-fiduciary substitution power, the trust would become a grantor trust in any year in which the power was determined to be held in a non-fiduciary capacity. Like some prior rulings, the IRS ruled that whether a power of administration is exercisable in a fiduciary or non-fiduciary capacity is a question of fact that can only be determined "after the fact" when the relevant federal income tax returns are examined. The IRS expressed no opinion on the gift tax effects of the modification or of an exercise of the substitution power.

8. Impact of Financial Action Task Force ("FATF")

a. Formation; Purpose; Implementation of Recommendations. The Financial Action Task Force ("FATF") was first formed in 1989 during the G7 Summit in Paris, France. It is an intergovernmental group of 32 countries and other associate members. Its purpose is to counter money laundering and terrorist financing. The members countries are expected to adopt the recommendations of the Task Force.

In 1990, FATF issued 40 recommendations to combat money laundering. They have been revised since, and nine more recommendations were added to combat terrorist financing. The recommendations initially focused on financial institutions. The recommendations are now being extended to gatekeepers, including lawyers, notaries, real estate agents, accountants, auditors, and others who deal with the movements of money.

Each country reviews whether it is implementing the recommendations, and there is a mutual review as well. In 2006, a high commission met with the Treasury Department and determined that the U.S. was non-compliant by not having measures in place to ensure adequate, accurate and timely information on beneficial ownership and control of legal entities.

b. Money Laundering. Money laundering is the criminal practice of filtering ill-gotten gains into the legitimate stream of commerce. Money laundering happens in three stages: (1) Placement Stage, in which cash is deposited in accounts allegedly from high cash flow illegitimate activities; (2) Layering Stage, in which the cash is moved further from the illicit activity into layered entities; and (3) Integration Phase, in which the cash is moved further into the legitimate system from these layered entities. The activities of lawyers and other gatekeepers can (sometimes inadvertently) facilitate the layering and integration phases.

c. Due Diligence Recommendation. A formal recommendation of the Task Force is that attorneys (and all gatekeepers) should be vigilant in performing client due diligence (like banks), reporting suspicious transactions, and promoting general transparency as to who are the actual owners of legal entities. Planners have been working with the Treasury Department for some years regarding how to implement the recommendations in a reasonable and workable way in the United States under ethical rules for lawyers in the United States (including the duty of confidentiality, the attorney-client privilege, etc.)

d. Rules-Based Approach in U.K. The U.K. adopted a rules-based approach. A lawyer in the U.K. has the affirmative duty to report suspicious transactions, and is not allowed to tell clients that they have been reported them. That seems highly intrusive to the attorney-client relationship under established ethical principles in the U.S.

e. Risk-Based Approach. Several ABA organizations and ACTEC have been working with FATF to adopt a risk-based approach in the U.S. rather than a rules-based approach. These negotiations resulted in the issuance by FATF of "Risked Based Guidance for Legal Professionals" in October 2008. There are 125 separate numbered paragraphs identifying risk factors that lawyers need to take into account.

f. Lawyer Guidance. A report entitled "Voluntary Good Practices Guidance for Transactional Lawyers to Detect and Combat Money Laundering and Terrorist Financing" has been prepared by ABA organizations, ACTEC, and various other professional colleges and groups. It emphasizes identifying and characterizing risks and putting efforts where there are real risks. The recommendations highlight client due diligence in three ways: (1) Verify the identity of client; (2) Identify beneficial owners; and (3) Obtain enough information to really understand the client's circumstances and business.

Also the Lawyer Guidance is limited to those who carry out one of five specified activities: (1) Buying and selling real estate; (2) Managing client monies, securities or other assets; (3) Managing client bank accounts, securities or savings accounts; (4) Organization of contributions for the creation, operation and management of companies; and (5) Creation, operation or management of legal persons or arrangements and buying and selling of business entities. These activities encompass much of the routine work by real estate, business and trust and estate lawyers. Our activities are the focus of the guidance.

The Lawyer Guidance identifies three major risk categories. 1. Country or geographical area. 2. Service risk. (For example, is the client asking the attorney to do something outside his or her area of expertise?) 3. Client risk. (Is the person a politically sensitive person, from a sensitive region, etc.)

There are no differences in the Guidelines for attorneys in large vs. small firms.

g. Legislative Proposals. In 2007, the "Stop Tax Haven Abuse Act" was introduced by Senators Levin, Coleman and Obama. It was reintroduced in early March, 2009. It is highly controversial.

A second bill is very important to transactional attorneys, S. 2956 "The Incorporation Transparency and Law Enforcement Assistance Act." It would impose expansive requirements on state agencies and taxpayers to make public filings regarding the creation and beneficial owners of corporations and limited liability companies. The legislation would require secretaries of state to keep lists of who are the actual beneficial owners of entities. Under the bill, a "beneficial owner" means "an individual who has a level of control over, or entitlement to, the funds or assets of a corporation or limited liability company that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the corporation or limited liability company." The ACTEC position is that these types of requirements are inappropriate at the federal level, but should be part of a uniform law effort. NCCUSL has a draft bill that would leave to the states the creation of transparency of ownership in ways that the states think appropriate. It states that the ethical obligations of lawyers would be respected.

h. Summary. Attorneys cannot ignore this. Money laundering and terrorist financing is real and we want to minimize it and identify risks where they exist. This system is far better than a rules-based system like in the U.K., where attorneys can be subject to criminal penalties and jail. (That has already happened to some lawyers in the U.K). Attorneys don't face that in the U.S., thanks to some ACTEC Fellows and ABA RPTE leaders and other groups.

9. Patenting Tax Strategies

a. Legislation. On September 7, 2007, the House of Representatives passed the Patent Reform Act with a provision that prohibits granting patents for a "tax planning method." A tax planning method is a plan, strategy, technique or scheme that is designed to reduce, minimize, or defer taxes, but does not include tax preparation software or other tools related to the calculation of tax or preparation of returns. A similar provision was never added to the Senate version of the Patent Reform Act.

The "Patent Reform Act of 2009" bill (S. 515 and H.R. 1260) does not contain a tax patent provision.

The "Stop Tax Haven Abuse Act" bill filed in 2009 (S. 506 and H.R. 1265) includes section 303 entitled "Tax Planning Inventions Not Patentable." It includes some of the variations for tax patent provisions considered over the past year (for example, clarifying that the provision does not apply to computer programs to prepare tax returns — TurboTax is safe.) It defines a "tax planning invention" as "a plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, determine, avoid or defer, or has when implemented, the effect of reducing, minimizing, determining, avoiding, or deferring, a taxpayer's tax liability or is designed to facilitate compliance with tax laws, but does not include tax preparation software and other tools or systems used solely to prepare tax or information returns."

At some point, a stand-alone tax patents bill may be introduced or added to a general tax bill.

The concern in crafting an appropriate "Tax Patent" definition is that patent applications could describe a technique without reference at all to "taxes" but to methods of satisfying certain requirements specified in a statute — without ever referencing that tax provision directly.

b. Comisky; Denial of Patenting a System for "Mandatory Arbitration Involving Legal Documents Such as Wills or Contracts". *In re Comisky, 449 F.3d 1365 (Fed. Cir. 2007)* denied a patent on "obviousness" grounds for a method and system for "mandatory arbitration involving legal documents, such as wills or contracts." The court reasoned that that a business system that *depends entirely on the use of mental processes* cannot be patented. There was also an additional sentence saying that commonplace use of a computer would be a prima facia case of obviousness, but in January, 2009, an *en banc* decision deleted that last sentence.

c. Bilski; Business Method Patents Must Meet "Machine-or-Transformation" Test. Tax strategies are patented under the general doctrine allowing the patenting of business methods. The Federal Circuit has cast considerable doubt on many business method patents in In Re Bilski, 545 F.3d 943 (Fed. Cir. Oct. 30, 2008). The invention involved in that case is a method for hedging risks in commodity trading. It is a classic "business method" case and similar to many of the business method patents issuing on tax reduction methods. Of the 12 judges who participated in this *en banc* opinion, three filed dissenting opinions and two filed a concurring opinion. The court confirmed that business methods remain patentable, but stated emphatically that the "machine-or-transformation" test set forth by the Supreme Court is the sole test for subject matter eligibility for a claim of patentability for a process: "A claimed process is surely patent-eligible under §101 if: (1) it is tied to a particular machine or apparatus, <u>or</u> (2) it transforms a particular article into a different state or thing." The court expounded somewhat how the machine-or-transformation test would be applied:

> "Thus, the proper inquiry under §101 is not whether the process claim recites sufficient "physical steps," but whether the claim meets the machine-or-transformation test. (FN25) As a result, even a claim that recites "physical steps" but neither recites a particular machine or apparatus, nor transforms any article into a different state or thing, is not drawn to patent-eligible subject matter. Conversely, a claim that reportedly lacks any "physical steps" but is still tied to a machine or achieves an eligible transformation passes muster under §101. (FN26).
>
> (FN25): Thus, it is simply inapposite to the §101 analysis whether process steps performed by software on a computer are sufficiently "physical."
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> (FN26): Of course, a claimed process wherein all of the process steps may be performed entirely in the human mind is obviously not tied to any machine and does not transform any article into a different state or thing. As a result, it would not be patented-eligible under §101."

This case casts doubts on the patentability of tax strategies, but it certainly does not definitively resolve the issue. Tax patent claims that involve only mental processes are not patentable. *Bilski* confirms *Comisky* in holding that such process claims are not patentable. However, many, perhaps most, tax strategy patents call for the use of the computer. The opinion leaves open the question of what it means for process to be tied to a "particular machine:"

> "We leave to the future cases the elaboration of the precise contours of machine implementation, as well as the answers to particular questions, such as whether or when recitation of a computer suffices to tie a process claim to a particular machine."

Thus, what is perhaps the most important practical question is left unresolved.

A petition for certiorari has been filed with the U.S. Supreme Court.

d. <u>*Fort Properties*, Section 1031 Exchange Patent Held Invalid Under *Bilski* Rationale</u>. A patent involving a "deedshare" (representing a tenant-in-common interest in real estate) that was designed to facilitate eligibility for tax-deferred treatment under §1031 was held invalid, based on the *Bilski* rationale. <u>Fort Properties v. American Master Lease, LLC</u>, 2009 WL 249205 (C.D. Cal. Jan. 22, 2009). The opinion reasoned that no machine was involved (a computer was not needed to perform the methods in the patent) and that none of the claims of the patent "transform any article to a different state or thing." The opinion emphasized that merely manipulating "legal obligations, organizational relationships and business risks" is not patentable under the *Bilski* test:

> "Like the claims at issue in *Bilski*, the claims of the '788 Patent involve only the transformation or manipulation of legal obligations and relationships. Specifically, the claims of the '788 Patent only transform or manipulate legal ownership interests in real estate. Under *Bilski,* the Court cannot find that those claims transform an article or thing.
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> …
>
> Plaintiff explains, 'what is allegedly created is nothing more than an arrangement of conceptual legal rights, which may or may not be in a printed document.'… Nor do the deedshares represent physical objects or substances. Again the deedshares represent only legal ownership interests in property. Those ownership rights are not physical objects. Creation of a deedshare does not constitute transformation of an article or thing under *Bilski*"

e. <u>Tax Patents "Scorecard"</u>. As of March 17, 2009, there have been 76 "tax strategy patents" issued and 124 applications have been published (in Class 705, subclassification 36T). (These numbers are up slightly, but not dramatically.) The latest "tax patent" has been the issuance of a patent on December 2, 2008 for a method and computer program for incorporating tax effects into calculations of the outcome of potential investments and a computerized method for optimizing an investor's portfolio in order to maximize total expected rate of return for a given level of risk.

f. <u>Tax Patent Applications May Be Higher Following Tax Legislation</u>. If there is tax legislation creating new concepts (such as portability of the estate tax exemption or restricting valuation discounts), there seems to be a greater likelihood of demonstrating something novel and non-obvious. If there is new estate tax legislation, we may see more patent activity with estate planning topics.

Items 10-28 are observations from a symposium by Cynda Ottaway, Deborah Tedford, and Bob Temmerman: "Practice Tips From the Best in the Business"

10. Survey of Fellows, Sample Forms

The speakers conducted a survey of ACTEC Fellows and accumulated a wide variety of "Best Practices" comments from a number of different Fellows. In addition, the materials include a notebook full of a FANTASTIC accumulation of sample memoranda, questionnaires, checklists, document summaries, schematic diagrams and flow charts, client instructions letters, etc.

The ideas discussed will not fit every attorney's practice. However, every estate planning attorney can probably take away 10 or more ideas that would enhance the attorney's practice.

