ACTEC 2010 Annual Meeting Musings

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Items 27 includes observations from a symposium by Duncan Osborne and Henry Christensen, "FATF and the Good Practices Guidance"

Items 28-33 are observations from a symposium by Henry Gissel, Elaine Bucher, and Shirley Kovar, "Marital Planning: A New Look in a New Environment" (Including Discussions of Portability, Tax and Expense Apportionment, Carryover Basis, Roth Conversions, Estate Planning for Divorced Spouses, and Marital Agreements)

Items 34-39 are observations from a seminar by Ed Beckwith, Turney Berry, and Michele McKinnon, "Selecting the Best Charitable Donees: Public Charity, Donor Advised Fund, or Private Foundation"

Items 40-43 are observations from a symposium by Skip Fox and Thomas Abendroth, "Tales From the Crypt: Lessons To Be Learned From Past Mistakes"

Items 44-48 include discussions of miscellaneous current developments, separate from topics that were addressed in seminars at the ACTEC Annual Meeting

Introduction

Some of my observations from the 2010 ACTEC Annual Meeting Seminars in Bonita Springs, Florida on March 9-14, 2010 and current developments from other recent seminars are summarized below. (At the request of ACTEC, 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.") All of the seminars presented at the Annual Meeting are not covered in this summary — only the ones that I was able to attend. In particular, a wide variety of current developments are summarized in my Heckerling 2010 Musings, available at the ACTEC private website (http://www.actec.org/private/default.asp) in the "New Materials" 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 1-6 come from the Hot Topics seminar by Ron Aucutt, Carol Harrington, and Steve Akers (as well as comments on these topics by various individuals at other seminars). The Program Committee asked the panel to focus exclusively on planning in light of the uncertainty in 2010.

1. Sunset of EGTRRA After 2010

a. Historical Background. Thomas Jefferson published the Manual of Parliamentary Practice for the U.S. Senate. His rules, which became formally adopted guidelines for the Senate, discouraged ever having cloture on debate. It was not until 1917 that a cloture vote was allowed to end debate, by two-thirds vote. (This was similar to Robert's Rules of Order, which allows two-thirds vote to end debate; Robert's Rules were patterned after Jefferson's guidelines for the Senate.) In 1975, Congress changed 2/3 to 3/5, requiring 60 votes. In 1974, in the Congressional Budget Act, Congress sought to take more control of the budget process, in somewhat of a dispute with President Nixon. It provided a procedure for establishing taxing and spending priorities during the year in the budget resolution, and it produced a process for all committees to bring their spending priorities into a reconciliation of the budget. That usually occurs late in the summer or early fall. No filibusters are allowed, and debate is strictly controlled. Soon, Senators got the idea to add additional measures to the budget resolution or the budget reconciliation process to avoid the 60 votes required to end filibusters generally. The Byrd Rule was passed in 1985, and amended in 1990, to provide that anything extraneous to the budget resolution was subject to a "Point of Order," which could only be overridden by 60 votes. Extraneous items include the reduction of net revenues in years beyond the period provided for in the budget resolution. Budget resolutions generally cover 10 years, and a net reduction of taxes beyond the 10th year could be ruled out of order.

b. Byrd Rule Concerns in EGTRRA. The 2001 Act was the Economic Growth and Tax Relief RECONCILIATION Act, which was subject to the budget reconciliation process. Senators thought there would not be 60 votes to overcome a point of order in the Senate, so the tax cutting provisions did not extend beyond 10 years. Indeed, the act ultimately passed the Senate with only 58 votes.

c. Sunset Provision in Section 901. Section 901(a) of EGTRRA says the act does not apply to decedents dying, gifts made, or generation skipping transfers after 12/31/2010. Section 901(b) says the Code shall be applied to "years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted." Much of the confusion around planning in 2010 evolves around uncertainties as to how this provision will be applied after 2010. Does this mean that in 2011, we treat transactions as if EGTRAA had never been enacted in 2010 and earlier? Or only as if it "had never been enacted" in 2011? For example, will GST exemption that was automatically allocated during 2001-2009 still be given effect, or is it ignored because it would not have been available if EGTRRA had never been enacted?

The "had never been enacted" language is not unique. The Crude Oil Windfall Profits Tax Act of 1980, repealing the 1976 carryover basis, provided that the Code would be interpreted as if those provisions in the 1976 act "had not been enacted." The major difference is that the 1980 provision addressed only one specific concept in a rifle-shot repeal.

d. Summary. Ron Aucutt concludes that the issues surrounding the sunset rule "are existential, cosmic and extremely difficult." (There is more discussion about the sunset rule below regarding GST issues.)

2. Testamentary Planning in 2010

a. Absence of Estate Tax Can Cause Unintended Results. Formula clauses that are designed to leave assets in a certain manner based on amounts that can pass free of estate tax may produce unintended (or uncertain) results in 2010. The results under some clauses may be uncertain (for example, a clause that leaves to the credit shelter as much as possible without generating a federal estate tax by reason of the unified credit under section 2010). Some clients will be delighted with the prospect of leaving the entire estate to a credit shelter trust, but other clients would be very unhappy with that result. Even if tax attorneys think they know what the clause means, the family may convince the court otherwise in a will construction suit.

b. Focus On Client's Intent Now That It's Not Just a Theoretical Exercise. Some prior documents have addressed the disposition of the estate in the absence of an estate tax. However, even those documents should be addressed because clients probably did not seriously focus on what they really wanted to happen in the event there is no estate tax.

c. Coordination With $3.0 Million Spousal Basis Adjustment. For many families, leaving most if not all of the estate to the credit shelter trust is satisfactory, and clients may not want to revise wills having that result. A concern is that the full amount of the $3.0 million spousal basis adjustment may not be available, because it applies only to bequests to spouses or QTIP trusts. Much of the complexity around testamentary planning in 2010 revolves around leaving the desired amount to the credit shelter trust AND qualifying for the full $3.0 million spousal basis adjustment.

d. More Sophisticated Approaches to Leave Desired Amount to Credit Shelter Trust AND Take Advantage of $3.0 Million Spousal Basis Adjustment. There are two main approaches to coordinate leaving the desired amount to the credit shelter trust and taking full advantage of the $3.0 million spousal basis adjustment. (1) Leave all of the estate to a QTIP trust, and rely on QTIP elections, and basis adjustments to cause the QTIP trust either to avoid estate inclusion in the surviving spouse's estate or to qualify for the marital deduction if the estate tax is reinstated, and to rely on disclaimers to cause assets that do not need to remain in the QTIP trust for tax purposes (such as qualifying for the $3.0 million spousal basis adjustment) to pass to a trust with more flexible terms for the spouse and the family. This approach is simpler from a drafting perspective than using complicated formula clauses. Relying on disclaimers, however, has several significant disadvantages, including the inability of the disclaiming spouse to keep a testamentary limited power of appointment and the danger of an inadvertent acceptance precluding a disclaimer. (2) Use formulas (or described specific amounts) to leave the desired amounts to the credit shelter trust and the QTIP trust (or to the spouse outright). These formulas may leave assets that could utilize the $3.0 million basis adjustment and may address whether the maximum or minimum current value would be included in that bequest (i.e, whether assets with the most appreciation or least appreciation would be chosen in funding a bequest to utilize the basis adjustment).

e. Practical Problem in Using Formulas Based on Appreciation. Some planners have a great deal of concern about using formulas based on basis adjustments. The entire value could be left in a QTIP trust if there is not a great deal of appreciation. Is the basis step-up issue worth running the risk of not being able to avoid estate inclusion at the surviving spouse's death of a potentially very large part of the estate?