11. Pre-Meeting

a. <u>Screening</u>. Spend some time on the telephone with the prospect before the first meeting to make sure the prospect is not just meeting to shop and get ideas for which you cannot bill.

b. <u>Balance Regarding Pre-Meeting Request for Information</u>. There is a balance between getting too much information, in which event the attorney predetermines the plan before even meeting with the client (or having a questionnaire so involved that the client never fills it out to come to the first meeting), or obtaining too little information with the result of impeding the planning process.

c. Questionnaires and Explanation Memos. Many attorneys send and receive information questionnaires before the first meeting. (One speaker does not do so, but makes associates at the firm use questionnaires.) Some attorneys send general information summaries about estate planning concepts that will be discussed in the initial meeting. Some of the interesting questions asked on some of the sample questionnaires include:

- "Have you made any gifts. If so, send a copy of any gift tax returns that have been filed."
- Get contact information for other advisors, including accountants, investment advisors, insurance agents, and physicians.
- Is there any possibility of having assisted reproduction technology children or other descendants (besides biological or adopted children)?
- One questionnaire has a section about family priorities (tax savings vs. simplicity; control vs. gifting, etc.), allowing the client to rank various listed priorities.

d. Time and Place of Meeting. Be flexible in the time and place at the meeting. Consider meeting in the client's home.

e. Handwritten Note. Send a handwritten note (written by staff member) before the first meeting, welcoming the client and setting a tone that personalizes the experience.

12. Engagement Letters

a. ACTEC Website. The ACTEC website has a variety of good samples. (Item 48.d below describes a terrific engagement letter prepared by Bruce Stone.)

b. Scope. Engagement letters should define the scope of representation, setting expectations of what the attorney will and will not do.

c. Get Conflict Waiver if Children Named as Fiduciaries. If children of the client are named as fiduciaries, have the client sign a conflict waiver, allowing the attorney to represent the children as fiduciaries if they should ever want the attorney to do so. (If you wait until the children actually become the fiduciaries, the client may be incapacitated and unable to waive the conflict at that point.)

d. Non-Engagement Letter. Immediately after any meeting, send a "non-engagement letter" to any non-clients who participated in the client meeting. (One speaker indicated that the only time that speaker has been sued was by a non-client who sat in a client meeting.)

13. Client Conferences

a. Promptness; Meeting Room. Do not keep the client waiting, and use an uncluttered room. Some attorneys prefer to use conference rooms, others like the personal atmosphere of their offices (which means they must keep their offices clean). Sit beside the client, not behind a desk.

b. Source for Family Information. During the meeting, find out the person who has "inside information" about the family, who can be contacted for quick responses. "Treat this person well and he/she will treat you well."

c. Family Members' Names. Learn the names of the family members. Have a family data sheet in the front of the file, listing the names. List the family names on every meeting agenda.

d. Diagrams. Preparing diagrams contemporaneously with the discussion during meetings is very effective.

e. Depersonalizing Death. To depersonalize the death of each individual in the meeting, refer to "spouse 1" and "spouse 2."

f. Paralysis by Analysis. Focus on what is important to the client. Do not overdo the tax discussion to the point that the client is overcome by complex issues and is unable to make decisions.

g. Sub-Projects. Divide the overall planning into projects or phases so the client is not overwhelmed. Do the basics first to show that some progress is being made. This develops trust in the attorney before moving to more complex areas.

h. Immediacy. To emphasize what the client wants to happen if death should occur in the very near future, refer to hypothetically "being hit by a bus after walking out the door."

i. Verbal Devices. Develop simple verbal devices to convey complex concepts. Examples: "Think of estate planning as putting all your assets into one basket so your family can more easily divide them among a number of smaller baskets after you you're gone" — and refer to what some of those smaller baskets might provide; "Inverse relationship between simplicity and saving taxes;" "Inverse relationship between simplicity and protecting beneficiaries from creditors;" "Get'm grown trust" for referring to different types of trusts to deal with age discrepancies in beneficiaries.

j. Show Progress at Each Meeting. At every meeting, make an effort to have at least one item that can be checked off the list of projects to show that the process is moving along.

k. Handouts At End of First Meeting. Provide appropriate handouts at the end of the first meeting. These might include a firm resume, articles on estate planning prepared by firm members, chart of the estate plan, summary of fundamentals of estate planning, or summaries of specific concepts discussed in the meeting. (Examples of all of these are included in the materials.)

l. Estate Administration; Checklist of Action Items and Information to be Collected. Providing a handout of what the client needs to assemble and a checklist of action items helps capture the energy that clients have at the outset of an estate administration.

14. Follow-up to Client Meeting

a. Post-Signing Tasks. Take care of post-signing tasks such as deed transfers, beneficiary designations, etc. One attorney obtains beneficiary designation forms and fills them out during the meeting and mails them directly to the insurance company.

b. Summary Memo of Each Conference. After each client conference, prepare a memorandum of issues discussed in decisions that were made. This assists greatly with drafting. Discipline yourself always to prepare the summary memo on the day of the meeting while the attorney's memory of the meeting is still fresh.

c. Brief Summary of Key Issues for Client. Prepare a short summary of key issues and action items to send to the client following the meeting. This gives the client immediate reinforcement, and allows the client to relax during the meeting without having to take detailed notes.

d. Deadlines. If a deadline cannot be met, have someone in the office call the client and let the client know that something has come up and there will be a delay of one or two weeks.

Ask the client if the issue is a high priority or whether the delay will be satisfactory. Let others in the office know that a deadline is being missed; someone else may be able to help.

e. Confirm Ball is in Client's Court. If the attorney is waiting on the client for information, set up a calendar tickler to check back after a certain period of time to confirm that the client realizes that the attorney is waiting on information. This is often best done by phone call.

f. Schedule Follow-Up Meeting. Calendar the follow-up meeting at the end of each meeting. This keeps the momentum going. Give the client a reminder call one day before the next meeting. If no follow-up meeting is scheduled, have a calendar tickler system to call the client two weeks after sending documents to make sure that the client received the documents (and to subtly prod the client to review the documents).

15. Billing

a. Rates. Most attorneys are not increasing rates this year.

b. Retainers. It is very prudent in these economic times to work off retainers. "Work smarter, not harder." Work for clients who you know will pay. Some attorneys get a retainer of half of the anticipated charge. This helps invest the client in the importance of the planning. It lets everyone know that the client is serious and committed.

c. Record Time Contemporaneously. Record time contemporaneously (or at least at the end of each day). This is much more efficient.

d. Project Billing. Clients like a project billing approach, but this can cause financial loss to the attorney if there are various prolonged client meetings. Some attorneys have a flat fee for document production but charge hourly for client conferences.

e. Billing Statements. Take the time to read bills closely. If a discount is allowed, show it on the statement. Bill promptly.

f. Overhead Charges. Clients hate charges for copies and faxes or other administrative items. One attorney's firm uses a standard overhead charge, adding 6% to most bills for long-distance, faxes, copies, IT work, etc. The attorney has never had a client object to the overhead charge (but has had a client negotiate the amount of the charge).

g. Late Payment; Problematic Bills. After a period of time has passed with the bill not being paid, take a proactive approach. Contact the client to see if there is a problem with the bill. Unpaid bills tend to "turn bitter" with age. If the client is upset, ask the client what the client thinks a reasonable charge would be.

h. Ending Engagement. The letter sending a final bill for a project is a good opportunity to say that the engagement is closed.

16. Drafting

a. Simplify. Simplify solutions and the drafting as much as possible.

b. Personalize. Show that the document is really for this particular family. Customize by inserting the names of the spouse and children wherever possible.

c. Family Values. Include family values in the estate plan in a precatory way. For example, consider a statement that the client does not want children to become trust fund babies, where they are not productive in society. Clients like that personalization.

d. Formatting. Some attorneys double space dispositive provisions and single space the rest of the document. Others single space the entire document to shorten it. Boldface captions to draw attention to them. Some attorneys use a table of contents for long documents.

e. Allocation of Assets Under the Plan. Prepare a summary or flow chart showing an allocation of assets under the plan. This demonstrates how the plan will actually work with the client's assets.

17. Transmittal Letters and Explanations

a. Summaries. Send summary memos with the documents. Some attorneys like to keep these purposely short, no longer than three pages. "I hope the clients read the letter and not the documents."

b. Flow Charts. Some attorneys prepare flow charts of the existing plan, and a follow-up chart of the new plan. The materials have a host of example charts for basic estate plans as well as more complicated strategies.

c. Highlight Drafts of Documents. Some attorneys highlight key provisions with a yellow highlighter when sending drafts of documents.

d. Emphasize Needed Client Actions. When sending drafts, emphasize issues remaining for decision by the client. When sending signed drafts of documents, emphasize follow-up steps that the client must take (i.e., beneficiary designation forms, etc.).

e. Document Notebooks. Some attorneys prepare document notebooks with indexes. Include a notation of where the original signed documents are kept.

f. Funding Instructions. Include a summary of funding instructions, particularly for funding revocable trusts. For out-of-state property, help the client locate a suitable attorney in the state where property is located.

g. Electronic Copies. Scan documents and provide an electronic copy to the client.

h. Describe When Updating Is Appropriate. When documents are sent, include a one-page memorandum of when changes to the plan may be advisable. Include that summary in the document notebook.

18. Client Communications

a. Shut Up. "Listen, Listen, Listen." "Shut up and listen."

b. KISS. This is always good advice. (Keep It Simple, Stupid)

c. E-mails. Never send an e-mail if a telephone call will do. (However, e-mails can avoid phone tag.)

d. Returning Phone Calls. Some have an approach of returning phone calls the same day. Some say within 24 hours. If that is not possible, have someone from the office call to let the person know when the attorney will call back. Sometimes the staff person who calls can answer the client's question.

e. Don't Just Respond To Squeaking Wheels. We should especially take care of our good clients that are not the "squeaky wheels."

f. Procrastination. No difficult task becomes easier by postponing what needs to be done. That includes communications with grumpy clients, opposing attorneys, etc. Face difficult tasks upfront and deal with them; often they are not as bad as the attorney thinks they will be.

g. Death in Family. Contact the client when there is a death in the family.

h. Be Accessible. If the client is going through a difficult time, give the client your home phone number. It is rare for a client to use it, but the client feels more relaxed and that the client is "not on his own until Monday morning."

i. Forward Articles. Forward articles from the general press that relate to the client's situation.

j. Don't Take Any Client For Granted. Some of the best referrals may come from small clients. Also, prior clients who have had financial reversals appreciate continued contact; they may rebound financially or refer friends.

19. Extras That Show You Care

a. Newsletters. Communicate through newsletters. A side effect is that this helps keep the database up to date, if any mail is returned due to a change of address. These letters often lead to referrals.

b. Holiday Cards. Rather than sending holiday cards in December, one attorney sends a "Thanksgiving letter" that includes year end tax planning suggestions.

c. Retention of Documents. Provide a memo advising the client of information that should be maintained in a personal file. Some of those items include: safe deposit box location, number and key; copies of estate planning documents, funeral and burial instructions, cemetery deed, social security records, divorce decrees, passports, real estate titles, mortgage statements, title insurance, list of all credit cards, recent statement for all bank and brokerage accounts, retirement asset statements, income and gift tax returns, life insurance policies, casualty insurance policies, and list of financial advisers and helpful contacts.

d. Happy Office. A happy office atmosphere facilitates good client relations. Consider candy in a bowl at the reception desk or reading glasses for clients who forgot to bring theirs to meetings. Keep tissues handy for post-mortem administration clients.

e. After Hours Communications. Make follow-up calls after hours to show that you are making extra efforts to get in touch with clients.

20. Staff Relations

a. Vitally Important. "Your staff will make or break you." Collaboration is critical. The best compliment from another attorney is "everyone in your office seems really happy."

b. Initial Client Meeting. Have an associate or paralegal sit in the initial client meeting. This helps in taking notes. The client can get comfortable with the other professional as a contact person at the firm.

c. Vacations. If the attorney will be unavailable due to vacation or for some other reason, notify clients that the attorney will be absent and who will cover the matter. This lets the client know to contact the attorney immediately if something really needs to be done before the vacation begins, and who the person should contact during the absence.

21. Delegation

a. Review. Have two professionals review every estate planning document. You cannot read your own documents and spot all mistakes.

b. Review Letters Being Sent Over Your Signature. Particularly review letters being sent over your signature by a younger associate. Closely check the spelling of names.

c. Produce "Completed" Work Product. Encourage staff to produce "completed" work product rather than a series of piecemeal drafts.

The following contains excerpts from a wonderful actual memorandum prepared by one law firm 45 years ago:

PLEASE KEEP THIS

IN YOUR DESK

October 1, 1964

TO ALL LAWYERS

…

"Completed staff work" is the study of a problem and the presentation of a solution by younger lawyer in such form that all that remains to be done on the part of the older lawyer is to indicate his or her approval or disapproval of the completed action…

You should consult the older lawyer as little as possible. The product should, when presented for approval or disapproval, be worked out in finished form…

Do not worry the older lawyer with long explanations and memoranda. Writing a memorandum to the older lawyer does not constitute completed staff work, but writing a memorandum or letter for him or her to send to someone else does.