Furthermore, such formulas could lead to difficult administration issues. It is hard enough to fund bequests based on their market values, let alone based on basis determinations that may be significantly more uncertain.

f. Consider Using Specific Dispositions Rather Than Just Relying on Formulas. In working with clients, Carol has found that instead of trying to patch formulas, it is clearer to say precisely what dispositions should be made if the client dies during the "gap" period.

g. "Daunting Task." After looking at a number of specific client situations in 2010, Carol Harrington concludes: "We are facing a daunting task to respond to all our clients to explain it to them. You can't just send a letter and say if you want it fixed, sign this document. I'm finding it does not work like that. It's much more time intensive than that. One size clearly does not fit all."

3. Remaining "Gift Exemption;" Client May Not Be Able to Make $1.0 Million of Gifts

a. Effect of Prior Gifts Over $500,000. While we think of having a gift "exemption" of $1.0 million, we actually have a gift tax credit of an amount that covers $1.0 million of gifts. Having a credit rather than an exemption system has an interesting impact this year when the gift tax rate has lowered to 35%. An individual who has made taxable gifts before 2010 of more than $500,000 will not be able to make gifts in 2010 of the difference between $1.0 million and the prior taxable gifts. This is because the prior taxable gifts over $500,000 utilized the gift tax credit at greater than the 35% rate that applies in 2010. For example a donor who has made taxable gifts before 2010 of $961,000 will not be able to make additional gifts in 2010 without paying gift tax.

b. Effect of 2010 Gifts on Gifts in Later Years. This same concept works in reverse. A donor who has made no taxable gifts in prior years and makes a $1.0 million gift in 2010 can make an additional $36,000 of gifts after 2010 that will be sheltered by the gift tax credit (assuming the maximum rate returns to 45%).

c. Significance. These are small amounts, but we should be sensitive to the issue because clients do not like to be surprised even in small amounts.

4. Deathbed Gifts

a. Utilization of Basis Adjustments. Assets received by gift from any individuals other than the decedent's spouse within three years of death do not qualify for the $1.3 or $3.0 million basis adjustments. However, gifts from one spouse to the other do qualify, even if they are deathbed gifts for decedents dying in 2010. Consider this if a dying spouse does not have sufficient assets to fully utilize the basis adjustments.

b. Bypass Planning Opportunity. Because the estate tax does not apply to persons dying in 2010, consider making gifts to a dying spouse, which he or she might decide to leave into a bypass trust for the donor-surviving spouse to take advantage of the opportunity of sheltering practically all marital assets from the estate tax. However, the IRS might argue that §2036 could apply if it could establish an implied agreement that the dying spouse would leave the donated assets back into a trust for the benefit of the donor spouse. To the extent possible, structure the transfer to remove the inferences of such an implied agreement (by allowing the passage of time, not transferring all assets, etc.). There is a specific exception in the QTIP regulations providing that the §2036 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. Therefore, make these kinds of deathbed gifts for estate tax savings purposes into inter vivos QTIP trusts. However, assets in an inter vivos QTIP trust for a decedent spouse will not be eligible for the basis adjustments (because those assets are not deemed to "pass from the decedent" under the carryover basis rules) — gifts for that purpose must be made outright to the spouse.

5. GST Issues

a. Uncertainty. There is a great deal of uncertainty regarding various GST issues. Some of the uncertainty revolves around possible Congressional action including (1) no action in 2010, (2) retroactive reenactment, or (3) prospective legislation. How the "had never been enacted" sunset rule will be applied is very uncertain. Even if we knew how it would be applied, there is the uncertainty of whether there will be legislation changing the sunset rule. There is the danger that Congress does something to change the sunset rule but does not directly address many of the peripheral impacts such as the various GST issues.

b. Can We Allocate GST Exemption in 2010? There is no GST exemption to allocate in 2010. However, in 2011, under the sunset rule, apparently there will be $1 million of GST exemption, indexed for inflation after 1997. A Revenue Procedure is issued each year providing indexing amounts. The $1 million GST exemption indexed amount happens to be the same as the indexed amount for the "2% interest rate portion" of §6166 installment payouts under §6601(j). For 2010, the indexed GST exemption amount would be $1,340,000. It is not totally clear that the indexed GST exemption amount in 2011 can be allocated to gifts made in 2010, but hopefully it can. Carol Harrington observes that she does not know why in a period of no GST tax the IRS would treat people more harshly than if there were a GST tax. "But that's logic."

c. Automatic Allocation to 2010 Direct Skips After 2010. In 2011, under the sunset rule, perhaps the automatic allocation rule under pre-2001 law would apply to direct skip gifts made in 2010, even though the transfers are not subject to the GST tax. To provide certainty that does not happen, a Form 709 could be filed for 2010 electing out of automatic allocation. However, if the gift asset will remain in trust, the donor may want automatic allocation to apply.

d. Recomputation of Inclusion Ratio For Gifts to Exempt Trusts in 2010. The inclusion ratio must be recomputed for gifts to trusts in 2010 when there is no GST exemption to allocate to the gift. Chapter 13 continues to apply generally, it just does not apply to GST transfers. A gift to a trust is not a GST transfer. However, GST exemption could be allocated in 2011 (as discussed in paragraph b above).

e. Gifts in Trust for Grandchildren. Section 2664 says that Chapter 13 does not apply to GST transfers in 2010, which includes direct skip transfers. While a direct skip transfer to a trust for a grandchild in 2010 is not subject to GST tax, there is a possibility that future distributions to the grandchild from the trust would be subject to GST tax. The "move-down" rule in §2653(a) ordinarily prevents that from happening, but that section is in Chapter 13 and Chapter 13 does not apply to GST transfers (including direct skips) in 2010. However, in 2011, the "had never been enacted" rule may mean that §2664 is ignored so Chapter 13 did apply to the direct skip in 2010, not to cause the imposition of a GST tax in 2010, but for all other purposes. Carol Harrington likes that answer and thinks it is correct because it is bad policy to punish transfers to a trust so harshly as compared to an outright transfer to a grandchild. Not only would the taxable distributions be subject to tax, they would be taxed more harshly. The GST tax on a taxable distribution is "tax inclusive" (the rate is applied to the total amount transferred, including the GST tax itself) while the tax paid under direct skip is tax exclusive (the rate is applied to the amount actually received by the grandchild). It would make no sense for the move down rule not to apply.

The same issue applies for annual exclusion gifts to a single beneficiary-vested trust. The zero inclusion rule under §2642(c) arguably would not apply for direct skip transfers in 2010. However, it may be deemed to have applied under the "had never been enacted rule" after 2010, for the same reasons discussed above. Carol does not think the IRS would want to go after these types of transfers and treat them more harshly than if a GST tax applied.

Transfers to custodianships are subject to the same issues because the regulations treat custodianships as trust equivalents.

Are gifts to 529 Plans for grandchildren subject to these same concerns? There is no clear answer. Transfers to 529 Plans are treated as present interest gifts that qualify for the annual exclusion, but it is not clear whether they are treated as outright gifts or as gifts in trust. The proposed regulations (now about 12 years old) have some indications that the IRS viewed transfers to 529 accounts as transfers to a trust that qualify for the annual exclusion.

Some planners have suggested making direct skip gifts in 2010 to a partnership that would block distributions until a partner reaches a certain age. Carol worries that looks a little like a trust. "But that means the IRS would be going after these things in a way that looks vindictive and I don't think that's going to happen. I think they will be concerned with trying to administer the tax law in a consistent manner given the chaos." (But Carol sarcastically notes: "That would be crazy. What am I saying?")

Carol is using a formula approach for these types of transfers. The transfer is made to a trust, but the assignment provides that the transfer will be outright if putting the asset in trust will cause distributions in 2011 or later to be subject to GST tax.

f. Taxable Distributions in 2010 From Non-Exempt Trusts. Taxable distributions in 2010 from a nonexempt trust may escape GST taxation totally. Do this by formula because we do not know if there will be a retroactive reenactment of the GST tax. For example, the assignment might transfer the maximum amount possible, perhaps up to cap, as long as it will not be subject to GST tax. (Theoretically, it is possible that such an assignment does not result in zero distribution to the trust if the GST tax is retroactively reenacted, but is a conditional transfer based on the odds of a retroactive reenactment.)