Your views should be placed before the older lawyer, if possible, in finished form so that he or she can make them his or her views simply by signing his or her name...

The theory of completed staff work does not preclude a rough draft, but the rough draft must not be a half-baked idea…

When you have finished your completed staff work, the final test is this: If you were the older lawyer, would you be willing to sign the paper you have prepared and stake your professional reputation on its being right? If the answer is in the negative, take it back and work it over, because it is not yet completed staff work…

Younger lawyers, in their wisdom and in the exercise of good judgment, will remember that there will be many exceptions to the foregoing in this office for one reason, namely, that we must always give prompt and efficient and cost-effective service of highest quality to our clients. Younger lawyers will know there are cases and problems where to give such service, he or she must consult with the older lawyer. Such consultations are among the most personally pleasant and interesting events in our relationship."

22. Communication With Staff

a. Use E-mail and "Facemail". Use e-mail to communicate with staff, but use "facemail" when appropriate — walk down the office and talk in person.

b. Open Door Policy, But Not Too Much. Be approachable by staff for guidance, but do not have a totally open door or else you will have no time to get work done for yourself and your clients.

c. Show Appreciation. Constantly express to associates that you appreciate the quality of their work.

d. Take Care of Others in Firm Outside Your Area of Specialization. Take excellent care of other lawyers in the firm outside the estate planning area. They will more likely refer clients to you.

e. Regular Staff Meetings. Have regular staff meetings to keep coordinated.

23. Staff Hiring and Development

a. Use Paralegals. Use paralegals; they are cheaper than attorneys. Also, malpractice policies are priced on the number of attorneys in the firm, not the number of paralegals.

b. Educational Sessions. Assign articles, cases or other developments, and have everyone report on a development at group meetings.

c. "Knowledge Company". Treat the firm as a "knowledge company." The experienced attorneys, as leaders, create new knowledge and disseminate it through the firm. Remember that staff and younger attorneys do not attend as many seminars as do the older attorneys.

d. Treat Staff as Colleagues. Treat all staff as colleagues. If the staff knows that you respect them, they will work loyally for you. Allow them to disagree with you.

24. Organization and Management Skills

a. Contact Information. Get all contact information up front, and keep the data worksheet handy with each file.

b. Original Signed Documents. Most attorneys prefer to let the client keep all original signed copies.

c. E-mail. Treat e-mail to clients with the same formality as letters. Print and file all incoming and outgoing e-mails and faxes. One attorney begins all client e-mails with: "Dear ___" One attorney recommends responding to e-mails with traditional letters to be sure of a proper response (malpractice protection).

d. Phone Memo Sheet. Keep a pad of "phone memo sheets" to record notes of each telephone conference.

e. Closing Checklist. Prepare a closing checklist for signing documents.

f. Estate Administration Checklist. One attorney uses a one-page checklist of all relevant probate and estate tax due dates for estate administration purposes.

g. Trust Data Sheet. Prepare a brief one or two page "trust data sheet" summarizing each trust with relevant information.

h. Giving Notes To Client. Keep meeting notes on yellow legal pads, and if you give the client a copy of notes or diagrams that you prepare during the meeting, give the client the original yellow legal pad copy. You will know you gave the original to the client if a photocopy is in the file.

i. Scan Files. Some attorneys recommend scanning all estate planning documents and office files. "When a client calls, you can open up their file on the computer and quickly find the document that you need to answer their questions. This saves a lot of time, eliminates non-billable travel time to retrieve files, and clients will be much happier to get an answer promptly than having to wait until after you have retrieved the file."

j. File Table of Contents. Have a table of contents for each file to be able to locate documents quickly. A standard form could be used for many clients.

25. Professional Management

a. Avoid Darth Vader Clients. Avoid the "Darth Vader" client. "If something does not feel right, if instinct says this will not be a good or rewarding relationship, then it is important to decline to enter into the relationship, no matter what the immediate financial considerations appear to be." It is easier to say no up front than to withdraw later.

b. Say No Early. Say "no" to clients early in the relationship. Set limits to let clients know you will give them your best professional judgment and that you are not a "yes man."

c. Disengage if Inappropriate Client. If it is necessary to disengage from a client, do so in an ethical manner. Get the case in a position where it is not damaged by your withdrawal from the representation.

d. Investment Advice. Do not give investment advice. If making referrals to investment advisors, give at least three names.

e. Long Term Relationships. The most rewarding client relationships are ones that are ongoing over many years. "We become close personally, even friends. But I believe it is of paramount importance always to remember that we are first and foremost professional advisors." In the professional relationship, respect boundaries.

f. Do Not Over-Commit. If you are too busy, decline the work. Tell the client "I cannot do it now, but I could do it in a month; do you want to wait?"

g. Admit Mistakes. The true test of a good lawyer is not when things go right, but when they go wrong. Take full responsibility for the mistake and offered to fix the problem at no charge. Address mistakes promptly; don't let them fester.

h. Express Appreciation for Referrals and Cultivate Relationships. Send short handwritten thank you notes for referrals. Schedule periodic reviews of the estate plan or other developments with clients.

i. Plagiarize Appropriately. Plagiarize colleagues' ideas and forms in your documents. Imitation is the sincerest form of flattery.

26. Life Management

a. Important Personal Life Management Steps.

- Pray.
- Take Vacations.
- Lunch. Get out of the office for lunch at least several times a week.
- Listen to Spouse. The speakers really emphasized this one. LISTEN TO YOUR SPOUSE.
- Regular exercise.

b. Balance of Home and Work. “If the economy does not get better, many of us may be working well past what we thought would be a normal retirement age, and this means that we all need to have a better balance of work and home.”

27. Substantive Drafting Tips

a. Incorporate All Prior Amendments. When drafting trust amendments, incorporate all prior amendments so that the latest amendment is complete. When the amendments get too cumbersome, restate the entire document.

b. Right to Withdraw Rather Than Required Distributions. Give the beneficiary a right to withdrawal rather than requiring a distribution. (A side effect is that grantor trust status continues for assets left in the trust. PLR 200840025) Also, consider giving the trustee a veto power over the withdrawal if the trustee determines that the beneficiary is substantially unable to manage his or her financial resources or resist fraud or undue influence.

c. Outside Resources. Draft to instruct the trustee whether or not to consider outside factors in determining when to make distributions, such as the ability to obtain gainful employment, outside resources, the size of the trust, etc.

d. Health Care Documents. Provide a laminated card naming the client’s health care agent and successor with telephone numbers for clients to carry in their wallets. (Another alternative is to write the names of agents on the attorney’s business card and tell the client to keep the card in his or her wallet.)

28. Litigation

a. Personality Issues; Grudges. Don’t let litigation morph into personality issues. Don’t hold grudges. “We are not the parties — we are only the attorneys.”

b. Objections to Fees. Object to opposing counsel’s fees “informally” rather than by filing formal objections in order to resolve the issue expeditiously.

Items 29-33 are observations from a symposium by Dennis Belcher, Louis Harrison, and Nancy Hughes: “I’m Happy and the Client is Happy: Creative Practice Management Techniques to Match Excellent Estate Planning with the Client’s Willingness to Pay for Services”

29. Realization is Key in Tough Economic Times

Typical planning meeting of most law firms: “How many attorneys want to keep the same income level next year?” [None] “How many want to work harder next year than this year?” [None] “Expenses are going up, so the only alternative is to increase rates." However, that will not work in the current economic climate. Law firms will need to make long-term adjustments, and there will be limits on rates. A key to success will be improving realization, and a key to improving realization is billing in a manner that clients perceive that they are being treated fairly.

30. Improvements to Billing Protocol

a. Client View of Estate Planning. “Where does the property that I have worked hard for (or have worked hard to inherit) go when I die?” That is not fun, and billing is another painful part of the process.

b. Client Perception: Key is Perceived Fairness. Lou Harrison posits that human behavioral financial studies conclude that “Human economic decisions are often irrational, non-economic, and sometimes selfless." We are not always motivated in a way that is financially maximizing.

Fairness matters more than anything else in the process, not necessarily rational economic decisions. As an example, Lou Harrison suggests the "Ultimatum Game." Lou would give Dennis and Nancy $1,000, but he lets Dennis divide the fund between himself and Nancy. If she accepts the division, they both keep their portions. If she does not accept the division, the money returns to Lou. Dennis proposes $300 to Nancy and that he keep $700. Lou says the studies of this scenario show that 50% of people will refuse the proposal in this situation, and the money will return to the original owner. Nancy would rather punish Dennis for his unfairness, even though it is not rational — the rational thing is to accept the "free" $300. People act selflessly to punish perceived unfairness.

Lou gives another example. An individual will walk down the street to another store to buy a CD for $4.95 instead of $14.95. However, the same individual would not go to another store to save $10 on a $1500 stereo system. The difference: a $10 difference for CD evokes a sense of unfairness.

c. Tailoring Billing Approaches to the Importance of Perceived Fairness. The hourly rate at any amount will rarely be perceived as fair. Attorneys often incorrectly assume that if hours are correctly reported, the hourly rate is reasonable, and the project is done timely, the clients will accept the bill has "reasonable" or as "good value."

Fixed Fee Approach. Estate planning clients typically prefer a fixed fee approach. The client is focused on whether the strategy is worth $5000, and not whether the attorney is worth $600 per hour with every minute of his time being $10. (From the attorney's perspective, a fixed fee approach rewards efficiency.)

Richard Thaler, one of the leading behavioral economists in the country, notes (interestingly, not in the context of law billing):

> "[C]onsumers don't like the experience of 'having the meter running.' This contributes to what has been called the 'flat rate bias' in telecommunications. Most telephone customers elect a flat rate service even though paying [for each] call would cost them less."

Despite the general bias toward flat fees in the minds of consumers, most estate planning attorneys use an hourly rate approach, with a range of fees.

d. Strategies to Facilitate Perceived Fairness if Using Hourly Rates.

(i) Quote a Range. Always quote a range for the project. This takes the focus away from the hourly rate.

(ii) Demonstrate Fairness by Attorney's Credentials. Even though it is not comfortable, communicate credentials to the client (speaking, writing, ACTEC Fellow, attending seminars to learn latest techniques, etc.). That makes the hourly rate sound fairer. "Most of us don't like telling clients we are great. But clients want to hear why we are great estate planners." Spend some time in the initial client conference describing the extra things that you do.

(iii) Anchoring. A basic tenet of negotiation is to throw out a big unreasonable number initially. Studies show that the negotiator will end up with a better result than if he or she had initially proposed a lower reasonable number. For example, when asked about rates, the attorney might respond: "It is interesting that you asked about my hourly rate. I read in the New York Times the other day that New York attorneys are charging $1200 per hour. Oh, you asked about my hourly rate. It's $800 per hour." (That may seem more acceptable to the client than if the attorney initially proposed $300 per hour.)

(iv) Relativity. Compare your credentials with other practitioners who are not as highly credentialed.

(v) Create "Starbucks Ambiance." Customers are willing to pay high prices for Starbucks coffee in part because of the ambiance of the Starbucks experience. Lou Harrison hates casual dress in the office. "We are professionals and need to create a 'Starbucks ambiance'." "Suits are professional. Clients may say that we can dress casual, but that does not create the ambiance for professional rates." Make the part of the office that clients see look professional. Leave a booklet of client "love notes" (with the names redacted) or other things in the office that help credentialize the attorney.

(vi) Bill Format. Make sure the bill is formatted in a way to demonstrate fairness. (More about this later.)

e. What Hourly Rate to Charge? The attorney logically should charge higher rates for complex projects. That is difficult to administer, and most attorneys just charge one uniform hourly rate.

The likely response is that the attorney should just do sophisticated matters, and charge a high uniform rate. However, legal work often tends to drift to less sophisticated matters. "What is complex today will be a commodity tomorrow." For example, FLPs were complex 10 years ago, but now clients "can get a form package at a Holiday Inn seminar."

Having a financially successful law firm depends upon having an office structure so that commodity work can be pushed to a lower level at a fair hourly rate while performing sophisticated work at a high hourly rate. A law firm can be profitable doing either lower-level or sophisticated work. A profitable firm can do a lot of work at a low-level if it has a flat compensation structure and pushes lots of work to lower-level staff persons who never expect to become a partner. "We cannot satisfy everyone's legal needs. We must figure out where we are on the scale of sophistication and staff and price the work accordingly. That is challenging to do but can be financially fruitful."

f. Narrative Descriptions on Bills. The goal is perceived fairness by the client. Be aware that detail can help in explaining fairness, but can also hurt in the case of a later malpractice or IRS action. The narrative description in the bill should tell a positive story of what is accomplished. For example, "incorporating estate tax savings trust" is more positive than "draft trust to address estate tax issues." Similarly, "structuring trusts to avoid tax as assets pass from generation to generation" vs. "draft GST trust."