Carol asked for a show of hands of any Fellows in the audience who had been involved in an audit of a taxable distribution return. No hands went up.

See Item 47 for a detailed discussion of formula transfers designed to hedge against retroactive repeal.

g. <u>Testamentary Transfers in 2010</u>. It is possible that testamentary transfers to trusts in 2010 will not be subject to GST tax in the future, because the "transferor" is the person subject to a transfer tax, and decedents who die in 2010 are not subject to estate tax. The definitions of skip persons and non-skip persons are tied to the definition of transferors. Non-skip persons are everyone other than skip persons, and if skip persons cannot be identified because of the lack of a transferor, perhaps everyone in the whole world constitutes non-skip persons. If so, future transfers from the trust would not be subject to GST tax. Inter vivos gifts are not subject to this same possible interpretation because donors are subject to gift taxes in 2010.

How would this apply in 2011 under the "had never been enacted" rule? It would make no sense to say that the transferor was deemed to have been subject to the estate tax in 2010. That is a real event, and it was not subject to estate tax. The IRS conceivably could issue regulations and deem the transferor to be the person in whose estate the asset would have been included if the estate tax applied, but it is questionable whether the regulation would be valid based on the statute. (Query whether the IRS might attempt to argue that the transferor is the person's parent? That is the last person subject to estate tax with respect to the assets. That seems very far fetched and would require tracing assets passing into the trust from the 2010 decedent to assets previously received from his or her parent.)

Another clearer opportunity is to make a bequest direct to a grandchild in 2010 without the imposition of the GST tax. That makes for a hard decision of whether to opt for the certainty of a GST tax-free direct bequest to a grandchild or the possible additional opportunity of having a long-term forever GST exempt trust. Consider using a formula approach. Make a bequest in trust for the grandchild if that could be done without future distributions being taxable, but otherwise outright to the grandchild. That will automatically adjust based upon whether the "move-down" rule applies or whether the trust is permanently exempt because there is no "transferor." (Carol says that a "really clever" planner might provide that after five years children would become discretionary beneficiaries of the trust. The transfer that to the trust would still be a testamentary direct skip in the year of death, but a longer term trust could then exist with children as discretionary beneficiaries.)

h. <u>ETIP</u>. Any ETIPs seem to have terminated in 2010, because the transferor is no longer subject to estate tax. If GST exemption has already been allocated to the transfer, to become effective upon termination of the ETIP, that allocation has "kicked in." If not, planners might consider allocating GST exemption in 2011 to those trusts. However, there is an issue as to whether a new ETIP would begin in 2011. Furthermore, the "had never been enacted" sunset rule conceivably would change the result in 2011 (so that the ETIP is treated as if it did not end in 2010), under the reasoning that §2664 (which caused the estate tax not to apply if the transferor died in 2010) would be deemed never to have occurred.

i. <u>Effect of Sunset Rule on Automatic Allocations</u>. Direct automatic allocations or "opt-in" automatic allocations for transfers to trusts under §2632(c), which was a part of

EGTRRA, might conceivably be invalidated under the sunset rule in 2011. The IRS could issue a regulation to treat any "opt-in" or automatic allocation as if it had been an affirmative allocation.

j. Effect of Sunset Rule on Qualified Severances. Qualified severances were allowed under EGTRRA, as a result of the IRS's strict interpretation of not allowing "downstream splits." The IRS could by regulations recognize downstream splits that previously occurred and continue to recognize them, or could adopt its own downstream split rule if it were so inclined.

6. Prospects for Legislative Action

ACTEC's political pundit, Ron Aucutt, gave his predictions for legislative developments regarding the transfer tax.

a. Compromise Approach. Efforts to reach a permanent resolution of the transfer tax in the Senate never mustered more than 58 votes for any proposal. The House of Representatives passed a bill in 2009 providing a permanent $3.5 million exemption with a 45% rate. A Republican-led proposal (with bipartisan support) in the Senate would provide a $5 million exemption with a 35% rate (in a very long phase-in). (Prior proposals suggested rates of 15% and 30%.) The disagreement seems to center more around rates than exemption amounts. Perhaps 45% is not enough relief and 15-30% is too generous. A 35% rate got a majority vote in the Senate but not 60 votes. "If all that is preventing them from reaching a compromise is rate, and maybe 35% is too low and 45% is too high, folks I can think of things between 35 and 45—44, 36, 40-that's a good one. The point is there seems to be no moral commitment to either side of this issue; it's just a negotiation over the rate. As a result it seems to me a compromise should be easy."

"I'll tell you the most important thing you'll hear at this meeting. It is certain that there will be a viable compromise of these issues by May. Now a few of the details are not certain, such as the detail of whether enough members of Congress will see that compromise, whether if they do that will have the willpower and the opportunity to do it, and whether the legislative procedure and agenda will allow it."

b. Timing of Legislative Action. Ron thought the best window of opportunity (other than, of course, the first eight years) to address this would have been in January or February. However, health care reform has dominated Congress. The next best window is in May, if health care reform can come to some kind of conclusion and there can still be a few months left before the summer. The next best window is in a lame-duck session after the election. Not much will happen in the summer or early fall, because while we may have budget reconciliation, it will have to deal with the expiration of the so-called Bush tax cuts from 2001 and 2003. Because this is an even numbered year (i. e., an election year), that is almost certain to be scheduled in a lame-duck session after the election.

In a recent Capital Letter, Ron suggested three things that have to happen for Congress to work out a compromise: (1) A THAW in partisanship; (2) TIME to address the estate tax; and (3) a new TACK for addressing the gap in issues. As to the "time" element, we think members of Congress are not doing anything. "But the fact of the matter is they're spending lots of time working on the things they're not doing." As to the new "tack" issue, the gap in views is so narrow that it doesn't need much of a new approach. It might be an idea that has merit or one that regardless of merit just allows an opportunity for saving face and rallying around. It might be rate brackets, a slow phase-in, or some form of retroactivity with techniques for protecting formulas that depend upon retroactivity.

c. Retroactivity. Whether retroactive legislation would ultimately be held constitutional is not the point. The real point is that it would take six, seven or eight years of uncertainty before we have an answer. That's the political cost of retroactivity.

There would seem to be very little risk of retroactive legislation in 2011 that would be retroactive back into 2010. (Republicans will likely be even more powerful next year. They will not say "we delivered on repealing the estate tax, but now we are reinstating it retroactively.")

d. Meeting With Staffs of Joint Committee. On February 19, 2010, Ed Beckwith, Ellen Harrison, Ron Aucutt, Beth Kaufman, Mary Ann Mancini, and Dennis Belcher met with staffs of the Joint Committee on Taxation at their invitation. Staff from both the Republican and Democratic members of the House Ways and Means Committee and Senate Finance Committee attended. The meeting was scheduled for about an hour, but a dozen or more staff members stayed for 2 1/2 hours. The chief of staff of the Joint Committee had to leave but came back and stayed until the end of the meeting. The members were very interested in hearing about the practical problems that our clients and attorneys have in dealing with the estate tax uncertainty. There was "more give than take." There is no push to do anything immediately, because they do not perceive a deadline. (They were willing to meet because they had a lull from the health care discussions.) They were willing to receive information, but gave no indication of when there might be congressional action. Concern was expressed for fiduciaries who may be in the position of having to raise cash to pay estate tax in case there is retroactive reenactment but having to pay income tax on such sales in light of the possible continued application of carryover basis. The ACTEC Washington Affairs Committee prepared an eight page issue paper that is available on the public side of the ACTEC website. The ACTEC representatives assured the staff that ACTEC does not lobby for a particular outcome but is available for technical assistance.

e. PAYGO Legislation. The PAYGO legislative adjustments adopted this year by Congress (H.J. Res. 45) include a two-year exception (through 2011) for extending the 2009 estate and gift tax system. The House version had included an exception for *permanent* extension of the 2009 system.

f. Summary: Likelihood of Action. "If I took a poll of his audience, I bet a lot of people would know that Congress will not act this year at all. You would know that with the same conviction that you knew last year that they had to act. And that's exactly where we are. I'm afraid the continued uncertainty flavored with whatever grain of optimism suits your personality is the best we can leave you with."