Bills often merely list multiple days of "drafting documents," "reviewing documents," and "drafting letters." The worst is "filing." Lou Harrison discussed one of his own bills that, in retrospect, did a terrible job of telling a positive story. The client paid the bill because it was within the quoted fee range. However, in retrospect Lou thinks it would have been better to just send a one-line bill: "For services rendered."

The book "Predictably Irrational" published last year, says that we often underestimate the power of presentation. For example, two caterers had the same quality of food, but differed in how they describe their menu selections. One failed and the other succeeded. The failure used "Delicious Asian style ginger chicken and flavorful Greek salad." The successful caterer used "Succulent organic braised chicken roasted to perfection and drizzled with a Merlot demi-glaze resting in a bed of Israeli couscous." (Lou Harrison observes: "That second description doesn't sound so good to me, but I get the point.")

g. Format and Structure of Bill. Behavioral finance studies indicate that purchasers would rather have one large pain than a series of small pains. For example, hotel customers would rather have one rate that includes everything instead of being billed separately for Internet, exercise room, etc. Similarly, clients may react in a hostile manner to charges for copies, faxes, etc.

This same principle applies to a bill with daily time entries. In the client's mind, "every day entry associated with a time is translated into an hourly charge, a loss… A bill with 20 daily time entries results in 20 losses. 'Death by a 1,000 Cuts.' It is more painful to review than a bill with one entry."

Lou particularly dislikes a structure that emphasizes the daily activity, rate, time and amount for each day. He described a story of a client who received that type of bill from an accountant. The statement emphasized the date, the billing rate and daily amount over and over. The bill angered the clients, but the accounting firm actually added a great deal of value, providing great service, creativity, and a good result. They sabotaged themselves by sending out a "crappy" bill. Those clients will leave the accounting firm at the first chance.

Even if the firm uses a daily reporting structure, do not list the hours for each day.

31. Premium Billing

a. Approach. Can the attorney arrange with the client to charge a higher amount, based on the results of the transaction?

b. Ethical and Regulatory Limits. The Model Rules of Professional Conduct (§1.5) provide that a lawyer's fee must be reasonable considering an enumerated list of factors, and provides that all contingent fee arrangements must be agreed to in writing by the client. As to federal tax matters, Circular 230 provides that practitioners must not charge an unconscionable fee and must abide by their published fee schedules. For fee arrangements entered into after March 26, 2008, §10.27(b) of Circular 230 allows contingent fees in any matter before the IRS only with respect to a specified list of items (including tax audits or tax litigation). For that purpose, a contingent fee includes any fee "that otherwise depends on the specific results obtained." The policy is that the IRS does not want to reward a practitioner for succeeding in playing the audit lottery. With respect to tax matters, one approach would be to provide a fixed fee or hourly rate approach until audit or tax litigation, and then provide that the fee will be renegotiated. It is possible to have a contingent fee with respect to a tax audit or litigation.

c. Premium Billing Summary. (1) Agree up front. (2) Define the scope of the premium billing arrangement. (3) Do not violate Circular 230. (4) Timing — if the premium payment is not based upon winning or losing, structure the timing of the payment before the result is known; as a practical matter, the client will not pay if the client does not win. (5) The agreement must be in writing and signed by the client.

32. Billing Best Practices

a. Initial Meeting. Discuss fees at the initial meeting.

b. Timing of Fee Discussion. Discuss fees toward the end of the initial meeting, after the client knows what will be done, the complexity of the matter, and after a discussion of all the things that the planning will accomplish.

c. Determine Fee Quote at First Meeting.

d. Believe in Fairness of Fee. The attorney must believe in the fairness of that fee, and it must be delivered in a way to convey fairness. Do not be defensive or add, editorial comments, such as "… and I think this is a fair fee."

e. Down Payment. Have the client provide a down payment to get "skin" in the project. After someone owns something, it is more valuable to them than when they are making the decision to purchase in the first place. (Example: An individual who has three cars is reluctant to give one up. If the same individual had no cars and is handed cash sufficient to buy all three, he or she likely would not buy three cars.)

f. Fairness; Flat Fee. Clients will pay for services they perceive as fair. Many estate planning projects will be perceived as fair if quoted as a flat fee.

g. Sub-Projects. Divide a big estate planning project into sub-projects, so that value and accomplishments can be more easily understood.

h. Value Added Billing. Value added billing can be considered but must be addressed in the initial engagement letter. Various studies have shown that a higher price does not necessarily mean that a client is less satisfied.

i. Timing of Bills. Send bills frequently and timely. Generally, bill monthly. If there is a "difficult" bill, the tendency is to put off addressing it. Especially in that situation, deal with it as if it's an emergency.

j. Do Not Exceed Quoted Fee. Do not exceed a quoted fee unless explained and discussed with the client during the project.

k. Narrative and Structure of Billing Statements. Connote value in the billing descriptions; avoid listing time spent on a daily basis.

l. Decouple Services and Bill. To the extent possible, decouple pain from happiness. For example, persons paying with credit cards do not feel the pain of paying at the time of purchase. Retainers can assist with decoupling services from payments; clients feel happy about the service because they have already paid for it.

m. Discounting. If a bill is discounted, show that on the statement. Discounting is appreciated by clients in many situations. In today's economy, an "economy discount" could be reflected. That lets clients know that you feel the economy's pain, just like they do.

33. Survey of ACTEC Fellows

a. General. A survey was sent to all ACTEC Fellows (using "Survey Monkey" — which costs a grand total of $40). About a third of the Fellows responded.

b. Fixed Rate vs. Hourly Rate. Most of the respondents used an hourly rate with a fee range approach. 20% use a flat fee approach. Fellows with less than 15 years experience are evenly split between straight hourly and flat fee approaches. 70% of Fellows with more than 35 years experience use a straight hourly approach.

The size of the firm also impacted the billing approach. In firms of more than 25, 70% used a straight hourly rate approach. In firms of more than 100, 80% used a straight hourly approach.

Summary: An hourly rate with a quoted range of fees is used most. Younger people and smaller firms use more project billing. It may be that many Fellows can get by with using an hourly rate approach because we are perceived as trusted advisors. However, our interests are not always aligned with the client under an hourly rate approach. For example, we may feel that we are imposing on the client's dollar by asking about the client's family, but we can give better service if we know about the family.

Items 34-39 are observations from a seminar by Ann Burns, Steve Litman, and Dale Stone: What Happens When the Agent Disappears: Managing Life Insurance Policies Within an Insurance Trust After the Initial Premium Is Paid

34. Scary Things That Can Happen

a. Ignoring Policy Resulting in Policy Lapse and Taxable Income. In Dyer v. Comm'r, T.C. Summ Op. 2008-23, a law partnership purchased life insurance for each partner, to pay the surviving spouse for a deceased partner's interest in the partnership. Mr. Dyer retired and left the partnership. His policy was ignored and allowed to lapse. The insurance company eventually informed the partnership that it had taxable income. The partnership responded that Mrs. Dyer owned the policy. The Tax Court concluded that she did not own the policy and did not have taxable income. Imagine Mrs. Dyer's frustration in having to take that case to the Tax Court to get it resolved.

b. Settlor's Refusal to Pay Premium. A Michigan case illustrates one approach to the problem of a settlor refusing to pay additional premiums unless the trustee of the irrevocable life insurance trust that owned the policy found a way to keep his son from benefiting from the policy. The trustee received court approval to change the beneficiary of the life insurance policy to all of the beneficiaries except that son. In re: Kotsonis Trust, No. 273265 (Mich. App. Ct. Filed Nov. 20, 2007).

c. Mistakes in Swap of Policies. In Letter Ruling 2000603002, a husband and wife transferred policies on their lives to a trust in return for a note. In the following year, they forgave the note. The two policies were swapped for a joint and survivor policy, but the insurance agent mistakenly named the husband and wife as owners of the new policy rather than the trust. The parents sought a state court reformation to correct the name of the owner of the new policy and sought a letter ruling that the correction and retitling was not a gift. The IRS issued a favorable ruling, but noted that the forgiveness of the note in the year following the transfer was a prearranged transaction and was treated as an indirect gift in the original year of transfer.

35. ILIT Trustee's General Fiduciary Duties Impacting Policies

a. Terrific Resource. A terrific resource regarding the administration of life insurance as part of a trust is a four-part series appearing in the ACTEC Journal. Ballsun, Collins and Jurkat, Trustee Administration of Life Insurance, 31 ACTEC J. 280-301 (Spring 2006), Standards of Prudence and Management of the Insurance Portfolio 32 ACTEC J. 66-90 (Summer 2006), Evidencing Care, Skill and Caution in the Management of ILITs, 32 ACTEC J. 145-158 (Fall 2006), ILIT Asset Management: The Written Investment Policy Statement, 32 ACTEC J. 229-259 (Winter 2006).

b. Typical ILIT Trustee is Stunned. Dale Stone says the trustees of life insurance trusts often eventually ask "What in the world have I got myself into?" The trustee has real responsibilities and liabilities.

In the typical life insurance trust situation, the grantor selects the policy and funding strategy. The trustee usually has nothing to do with those decisions. The trustee is often a friend or the business associate with no special knowledge or skill regarding life insurance. The trustee believes its job is just to perform ministerial duties, receive gifts each year and pay premiums, give Crummey notice, maintain records, provide reports to beneficiaries, receive policy notices from the insurance carrier, etc. Most trustees do not realize the scope of their duties until notified that there is a problem with the policy.

c. UPIA. Under the Uniform Prudent Investor Act, modern portfolio theory applies in evaluating investment decisions. Higher returns require higher risks, but the trust tolerance for risk depends upon the purposes of the trust. There are various factors that the trustee must consider, including tax consequences and the extent to which the assets may have a special relationship or value to the trust or its beneficiaries. UPIA, §2(c).

36. Minimizing ILIT Trustee's Responsibility and Liability

a. State Statutes. Some states have statutes that relieve the trustee from some liability regarding life insurance policies. Most include relief for failure to determine if the policy is a proper trust investment or for failure to diversify. Some statutes also include items such as failure to exercise policy rights or failure to check on the health of the insured or the financial condition of the insurance carrier. States having such statutes include Alabama, Delaware, Florida, North Dakota, Pennsylvania, West Virginia, and Wyoming.

b. Exculpation. The trust instrument can relieve the trustee of some, but not all, duties. There are special limits if the trustee causes the exculpatory clause to be included. Unif. Trust Code §1008(b) (exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of fiduciary or confidential relationship, unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the grantor).

c. Delegation. UPIA allows delegation of investment and management responsibilities. The agent must acknowledge and accept a fiduciary responsibility to the trust and to the beneficiaries. The trustee should at least annually review the agent's performance. A checklist of what the trustee should review is in Ballsun, Collins and Jurkat, Trustee Administration of Life Insurance, 31 ACTEC J. 297-301 (Spring 2006).

d. Other Ways. Other ways of protecting the trustee include obtaining indemnification by the grantor, liability insurance, consent of the beneficiaries, or court approval.

37. Trustee's Specific Fiduciary Duties Regarding Management of Policies

a. Summary. The trustee should (1) monitor the policy and the carrier, (2) measure policy performance and carrier stability against industry benchmarks, and (3) consider alternatives in light of the information received.

b. Trust Investment Policy Statement. Each trust should have a trust investment policy statement ("TIPS"). Corporate fiduciaries do that; individual trustees often do not. The statement for a life insurance trust would include the purposes of the trust, the suitability of policies to meet the goals, standards the policy should meet in order to be retained, and alternatives that should be reviewed should the policy become unsuitable. Having a TIPS is not absolutely necessary — as long as the policy produces good results. If bad news arises, it will be helpful to have had a TIPS.

c. Monitor Policy and Carrier. Primary variables to monitor include the policy not performing as projected, the financial failure of the carrier, a lack of funds to pay premiums, and changes in the insured's health.

In-Force Illustrations. Compare the in-force illustrations with the original projections to see if conditions are changing. The in-force illustrations are the best source of information about the policy. Confirm the current cash surrender value and how it will change in the future under current assumptions (i.e., premiums paid as scheduled, current interest crediting rates and policy expenses). It is not a prediction or guarantee as to what will happen with policy values. The trustee should not accept that on its face, but realize that it is based on assumptions.

Policy Performance. Determine how long the death benefit will be supported. There may be a need to increase the premium amount or decrease the death benefit.

Financial Strength of Carrier. Check the financial strength of the carrier annually. There are various rating agencies.

Ability to Pay Premiums. Check with the settlor annually regarding the ability to make gifts or loans to pay future premiums.

Health Changes. Health issues change each year as the insured gets older. The Leimberg Information Services system in late February, 2009 had articles about companies that provide customized personalized life expectancy calculations. What should the trustee do if there is a significant health decline? "A significant decline in health would be a reason to consider reducing or completely stopping payment of premiums with a level death benefit and relying on the existing policy values to meet future policy costs."

d. Measure Policy Performance and Carrier's Stability Against Industry Benchmarks. Use a qualified consultant, who for a fee will analyze the suitability of the policy. There are benchmarks for policy expenses (including administration expenses and mortality charges), policy earnings, and carrier ratings.

38. Managing the Policy — What Are My Options?

a. Overview. All too often the trustee goes through the process of considering alternatives only in a crisis — after getting information that the policy is in trouble. This typically occurs after the insurance company notifies the trustee that it must extend the time of making premiums or increase the amount of premium payments. A key factor in the decision-process is the health of the insured — is it possible to get new insurance?

b. Cancel Policy or Let It Lapse. If the policy is cancelled or lapses, the death benefit is lost, but the ongoing premium cost is avoided. A tax problem is that if the combined amount of outstanding policy loans and the remaining cash surrender value exceeds the trust's basis in the policy, there will be taxable income. For example, in Atwood v. Comm'r, T.C. Memo. 1999-61, the lapse of life insurance policies on which loans were outstanding in excess of basis created taxable income to the policy owners.

The following discussion about the tax treatment of cancelling (or selling) a policy is primarily from prior seminars.

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

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

This issue is important in any cancellation, lapse, sale or other life settlement of an insurance policy.

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

Ordinary Income or Capital Gain? Is the taxable gain ordinary income or capital gains? It appears that the gain would be ordinary income to the extent of the cash surrender value in the policy. Section 1001 would suggest that the sale of the policy is the sale of a capital asset, whereas §72 says that the inside build-up of policy value in excess of the premium payment is ordinary income. However, §72 applies to the surrender of policies, not necessarily to the sale or exchange of policies. The reasoning behind §72 is that the owner hasn't paid income tax on the inside build-up, and the build-up in value is taxed as ordinary gain at surrender. However, in the last 10 years, a whole new market is developing where purchasers on the secondary market are not buying policies just for the cash surrender value. They are buying policies as a continuing investment to realize on the death proceeds. They don't care about the cash value. That smells like a capital asset. Some cases have recognized that the sale of a policy generates capital gain. E.g., Percy v. Phillips, 30 T.C. 866 (1958).

Commentators have suggested that this result might even apply to the surrender of a policy, because Technical Advice Memo 200452033 intimates that §1234A can apply to a life insurance surrender so that the gain qualifies for capital gain treatment, to the extent that the gain does not just represent cash-value build-up. Gans & Soled, A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference, 7 FLA. TAX REV. 569 (2006).

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

Tax Liability in Excess of Trust Assets. If the policy has gone into loan status to pay premiums, the tax liability may often exceed the cash surrender value. If the trust does not have the money to pay the tax, perhaps the IRS will not pursue the tax payment. However, life insurance trusts are often grantor trusts, and the grantor owes the tax.

c. Continue to Pay Premiums. Continuing to pay premiums can result in significant gift effects. In addition, the trustee may consider adjusting the investment allocation of the cash surrender value in the policy to help increase financial funding of future policy costs.

d. Pay Premiums With Dividends or Cash Value. Dividends are typically used to buy paid-up insurance. Another option is to use dividends to reduce premium payments.

e. Pay Premiums With Policy Loans. Typically, do not use policy loans for paying premiums until the dividend option has been changed to use dividends to reduce premiums. Often, paying premiums with policy loans is a short-term fix. If there is a long-term need for insurance, a policy typically will not be sustained indefinitely on the basis of policy loans alone.

f. Replacing the Policy. The obvious key to being able to replace the policy is that the insured must still be insurable.

(1) Section 1035 Exchange. The policy may be exchanged for another policy with a reduced death benefit. For example, in one situation a $3.5 million policy was replaced with a $1.55 million paid-up policy. (Caution: When exchanging the policy, there is a new two-year contestability period. One speaker has a case in the office now where the insured died under questionable circumstances one week before the end of the new two-year contestability period. Be sure to advise clients of the new contestability period.)

(2) Partial Surrender for Lower Death Benefit. One Fellow indicates that the IRS issued Notice 2006-95, stating that unless the original contract specifically allows a partial surrender of the policy, a reduction in the death benefit after December 31, 2008 would require retesting the policy to see if it meets the definition of life insurance. The cash value and guideline premium tests on a policy that is deemed issued after 12/31/2008 have to be based on 2001 CSO tables. The Notice establishes a "safe harbor" rule, but the owner cannot force the issuer to change the mortality rates or perform the tests. In one case, the insurance company did not want to do a partial surrender, and the company advised that bad tax results would result from a partial surrender under the IRS position. Why would the IRS take that position or why it would want to discourage partial surrenders of policies to reduce the death benefit from the policies?

(3) Swap Policy for Annuity Contract. A life insurance policy may be swapped for an annuity contract on the life of the insured. In one example, the annuity payments were used (on an after-tax basis) to purchase a second-to-die policy. (In analyzing this approach, be sure to consider the time value of money difference of receiving the death benefit at one spouse's death versus at the survivor's death.) This transaction involves an arbitrage of the annuity amount versus the premium payments. The parties must give full medical information to the annuity company

and the new insurance policy carrier, but sometimes the annuity company will rate the insured's health as "poorer" then the insurance company, and a favorable arbitrage is achieved. An alternative is to obtain the annuity on the life of the spouse whose health has declined, and purchase the new policy on the life of a healthy spouse (leaving the obvious problem of how premium payments will be made after the first spouse dies when the annuity payments end.)

g. Sell Policy in Secondary Market. Selling policies in the secondary market has been around for over 10 years. However, the secondary market has changed substantially in the current economic downturn. Credit and cash has tightened so that there is less money available for buying these policies. In addition, there are many more policies on the market currently because financially strapped people are considering selling their policies. The settlement market is changing literally day by day.

A typical life settlement used to be about 23% of the face value. Now, 14-15% of face value is a great deal. Many offers are being made at 5-8% of the face value of the policy.

After returning from the ACTEC Meeting, I received a notice from an insurance consultant indicating that more investment dollars are now flowing into the life settlement marketplace, as investors look for safer investment vehicles than the stock market. One report indicated that $2 *billion* of new funds will be available by April 1st. The consultant says this indicates that "the tight market we've recently seen for policy purchases is loosening" and that "this market will be very favorable for policies sold during the second quarter."

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

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

h. Borrowing to Finance Premium Payments. Before borrowing from an outside vendor, the key is to have an exit strategy.

39. Private Split Dollar

a. Where Used. Private split dollar arrangements are used in larger cases. For policies up to $3-5 million, premiums can usually be made with annual exclusions and gift exemptions without paying gift tax. Split dollar is often used with family businesses where there are permanent substantial liquidity needs. The goal is to find the most effective way to pay a large premium without gift tax (or to reduce the gift tax). A private split dollar arrangement is typically used to "buy time" for an exit strategy to produce the financial ability to pay off the prior advances and to pay premiums going forward without gifts.

Steve Litman says the key concept is that **split dollar allows using OPM — other people's money.**

b. Economic Benefit Regime Typically Used. There are two major alternatives for the tax treatment of private split dollar managements — the loan regime or economic benefit regime. The economic benefit regime is available for non-equity collateral assignment split dollar in the family donor/donee situation and the employer/employee situation, but not for the corporation/shareholder situation. The economic benefit regime results in the donor making a gift (or an employer paying compensation) equal to the annual economic benefit of having the insurance coverage. The economic benefit approach often offers the lowest economic cost (resulting in the lowest gift and income tax). IRS Notice 2002-8, 2002-1 C.B. 398 governs the determination of the economic benefit. One option is to use Table 2001-10 rates, and the other option (available for split dollar contracts entered into after January 27, 2002) is to use the term rate of the insurance carrier, as long as that rate is available and known to persons who apply for term insurance from the insurer and the insurer regularly sells term insurance at that rate. In one actual case, the table rate would produce a $19,800 reportable gift in the initial policy year, but the John Hancock term rates would produce only a $7,000 gift. By year 16 of the policy, the table rate would be $90,000, and the term rate would be $25,000. However, the parties must be aware that the insurance company can change the term rates at any time.

The economic benefit regime typically results in relatively low annual gift/compensation amounts for joint life policies while both insureds are alive (because the actuarial likelihood of both insureds dying in the same year is extremely low), and for younger insureds.

c. Example Exit Strategies. Because the economic benefit increases as the insured ages, there must be an exit strategy, or else the deemed gifts or deemed compensation may become unbearably large. Steve Litman discussed several example situations.

(1) Gift of S Corp Stock; Grantor Trust. The $1 million gift exemptions of husband and wife were used to make gifts of S corporation stock (valued at a one-third discount) in connection with a split dollar arrangement that terminates in year 16. The cash flow from the S corporation to the trust would be sufficient to pay off the premium advances and pay future premiums after year 16.

A significant contributor to the overall result is that the trust is a grantor trust, with the parent paying income taxes on the trust's flow-through S corporation income. (Because of the grantor's continuing liability for income taxes on the trust's income, the arrangement may work so well that the grantor would be bankrupted without the ability to "toggle off" the grantor trust status at some point in the future.)

(2) GRAT of S Corp Stock. A similar arrangement would be to use a GRAT to contribute S corporation stock free of gift tax at the end of the GRAT term. (A formula could be used to allocate the S corporation stock between an ILIT and another other family trust if more shares may pass at the end of the GRAT term than are needed to support the policy.)

(3) Combination of Gift Exemptions and Policies From Multiple Generations. A single ILIT acquires a second-to-die policy on the senior generation funded by gifts and premium financing and also acquires a second-to-die policy funded by gifts and a non-equity split dollar agreement. A rollout of the junior generation's split dollar arrangement would be contemplated at the end of the actuarial life expectancy of the senior generation.

(4) Older Generation Low Interest Loans. The parents could make low interest loans to the trust for investments. The trust can arbitrage the money received and invest it with a return (hopefully) in excess of the approximately 2% rate on the low interest loan.

d. Observation Regarding Graded Premiums. A policy may provide for graded premiums (increasing in every fifth year), rather than a single uniform premium amount. When the death benefit is compared to the aggregate premium outlay, to determine the internal rate of return (IRR) for all years, the graded premium approach often produces a significantly higher IRR for many years as compared to the IRR using a set premium.

e. Forms. Steve Litman's materials include a form for an economic benefit limited collateral assignment non-equity split dollar agreement and an accompanying collateral assignment pursuant to the split dollar agreement.

f. Favorable Letter Rulings. Favorable letter rulings have been issued for family split dollar transactions entered into both before (200848002 & 200822003) and after (200910002 & 200825011) the effective date of the final regulations. The rulings confirm that the parents will not be treated as making gifts to the policy owner to the extent that they advance the excess portion of the premium over the economic benefit under a collateral assignment split dollar agreement.

For example, in Letter Ruling 200910002, an irrevocable life insurance trust owned a second-to-die policy, and under the agreement would pay the economic benefit value of the coverage. Parents will pay the balance of the premiums, with the right to recover the advances from the policy under a split dollar agreement. All incidents of ownership over the policy (including the sole right to surrender or cancel the policy, and the sole right to borrow against or withdraw from the policy) are vested in the trustees and not in the parents. The IRS ruled that the parents would not be treated as making a taxable gift by making the excess portion of the premium payment (except to the extent that some or all of the cash surrender value is used, either directly or indirectly through loans, to fund the trust's obligation to pay premiums.) In addition, the IRS ruled that the parents would not be treated as having any incidents of ownership in the policy that would cause inclusion in their gross estates.

Items 40-44 are observations from a seminar by Mil Hatcher and Lee Wendel: "How to Profit Without Getting Carried Away: Carried Interests, Profits Interests, or Black Holes?

40. Overview and Bottom Line — Significant Section 2701 Uncertainties

Most readers will not read further in this section regarding profits interests and carried interests with respect to transfers between related parties, because of the significant section 2701 risks. Apparently, very few estate planning attorneys are making intrafamily transfers with profits interests or carried interests, but such transfers are sometimes implemented by business attorneys who do not have estate planning experience.

Section 2701 poses special valuation rules whenever a "junior interest" is transferred to a younger generation family member if someone in the donor's or an older generation retains a "senior interest". It is conceivable that the IRS will take the position that the donor's retained "capital interest" is akin to a "senior interest" and that a transfer of a profits interest or carried interest to a younger generation member is akin to a transfer of a "junior interest" such that §2701 would apply. There are various exceptions to §2701. Furthermore, IRS agents are as confused about

§2701 as planners. Mil Hatcher had an audit involving §2701 issues, and the field agents kicked the issue to the national office because they had no idea how §2701 would apply to the interest at issue in that audit. (He got a favorable result from the national office.) However, Mil Hatcher concludes: "Anytime you start interpolating in this particular area, my squirm factor goes up; and I'm still squirming in this area." Mil says that while some people *think* the §2701 issues can be avoided, no one is saying "It *WILL* work."