Items 7-16 are observations from the Trachtman Lecture, by Jonathan Blattmachr: "Looking Back and Looking Ahead: Preparing Your Practice for the Future"

Jonathan's analysis of looking first to the past to see directions for the future, and his predictions for the future are extremely creative. The analysis necessarily includes a great amount of original thinking (indeed, at one point he says there's nothing written about that particular topic and to take his comments with a grain of salt). I have included portions of his PowerPoint materials verbatim. Many of the topic headings in this summary are directly from his materials, but usually are not shown as quotations from his materials.

7. Accelerating Changes

For 15 years, computer capacity has doubled about every 18 months. However, the time to double knowledge has been shortening. Ray Kurzweil, author of Age of Spiritual Machines says that the rate of change is increasing rapidly. (KurzweilAI.net has a great deal of information about technological rate of change and predictions for the future.) In some respects we are reaching not only exponential growth [Ex., 3^1, 3^2, 3^3, 3^4, 3^5 etc.] but growth by an exponent to the exponent [Ex., 3^1, 3^2, 3^4, 3^8, 3^{16} etc]. Kurzweil says that in this century there will be 20,000 times more changes than in the last century.

8. Planning; Law as a Business

a. Case for Long-Term Planning. Reasons for long-term planning include (1) financial, (2) consistency in practice and life, (3) intellectual satisfaction, (4) emotional satisfaction, and (5) standing in the community.

b. Why Lawyers and Law Firms Don't Plan.

- "It's Not Another Money Getting Trade." When Jonathan became a partner at Milbank in 1979, he asked when there would be a meeting for new partners. The managing partner laughed. Jonathan, as I suspect only he could, was quite persistent and finally convinced the managing partner to have an orientation meeting for the new partners. At that meeting, the managing partner expressed that he thought having lawyers plan might be unethical, proudly bragging that "we're not another money getting trade."
- "Nature of Lawyers: No Three Musketeers." Lawyers can leave their firms at any time and take their book of business with them. If an employee leaves General Motors, it cannot take business with him.
- No Traditional Ownership of the Enterprise, Contrasted With Australia. As a practical matter, lawyers now own 100% of their book of clients. From a legal standpoint, ethical rules prevent non-lawyer owners of firms. Some day that will change. In Australia, there are now publicly-traded law firms.
- "I Decided Not to Go to Business School; Lack of Training in Business Matters"

c. Law As a Business. Growth revenue minus expenses equals profits. That is true for all businesses including law firms. Jonathan's great epiphany, as he thought about this topic, is that the cost of everything, including legal services, is governed by the law of supply and demand (unless there are government controls).

d. Supply is Increasing. The supply of lawyers and legal service providers is increasing dramatically. The number of lawyers from 1972 to today has increased from about 300,000 to 1.2 million. The number of paralegals in that time has increased from zero to about 300,000. The number of individuals rendering legal services has increased by four or five times. Furthermore, many other providers of legal services are emerging. California now allows paralegals to form their own "Legal Document Assistance" firms (or "LDAs"). They are not under the supervision of a lawyer, and in theory they do not supply legal advice. LegalZoom prepares legal documents but claims that it does not practice law. (It is being sued by the state bars in Mississippi and North Carolina, but Jonathan suspects that the bars will not win those lawsuits.) LegalZoom has had over 1 million customers to date, and over 99.5% of the customers say they are satisfied. (A will on LegalZoom costs $71. Jonathan ordered a will, which is based on interactive questions.

However, the system would not allow him to choose to leave assets in trust for his son for life. He called to ask why not, and was told that the system could not accommodate a lifetime trust. He was told he had to choose an age, so he chose age 125. He has yet to receive the will from LegalZoom.)

e. Price Is Increasing Also. Although there has been at least a five-fold factor in the supply of legal services, the price of legal services has increased dramatically. From 1972 to today, hourly rates have gone up by 8 to 10 times. The supply has increased five-fold and the price has increased 8 to 10 times. Why? Demand is increasing dramatically.

f. Demand. The demand for legal services has increased by an almost exponential factor. Why? (Jonathan cautions that very little is written about this so take all this with a grain of salt.)