Even beyond §2701, there is a standard gift analysis problem. Transactions with unrelated active business associates and executives may fall within the business transaction exception, but transactions with related persons will be scrutinized.

The §2701 issues and standard gift issues do not arise if there are transfers among unrelated persons. Profits interests and carried interests are often used, with very favorable results, for transfers of significant value to unrelated persons who are providing significant services to the business entity. The problems arise when profits interests or carried interests are transferred to younger *family* members.

Mil's conclusion: If there are enough bucks on the table, he would request a private letter on the §2701 issues. Otherwise, he recommends using an alternative transfer planning strategy. To get 20% of the entity to a child without a gift tax, consider a GRAT with a cap or rolling GRATs with a cap. If that can be done without tax uncertainties, why do something with a lot of issues? (Installment sales might also be considered, but in these volatile markets, Mil thinks that GRATs look better than sales as compared to several years ago.)

Despite this pessimistic assessment, some attorneys are using transfers of profits interests and carried interests in the estate planning context, and the §2701 arguments are briefly summarized below.

41. Heckerling Summary of Profits Interests and Carried Interests Transfers

Richard Robinson presented a terrific summary of the tax issues and wonderful planning opportunities available with transfers of profits interests. Richard's summary includes a terrific explanation of the substantial *income* tax advantages of using profits interests to transfer business interests, which do not have the tax uncertainties associated with the potential *gift* tax issues. Jonathan Rikoon addressed transfers of carried interests. A brief summary of their presentations at the Heckerling Institute is available in my Heckerling 2009 Musings (referenced in the Introduction of this summary of the Annual Meeting).

42. Description of Profits Interests and Carried Interests

Description of Profits Interest. This is only available for partnerships (or LLCs taxed as partnerships). A transfer is made to a person providing services of a right to receive a specified share of future profits (i.e., both income and appreciation), losses, and distributions, but not a share of the existing capital of the entity.

Description of Carried Interest. This is a share of future profits (typically through the fund's general partner). The carried interest receives 20% of profits AFTER capital contributions have been returned to the investors, a hurdle rate of return (e.g. 8%) has been met, and a corresponding make-up amount of the 8% hurdle has been allocated to the general partner so that the investors and general partner are in proportionate sharing ratios.

Distinction Between Profits Interest and Carried Interest. The distinction between these interests is in front loading. The profits interest is accelerated and receives income allocations before the capital interest. However, for carried interests, the "investment interest" is frontloaded and receives allocations before the carried interest.

43. "Chapter 12" Gift Tax Issues

Even aside from the complexities of §2701, there are significant basic gift issues under Chapter 12 if a younger family member owns a profits interest or carried interest in return for providing services to the entity. For income tax purposes, there is no requirement that the value of the profits interest equal the value of services provided. Rev. Proc. 93-27 and Rev. Proc. 2001-43. For gift tax purposes, if the key employee is not a relative, the transaction should fall within the business transaction exception. Reg. §25.2518-2. If the profits interest is transferred to a relative, there is an issue of donative intent and a gift can result unless the value of services to be provided equals or exceeds the value of the profits interest. Gross, 7 T.C. 837 (1946). Furthermore, the profits interest must be valued using traditional valuation principles rather than using the liquidation approach that is allowed to value the interest at zero for income tax purposes under Rev. Proc. 93-27. Knots, 55 T.C.M. 424 (1988) (determined value of profits interest for gift tax purposes by applying a 10% discount rate to the projected future income stream).

What if transfers are made to both family and non-family members. Can the fact that similar transfers are made to unrelated persons providing similar services avoid gift treatment for similar transfers to family members. Rulings have gone both ways under general gift principles. Compare Letter Rulings 199928013 (no gift) and 9117035 & 9253018 (gift).

44. Section 2701 and Exceptions

a. General Rule. Even if the value of services provided is equal to the value of the profits interest, a substantial gift may still result if the parents' retained interest in the partnership is valued at zero under the special valuation rules of §2701. As an oversimplification of the general rule of §2701, the parents' capital interest would be an "applicable retained interest" that must be valued at zero if the capital interest is a "distribution right" (which includes the right to receive distributions with respect to the partner's interest if the partner's "family" controls the entity) or is an "extraordinary payment right" (which is a right to put, call or convert the stock or compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest). If the parents' interest is an "applicable retained interest" and if the profits or carried interest being transferred to a younger family member is a junior interest, the special valuation rules of §2701 may apply. There are various exceptions to this general rule, some of which are addressed below.

b. Business Transaction Exception May Not Apply. Commentators disagree, but Lee Wendel thinks that the business transaction exception cannot be used to avoid §2701. The statute and regulations under §2701 provide exemptions, and this is not one. The §2701 regulations say that §2701 applies even if the transfer would not be considered a gift under Chapter 12 because it was in full consideration for money or money's worth — suggesting a similar result if a transfer is not a gift under Chapter 12, because of the business transaction exception. Some planners believe that the business transaction exception can avoid §2701 in some circumstances, but the IRS position is that the business transaction exception cannot be used to avoid §2701.

c. Control Requirement Regarding Distribution Rights. A "distribution right" is potentially subject to zero valuation under §2701 only if the transferor and a broad class of family members control the entity immediately before the transfer. For a corporation, control means holding at least 50% (by vote or value) of the stock. For a partnership, control means holding at least 50% of the capital or profits interest in the partnership, or, in the case of a limited partnership, *any* interest as a general partner. Parents will typically have control in the profits interest context. However, for carried interests, the parents (and the broad class of family members) may not have control. The general partner of a hedge fund or private equity interest limited partnership may be an LLC, and the question arises as to whether the parents' interest *in* the LLC is treated as an interest *as* a general partner. (Planners have taken different positions on that issue.) If the lack of control argument is being relied upon, it is important that the parents not have a unilateral liquidation right. The authority to cause the liquidation would be an "extraordinary payment right" regardless of whether the parents have control, and the presence of an extraordinary payment right triggers the 10% minimum-value-for junior-equity rule.

d. Retained Junior Interest Exception. Query in this case whether the retained capital interest is junior to the profits interest? In all respects, the profits interest will receive equal or greater allocations of future income than the capital interest. However, if the entity is liquidated before sufficient appreciation has occurred to bring the capital account of the profits interest up to the level of the parent's capital account, the capital owner would receive the preferred amount. To that extent, the capital interest is not junior.

e. Same Class Exception. If the partnership liquidates immediately, the parents received 100% of the asset value but only some lesser percentage of future profits. Are they the same class? Richard Robinson argues that the only difference in the partners' interests is that profits will first be allocated to the profits interest holder until her capital account is in parity with her percentage ownership. The fact that the partners' capital accounts are not in the same proportion as their share of profits and losses cannot be considered as a preference or a priority. It is merely a non-lapsing difference with respect to limitations on liability and is not taken into account for purposes of determining whether the partners' rights are identical under Regulation §25.2701-1(c)(3). Richard Robinson points to several private letter rulings to seem to support this analysis. However, there is no certainty. Guidance from the IRS is not directly on point, and there are some suggestions that differences like this mean that the same class exception would not apply. The Senate Finance Committee report describing the same class exception uses an example of straight-up allocations of losses and gains, without mentioning starting capital account balance differences.

f. Proportional Class Exception. A proportional class exemption applies if the rights provided by the owners' various interests are "proportional," except for non-lapsing differences with respect to management limitations on liability. The partners have proportional allocation of profits, losses and cash flow distributions, and also have proportional rights to share on liquidation according to positive capital account balances. However, the proportion for allocating profits, losses and cash flow is different from the proportion for returning their respective starting capital account balances. In the one example in the legislative history about the proportional class exception, profits and capital interests were all proportional.

g. Separate Classes. Are the profits interest and capital interest treated as totally separate classes that are tested separately? If so, the profits interests of the owners would be proportional, and if the younger generation member has the authority to terminate the entity and receive her capital account balance of any time, the senior generation's capital interest may be subordinate so as to fall within the junior class exception. (Lee Wendel is not persuaded by that argument, reasoning that the statute and regulations suggest that economic interests are a bundle of rights.)

h. Reducing Deemed Value of §2701 Transfer by Liquidation Participation Right. The mere right to participate in liquidation distributions is neither an "extraordinary payment right" nor a "distribution right." Under §2701's subtraction method for determining the amount of the deemed gift, making an adjustment for the assumed present value of the liquidation right at the end of the partnership term may mitigate the § 2701 value. (Mil Hatcher did not find this argument as persuasive as the "separate class" argument.)

i. Reducing Value of §2701 Transfer by Value of Donee's Services. The last step of the subtraction method is to take offsets against the deemed gift amount, one of which is for the value of consideration received by the transferor. If the younger generation family member is providing services in return for the profits interest, perhaps the deemed §2701 value could be offset by the value of those services.

j. Reducing Value of §2701 Transfer by Spouse's Interest. If both parents are owners of capital interests, it may be possible to mitigate the deemed §2701 transfer by each. For example, assume that mother and father each own 45% of the entity. If father is subject to §2701, mother is a "member of the family" and whatever amount is deemed transferred under §2701 is allocated partly to mother and partly to child. If the deemed transfer to mother qualifies for the marital deduction, this may significantly mitigate the amount of the deemed gift by father under §2701. Mother's deemed gift under §2701 may similarly be mitigated.

k. Parents Investing In Children's Hedge Fund. Even if the client just owns a small 1% capital interest, if parents or the client's spouse also owns capital interests, the same class test is applied taking into consideration all applicable retained interests held by all applicable family members (i.e., ascendants or the client's spouse) — which might require substantial capital transfers by those other family members.

Items 45-49 are observations from a seminar by Elaine Bucher, Bruce Stone, and Adam Streisand: "Lawsuits Against Lawyers For the Plan You Do and the Plan You Don't Do By Those You Don't Know"

45. Standing for Non-Client Beneficiary to Sue Attorney

a. California General Rules. The California case law is more developed on this issue than in any other state. When the testator's intent is clear and ambiguous (and therefore undisputed), if there is an error in drafting or execution of the instrument, courts will generally extend standing to non-client beneficiaries. However, if the testator's intent is ambiguous or is the very issue in the case, the courts will not extend the attorney's duty to a non-client beneficiary. There are several rationales for this distinction. (1) It is too great a burden on the profession to cause the lawyer to be the arbiter of the client's intent. (2) The testator's intent cannot be known for sure because he or she is dead. (3) The beneficiary generally has another remedy where intent is an issue. The beneficiary can contest the instrument to say that it does not reflect the testator's intent; the beneficiary does not have that remedy in an improper execution situation.

b. Other States. Some states have different tests, but the results are typically consistent with the California tests.

46. How to Minimize Liability If Doing Asset Protection Planning

a. Defensible Purpose. The plan should have a defensible purpose. Do the planning well in advance of creditor issues. Do not use asset protection techniques to avoid existing or reasonably foreseeable creditors.

b. Avoid Insolvency. Make sure that there are sufficient assets in the client's name to satisfy known or foreseeable claims. Overstate the liability, especially in this economy with decreasing market values. Get an assessment letter from litigation counsel of the estimated value of claims.

c. Due Diligence Steps.

- Get a detailed asset list from the client.
- Get copies of income tax returns for two-to-three years.
- Get copies of liability insurance policies.
- Do third-party research regarding the client's background.
- Most important: Have the client sign an affidavit of insolvency that reflects the assets and debts of the client, including existing and reasonably foreseeable claims, and reflecting that there are sufficient assets to satisfy claims. The affidavit should state that the client is not intending to defraud any creditors.

47. How to Minimize Claims When Representing a Fiduciary

a. Consider Privity Rule. Understand the privity rule in the state, and the ability of beneficiaries to sue the attorney who is representing a fiduciary.

b. Engagement Letter. The engagement letter should clearly state that the attorney is representing the fiduciary in its fiduciary capacity, not individually or as a beneficiary.

c. Interactions with Beneficiaries. The attorney should let beneficiaries know, preferably in writing, that the attorney represents the fiduciary and not the beneficiaries. If the beneficiary asks the attorney a question, the attorney may answer, but make clear that the attorney does not represent the beneficiary.

48. Attorney Referrals to and Separate Representation of Corporate Fiduciary

a. Gunster v. McAdam. This case involved a lawsuit against J.P. Morgan, and attorneys who recommended J.P. Morgan to serve as co-executor and co-trustee under a will. Gunster, Yoakley & Stewart P.A. v. McAdam, 965 So.2d 182 (Fla. 4th DCA 2007). The plaintiffs asserted claims of breach of fiduciary duty, constructive fraud, civil conspiracy, negligence and unjust enrichment. While there were many issues in the case, one of the issues is that the plaintiffs alleged that the law firm had a conflict of interest. It had recommended J.P. Morgan or U.S. Trust as corporate fiduciary, and the firm worked for and with both institutions.

- Two of the decedent's sons who were beneficiaries under the will alleged that the attorney did not tell the client how much the corporate fiduciary would charge to serve as executor. (The attorney said he did.)
- The sons said that the lawyer gave the client draft documents that allowed the sons to remove the corporate fiduciary without a two-year lockup, but later documents included a two-year lockup. There was nothing in the law firm files indicating that the

client was ever told about the lockup or agreed to it. The sons alleged that clause was included so that J.P. Morgan would get a $1 million fee.

- The sons claimed that the attorney never discussed that funding a revocable trust would reduce the executor fees. The attorney said that he gave a memorandum to the client making clear that the client was responsible for funding the revocable trust and to contact the attorney if the client needed assistance. The sons said the attorney never really sent that memorandum and that the lawyer was lying.
- The client lived another five years after signing the documents naming J.P. Morgan as co-executor and co-trustee. Various changes were made to the will during that time, but there were no changes to the executor or trustee provisions.
- The attorney never inquired about funding of the revocable trust. The attorney acknowledged at trial (in response to a question submitted by one of the jurors) that he made a mistake in making the assumption that the trust had been funded. (Bruce Stone said he thinks that was a key factor in the case.)
- J.P. Morgan originally said that the executor fees would be $2 million, but agreed to do it for $1 million. The law firm said that its fee would be $500,000 and purportedly told the beneficiaries there was not a "damn or darn thing they could do about it." The sons negotiated the J.P. Morgan fee to $500,000, and fired the law firm.
- The sons sued the law firm and J.P. Morgan, alleging professional negligence, breach of fiduciary duty, and conspiracy. The sons eventually settled with the bank, and it resigned as co-executor and co-trustee.
- In the continuing lawsuit against the law firm, the sons also alleged malpractice in failing to advise the client to fund the revocable trust or to create a family limited partnership. The attorney had completed a QPRT transaction with the client. Plaintiff's expert in the case testified that the use of a QPRT was inappropriate because it should be used only as a last resort.
- The suit also alleged malpractice by failing to advise the client of the relationship of the law firm and the bank:

  > "According to the expert witness who testified for the sons, the law firm's recommendation of the trust company constituted malpractice when the law firm failed to inform the client of the relationship between the law firm and the bank. According to the sons, the law firm represented the trust company both as a principal, and when it acted in a fiduciary capacity for estates and trusts. They said that the trust company was one of the law firm's most valuable clients and was listed on the law firm's website. The sons characterized the relationship as one where wealthy clients came to the lawyer for estate planning, he would recommend they appoint the trust company as a fiduciary, for which the trust company would charge extremely large fees. In return, the trust company would hire the lawyer as its attorney in the estate administration, and he charged a large fee. At trial, and closing argument to the jury, the plaintiff's lawyer told the jury: "this case is like Robin Hood in reverse. You steal from the rich and put it in your own pocket. That's what these folks did."

- The law firm argued that rule 1.7 of the Model Rules of Professional Conduct provides the standards which lawyers must follow for conflicts of interest, that there were no limits on its ability to represent the client because of its separate representation of J.P. Morgan, and that their interests were not directly adverse. The court concluded that those are matters for the jury to decide. (Bruce Stone says that is scary, but he thinks it is the right result — that the conflict issue is a jury issue.)

- The trial judge granted summary judgment in favor of the law firm with respect to the allegation of failing to form a family limited partnership, because there was no evidence that the client has ever asked the law firm for assistance on that topic.
- The jury awarded damages against the law firm of $1.2 million. The judge reduced the award to the maximum amount the plaintiffs had requested (about $868,500).

b. Savu v. SunTrust Bank. This case involved allegations of (1) conflict of interest and breach of fiduciary duty by SunTrust for obligating itself to hire the attorney who drafted the will (and was one of several attorneys recommended by the bank) and for paying excessive attorneys fees to the attorney, (2) breach of fiduciary duty in failing to pursue a legal malpractice claim against the attorney for failing to advise about using a family limited partnership to save estate taxes, and (3) breach of fiduciary duty in failing to advise clients directly about using a family limited partnership. The appellate court approved the trial court's grant of summary judgment to SunTrust against the claims of breach of fiduciary duty. Savu v. SunTrust Bank, 668 S.E.2d 276 (2008).

c. Key to Avoiding Exposure: Disclosure. The key to avoiding exposure to most of the types of claims raised in the Gunster case revolves around full disclosure of information, disclosure of potential conflicts of interest, and clear notification of funding responsibilities.

d. Sample Engagement Letter To Provide Full Disclosure in Light of These Cases. Bruce Stone indicates that he changed his standard engagement letter, particularly in light of the Gunster case. Bruce included some terrific sample documents, including his firm's standard engagement letter, a letter observing completion of the estate planning and recommending periodic review, and sample memoranda regarding funding and future administration of revocable trusts and irrevocable trusts.

One Fellow at the seminar expressed that Bruce's engagement letter is the best that she has seen. While it is over six pages long, she observed that simplicity in an engagement letter comes at the expense of protection for the attorney. Bruce indicates that he has never had a client complain about the length of the engagement letter. [My observation: Perhaps this is because of its extremely "easy to read" straightforward style.] The various sections of his engagement letter include the following:

- "Our Duty to Preserve Your Confidential Information"
- "Our Duty To Share Information With Each of You"
- "If You Become Disabled"
- "After Your Death"
- "How We Charge for Our Services"
- "Conflicts with Other Clients"
- "Relationships with Financial Institutions"
- "Completion of Our Engagement" (including examples of things the clients may need to do after signing documents such as with revocable trusts, irrevocable trusts, family limited partnerships and LLC, and pointing out that services regarding those future matters are not included in the current engagement)

- "Your Agreement With Us"

The Section entitled "Relationships with Financial Institutions" is particularly relevant in light of the Gunster case. Here are some excerpts from that section of his engagement letter:

> "Our firm works with a number of banks, trust companies, and other financial institutions. Sometimes we may represent those institutions as clients, either in a fiduciary capacity such as when they serve as personal representatives or trustees, or directly such as when defending them in litigation matters. Those institutions may refer potential clients to our firm, and we may recommend their services to our clients. If you ask us to recommend a financial institution for your estate planning arrangements, it is possible that we may have separate attorney-client relationships with the institutional institutions we recommend. If you name a corporate fiduciary to serve as your personal representative or trustee, it is possible that the corporate fiduciary might retain our law firm in the future to represent it in performing its duties (assuming that there are no conflicts of interest). You acknowledge that the decision whether to use a corporate fiduciary and the selection of a particular institution is your responsibility, even if you ask us for advice and recommendations.
>
> …
>
> … The corporate trustee might want provisions allowing it to invest trust assets in investment products sold by its affiliates, which can result in increased revenues to the financial institution's overall group of affiliated companies. Florida law generally would not permit these types of results in the absence of a specific waiver or authorization by you in your will or trust agreement. If a particular corporate fiduciary asks for these types of provisions to be included in your estate planning documents, we will discuss them with you so that you can make an informed decision whether you wish to use the services of the corporate fiduciary if it won't agree to modify or waive those provisions, even if you were referred to us by the corporate fiduciary or if we separately represent that corporate fiduciary in other matters."

49. Unsolicited Information From Prospects, Florida Bar Ethics Opinion 07-3

What if an attorney receives unsolicited information by e-mail from a prospect? Does the attorney owe a duty to those persons and do they have an expectation of confidentiality? Florida Bar Ethics Opinion 07-3 (issued January 16, 2009) addresses this issue. It is a well-written opinion, concluding that a person who unilaterally sends information to an attorney has no reasonable expectation that the attorney will keep the information confidential if the attorney has not discussed the possibility of representation with the person, and that the attorney can use the information in representing an adversary. *The opinion says that attorneys should a post a notice to that effect on their websites.* The opinion states:

> "A person seeking legal services who sends information unilaterally to a lawyer has no reasonable expectation of confidentiality regarding that information. A lawyer who receives information unilaterally from a person seeking legal services is not a prospective client within Rule 4-1.18, has no conflict of interest if already

representing or is later asked to represent an adversary, and may use or disclose the information. If the lawyer agrees to consider representing the person or discussed the possibility of representation with the person, the person is a prospective client under Rule 4-1.18, and the lawyer does owe a duty of confidentiality which may create a conflict of interest for the lawyer. Lawyers should post a statement on their websites that the lawyer does not intend to treat as confidential information sent to the lawyer via the website, and that such information could be used against the person by the lawyer in the future."

Item 50 contains observations from a seminar by Susan Westerman, Henry Grix, Joshua Rubenstein, and Professor Lawrence Waggoner: "Planning for the New Biology" (The comments summarized below are primarily based on comments by Professor Waggoner.)

50. Impact of Assisted Reproduction Technologies on Class Gift and Intestacy Rights

a. Uniform Probate Code. The Uniform Probate Code ("UPC") was amended this past summer to deal with children of assisted reproduction. "Assisted reproduction" is any "method of causing pregnancy other than sexual intercourse." The Uniform Parentage Act, adopted in 2000 and amended in 2002, also addresses children of assisted reproduction. That act predominantly addresses non-inheritance issues. The UPC takes precedence over the Uniform Parentage Act to the extent of any inconsistency regarding intestacy and class gifts.

b. Significance. The primary significance of the UPC rules on assisted reproduction to planners will be for class gifts. For example, if a trust eventually passes to a beneficiary's "children" or "descendants," will that include children or descendants by assisted reproduction methods (which could include by conception after the settlor's or even after the beneficiary's death)? Under the UPC, the class gift rules follow the intestacy rules. (UPC §2-705(b)) Once a parent-child relationship exists under these rules, the parent is a parent of the child and the child is a child of the parent for intestacy and class gift purposes.

An important distinction for class gifts is that the UPC establishes a rule of construction, rather than a mandatory rule of law. (UPC §2-701) Therefore, the settlor can express a contrary intention, which will control.

c. Non-Surrogate Situations. The non-surrogate rules apply if the woman who bears the child intends to be the child's mother. This is contrasted with surrogacy situations, in which a pregnant woman has agreed to be a surrogate (under what the UPC terms a "gestational agreement") to bear a child for another couple or individual.

The non-surrogate *birth mother* automatically has a parent-child relationship with the assisted reproduction child, whether or not she is the genetic mother. (UPC 2-120(c))

Any other *third-party donor* (i.e., either a woman who provides eggs or a man who provides sperm) does not have a parent-child relationship, with several exceptions. The following are not treated as "third-party donors" (and therefore they are treated as the other parent):

(1) A husband or wife whose sperm or eggs are used for assisted reproduction by the wife (UPC §2-120(a)(3)(A));

(2) The birth mother (UPC §2-120(a)(3)(B));

(3) An individual identified on the child's birth certificate as the other parent (UPC §2-120(a)(3)(C), referencing UPC §2-120(e)); or

(4) An individual who consented to assisted reproduction with the intent to be treated as the other parent of the child. (UPC §2-120(a)(3)(C), referencing UPC §2-120(f)) Consent can be given (i) by a written document signed by the person, (ii) by functioning as the parent of the child within two years of the child's birth, (iii) by intending to function as the parent within two years where that is prevented by death, incapacity, or otherwise, or (iv) by intending to be treated as the parent of a posthumously conceived child if established by clear and convincing evidence. If the birth mother and the other person are married, there is a strong but refutable presumption that the person satisfies the "functioning as a parent within two years" test or "intended but was prevented from functioning as a parent within two years" test. (UPC §2-120(h))

If there is a *posthumous conception* using an individual's sperm or egg, the child is treated as in gestation at the individual's death if the child is in utero within 36 months of the individual's death or is actually born within 45 months of the individual's death. (UPC §2-120(k)) (The policy behind these various time periods is to balance the competing interests of having a final settlement of trusts and estates within a reasonable time and allowing a sufficient grieving period for the surviving parent to make the decision to go forward with an assisted reproduction, with a reasonable allowance for unsuccessful attempts to achieve a pregnancy.)

Example: A creates a trust that lasts for the life of her son, B, at which time the assets will pass to B's descendants. If B while married deposits sperm, and if his wife is impregnated with the sperm two years after B's death, and if the child survives 120 hours after being born, the child will be treated as in being at B's death, and is therefore a class member who can share in distribution of the trust assets to B's descendants.

d. <u>Surrogacy Situations</u>. The *birth mother* (referred to in the UPC as the "gestational carrier") does not have a parent-child relationship, because as a surrogate she did not intend to do so. (Minor exceptions are if she is designated as the parent under a court order or, if she is the genetic mother and a parent-child relationship does not exist with any other individual.) (UPC §2-121(c)).

An "*intended parent*" pursuant to a "gestational agreement" does not automatically have a parent-child relationship. One of the following tests must be met:

(1) Court order recognizing the intended parent or parents (UPC §2-121(b);

(2) Functioning as parent or parents within two years of the child's birth (UPC §2-121(d)(1); or

(3) Died during the pregnancy but (i) was one of two intended parents and the other intended parent functioned as a parent within two years of the child's birth, or (ii) was one of two intended parents and the other parent also died during pregnancy and a relative of either deceased intended parent functioned as parent of the child within two years of the child's birth, or (iii) was the only intended parent and a relative of such intended parent functioned as parent of the child within two years of the child's birth. (UPC §2-121(d)(2))

The enforceability of the surrogacy agreement is irrelevant in applying these rules. (UPC §2-121(a)(1)) If an intended parent meets one of the three tests described above, the parent-child relationship exists even if the "gestational agreement" was illegal or otherwise unenforceable in the jurisdiction.

In the case of a *posthumous conception* under a gestational agreement, (for example, if the decedent's surviving spouse entered into the surrogacy agreement after the decedent's death), a parent-child relationship exists only if there is a court order recognizing the relationship, or if the person's sperm or egg was used in the assisted reproduction and the person intended to be treated as parent of the child as shown by:

(1) A signed document, which considering all the facts circumstances evidences the individual's intent, or

(2) Other facts and circumstances establishing intent by clear and convincing evidence. (UPC §2-121(e)) A person is deemed to meet this "other circumstances" test if the individual is married and before death deposited the sperm or egg used in the conception and if the spouse functioned as the child's parent within two years of the child's birth. (UPC §2-121(f))

e. Class Closing Rules. Under the class closing rules, an individual must be in being (or treated as in being) at the time of the stated distribution date. There are special class closing rules under the new assisted reproduction provisions of the UPC if the distribution date is the deceased parent's death. A child in utero is treated as living if the child lives 120 hours after birth. (UPC §2-705(g)(1)) In addition, a child conceived posthumously by assisted reproduction is treated as in being at the deceased parent's death if the child lives 120 hours after birth and was in utero within 36 months of the deceased parent's death or actually born within 45 months after the deceased parent's death. (UPC §2-705(g)(2))

If the distribution date is sometime other than the deceased parent's death, the special rules are unneeded and do not apply. For example, if a trust provides that the trust assets will pass to A's surviving descendants on January 1, 2015 (or on B's death or at any specified time other than at A's death), the only issue is if children by assisted reproduction are treated as one of A's descendants at that stated time. There is no need for a special closing rule related to A's death. Accordingly, the 36 month or 45 month rules are irrelevant. If A has a child by assisted reproduction five years after A's death, but the child is living (or is in utero and survives 120 hours after birth [UPC 2-104(a)(2)]) at the termination date, then the child will be treated as part of the class of A's descendants at the termination date.

Items 51-53 are observations from the Trachtman Lecture, by Professor Robert H. Sitkoff (Harvard Law School): "The Quiet Revolution in Modern Trust Law: Evidence From Trust Income Tax Returns.

51. Trust Law Reform Mechanisms

a. Three Branches Of Trust Law. Three distinct branches of trust law have emerged: (1) Irrevocable trusts (there has been a shift from using irrevocable trusts for conveyance purposes to using them for management purposes, and the law is responding accordingly regarding management powers); (2) Revocable trusts (there has been a shift from using revocable trusts for management purposes back to conveyance purposes primarily as will substitutes); and (3) Business trusts (which dominate mutual funds and securitization).

b. Top Down Reforms. Reform efforts by the American Law Institute, ACTEC, ABA organizations, the Joint Editorial Board, and Uniform Law Commissioners have included revised uniform laws and restatements of the law that have resulted in revisions to trustee powers, investment provisions, and perpetuities provisions.

c. Bottom Up Reforms. There have also been substantial reforms instituted by local bankers and lawyers groups, such as the Delaware Bankers Association, which regularly proposes amendments to Delaware laws that are quickly enacted. These efforts have resulted in a drift toward greater "dead hand control" as these groups encourage law changes that will attract clients. Examples include changes in the laws regarding perpetuities, asset protection trusts, directed trustees, and provisions allowing clients to opt out of standard diversification requirements for trusts. In addition, revisions to state income taxation of trusts can attract trust clients.

52. Empirical Analysis of Effects of Trust Law Reform

a. Analytical Studies. Professors Sitkoff and Max Schanzenbach have produced several impressive articles summarizing the findings from their empirical analysis. Sitkoff, Robert H. & Max Schanzenbach, "Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?" 50 *Journal of Law and Economics* 681 (2007); Sitkoff, Robert H. & Max Schanzenbach, "Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes," 115 *Yale Law Journal* 356 (2005). They are working on a book that will be published in several years, to be titled "Lawyers, Banks and Money."

b. FDIC and Trust Return Data. Empirical evidence is being gathered from two types of data. First, the FDIC requires that corporate fiduciaries file information reports annually of the number of trust accounts, amounts under administration, and a breakdown of trust investment allocations. This information is available through 2006. (Of course, this information only reflects trusts with corporate fiduciaries, and therefore likely understates the experience for all trusts.) Second, federal income tax returns for trusts (Form 1041s) can be sorted by states. (This data would not include grantor trusts.) The IRS has provided Professor Sitkoff with eight years of Form 1041 data sorted at the state level.

c. Huge Amounts of Trust Funds. Reports to the Federal Reserve in 2004 indicate that $1 trillion of funds were in noncommercial trusts, with an average account size of $1 million. By 2006, as a result of market declines, corporate fiduciaries reported $740 billion in 1.25 million trusts, with an average account size of $600,000.

In 2004, two million trusts filed Form 1041s, reporting total fiduciary fees of $2.3 billion and attorney fees of $1.4 billion. In 2006, two million trusts filed Form 1041s, reporting $112 billion of income, total fiduciary fees of $3.5 billion and attorney fees of $1.6 billion.

d. Investment Allocation Changes. From 1986 to 2006, stock allocations increased from 50% to 70%, and bond allocations dropped from 25% to 15%.

e. Transferors are Avoiding the Rule Against Perpetuities. There has been a significant trend toward abolishing (or substantially revising) the rule against perpetuities. In 1987, there were only three perpetual trust states (Idaho, South Dakota, and Wisconsin). After Delaware changed its perpetuities law in 1995, the trend toward abolishing perpetuities accelerated, and about 20 states have now abolished (or substantially revised) their perpetuities restrictions. Empirical evidence indicates that trust money moves out of states to avoid the Rule. This trend may impact the standard of care, and it also has implications for federal tax policy. If GST policy is important, Congress may have to decouple the generation-skipping transfer tax from state perpetuities law.

f. Substantial Increase in Delaware, South Dakota and Illinois Accounts. Between 1985 and 2003, the average account size in Delaware, South Dakota and Illinois grew rapidly. Those are states where there is no rule against perpetuities and no fiduciary income tax on undistributed income for out-of-state residents.

g. Summary of Empirical Findings Regarding Impact of Abolishing Rule Against Perpetuities.

(1) 20% increase in assets and average account. On average, states that abolish the rule against perpetuities increased reported trust assets and average account size by 20% relative to states that retained the Rule.

(2) Average $6 billion increase in assets. On average, after a state abolished the Rule, its reported trust assets increased through 2003 by roughly $6 billion relative to those that retained the Rule, and average account size increased by roughly $200,000. This implies that through 2003, about $100 billion poured into states that have no rule against perpetuities or fiduciary income tax. This is about one out of every 10 trust dollars. Furthermore, this likely understates the actual movement, because individual trustees are not included in this data. Following up this data through 2006 has not changed the results.

(3) Conclusion: Significant increase in states that do not tax trust income for out of state residents and that abolish perpetuities. The movement of trust funds has been driven by states that have abolished the Rule AND that do not tax undistributed income from trusts created by out-of-state residents. States with no fiduciary income tax show about a 25% increase in the amount of complex trust income. When combined with states that have abolished the rule against perpetuities, there is a high statistical significance of the increase in average trust size. The FDIC data and federal income tax data produce similar results.

h. Empirical Findings Regarding Effect of Investment Law Changes. All 50 states now have some version of the modern portfolio theory. Results of the empirical study indicate that default rules do have an impact on investment allocations. The regression analysis so far indicates that there is about a 17% increase in trust monies associated with directed trustee statutes. That may not be a statistically significant number (although drug tests are typically based on a 5% statistical significance).

i. Conclusions from Analysis.

(1) There is national competition. Under well accepted econometric techniques, there is national competition for trust funds. Situs and choice of law matters. The results of what others are doing may impact the standard of care.

(2) RAP is dead. The rule against perpetuities is dead, because when it matters, clients move the money to states without the Rule. For real estate, this may be accomplished by putting real property into an LLC and contributing the LLC to the out-of-state trust.

(3) Asset protection statutes. There is no clear effect of asset protection statutes. The phenomenon is probably too new to be reflected in the data.

In any event, the movement of trust assets attributable to asset protection statutes is not nearly the same magnitude as the effect of abolishing the rule against perpetuities.

(4) Further study. Further study is underway to consider the effect of directed trustee statutes, total return unitrust statutes, and changes to the prudent investor rule.

53. Interesting Quotations

a. Who Knows in Washington? In Washington, it's often said: "Those who know don't talk and those who talk don't know." — Ron Aucutt

b. Profits? What's That? "I know this is going to sound like a strange concept: Profits" — Mil Hatcher

c. Profits Interests, Carried Interests, and Section 2701. "Anytime you start interpolating in this particular area, my squirm factor goes up. And I'm still squirming in this area." — Mil Hatcher

d. Section 2701 Audits. Mil Hatcher has been through a §2701 audit. It got kicked to the national office because the field agent said he "did not have the foggiest idea of what this thing does." (Mil got a favorable result from the national office.)

e. Behavioral Finance. "Human economic decisions are often irrational, non-economic, and sometimes selfless." — Lou Harrison

f. Client-Speak. Client: "Let me get back to you on that." Euphemistic for "No way Dude." — Lou Harrison

g. Keep Going to Seminars. "What is complex today will be a commodity tomorrow. For example, FLPs were complex 10 years ago, but now clients can get a form package at a Holiday Inn seminar. Attorneys must stay up to date." — Dennis Belcher

h. Active Participation by ACTEC Fellows. One-third of Fellows attend an ACTEC national meeting each year. This shows the high level of commitment of the organization. One-third of Fellows participated in a survey about billing practices. "My family does not participate in family reunions at this level." — Dennis Belcher

i. Spending The Big Bucks on Surveys. The survey of all ACTEC Fellows was done using "Survey Monkey"— costing $40.

j. Where the Action Is. "It is a truth universally acknowledged, that a recently widowed woman in possession of a good fortune must be in want of an estate planner." — Judge Holmes introducing his opinion in Estate of Hurford

k. ILIT Trustee Duties. "Individuals serving as trustees of irrevocable life insurance trusts often ask at some point: 'What in the world have I got myself into?' Trustees have real responsibilities and liabilities." — Dale Stone

l. ILIT Management Resource. A terrific resource regarding the administration of policies in irrevocable life insurance trusts is a four-part series of articles by Kathryn Ballsun, Patrick Collins, and Dieter Jurkat in the ACTEC Journal beginning with the Spring 2006 issue.

m. Actuaries. "What's the difference between an actuary and a Sicilian actuary? An actuary can predict when death will occur. The Sicilian actuary can predict when, where, and how." — Dale Stone n, The Essence of Split Dollar. "Split dollar insurance allows using OPM — other people's money." — Steve Litman

o. Trauma and Tides. "A rising tide floats all ships. A falling tide exposes a lot of stuff." — Bruce Stone

p. Insolvency Test. "For fraudulent conveyance purposes, you say we can't render our clients insolvent. Does that mean by our fees?" — Bruce Stone

q. What They Teach in Law School. Professor Robert Sitkoff, Professor at Harvard Law School, congratulated the ACTEC Foundation on its support of a trusts and estates clinic at Harvard that is funded by the Foundation. He points out that students who want real world experience in trust and estate matters can get it in the clinic. He candidly acknowledged the T&E class that he teaches at the law school "is to teach you to be an appellate judge."

r. Statistics. "What is the plural of anecdote? Data." — Robert Sitkoff in explaining why his empirical analysis has truly been able to move from anecdote to data

s. Can't Have Children? Someone asked the Spanish ambassador to the UN at a press conference why he did not have children. He did not have a Spanish-to-English dictionary handy and responded: "My wife is impregnable, inconceivable, and unbearable." — Joshua Rubenstein

t. Posthumous Conception. In summarizing the history of the legal ramifications of posthumous conception: "All of the responsibility and none of the enjoyment." — Joshua Rubenstein

u. The Untouchables. "There are certain things you just don't do. You don't play poker with a man named Slim. You don't buy a Rolex from a man who's out of breath." — George Will

v. The Fool. "It's not what a man don't know that makes him a fool, but what he does know that ain't so." — Josh Billings