(1) Accelerated Increase in Laws and Regulations: Federal, State and Local. One of George W. Bush's campaign planks was the overabundance of regulations. However, during his term, the number of new regulations increased by more than twice as much as any other president in history. Clients are interested in addressing either compliance with or financial opportunities under new regulations.

(2) Globalization. If the company does business only in the state of Washington, it has only one set of laws to deal with. Global companies have dramatically increased legal needs.

(3) Increased Litigation. 24 million lawsuits are brought in the United States each year, and that number is growing.

(4) Advertising. A subtle kind of advertising is "one-on-one." The client comes to get a will, and the attorney advises that the client needs a GRAT, QPRT, FLP, etc. The attorney becomes an advertiser by explaining additional opportunities, which increases the demand for the attorney's legal services.

In addition, traditional advertising has a double effect. It does more than just say, "Hire me." It also increases the demand for legal services generally.

(5) Patents. Legal strategies have been patented in recent years. Marketing of the strategies may lead to increased demand. (The Bilski case which is now before the Supreme Court may have an impact on whether business methods, including legal strategies, can be patented. Jonathan said that he submitted the first patent application for a tax idea, regarding reverse split dollar life insurance. He withdrew the application because the IRS wasn't happy with it. The most recent tax patent involves multiple charitable remainder trusts with different types of assets in each trust. Jonathan says that there is no "sizzle" in the strategy but it was patented.)

(6) Change in Demographics. As the population grays, the demand for estate planning increases. The more educated people are, the more likely they are to consume legal services.

(7) Changes in Wealth and Income.

(8) Changes in Science. Changes in science lead to new legal complexities (such as the issue of posthumously conceived children under existing trusts).

g. Summary Regarding Supply and Demand. There will be more demand for legal services, but the services may be different and delivered in a different way in the future.

9. Changes to Legal Profession Caused by Technology

a. Document Preparation. The IBM Selectric Typewriter was the state-of-the-art when Jonathan got out of law school. About that time, Fran Musselman, managing partner of Milbank, asked IBM to put sentences on punch cards, rather than numbers, so that sentences and paragraphs could be built from the cards. IBM told him he was out of his mind; there was no need for it and no demand for it. Later, he went back to IBM and asked again. Finally IBM relented, but said it would charge Milbank its full expense for creating the system. IBM asked Fran to sign a document saying that it would own the process if it had any commercial appeal. Fred always said signing that document was "the biggest mistake of my career."

A huge change came with the development of WZIWYG (for us non-techies, that stands for "what you see is what you get") systems, which allowed lawyers to type their own documents.

b. Tax Return and Other Report Preparation.

c. Written Communication. Written communications used to be delivered by the post office. In 1985 came the fax machine, and email now dominates written communication.

d. Voice Communication. Traditional telephone conversations have now developed into conference calls with inexpensive international capability.

e. Calendaring Events and Appointments. Remember when we used printed calendar books?

f. Research and Law Libraries; Word Search Capability. In 1972, Jonathan was the seventh person in the country to learn how to use Lexis. He could not understand why it was so extraordinary. It is been extraordinary for two reasons: finding laws more efficiently, and finding facts. When Jonathan started law practice, Milbank had 35 staff members in its library. It now has five. Many law libraries have no books but just internal disks or online capabilities.

g. Calculations. CRT calculations by hand used to take hours. Economical software packages now do the calculations instantly.

h. In Person Meetings. This is one area where not much has changed. Technology has not propelled us forward yet, but Jonathan thinks this will change.

i. Education/Learning. Educational sources are available on line for all topics. Webinars are everywhere.

j. Billing Practices. When Jonathan started practicing, it was "guess and by golly" to piece together monthly billing statements.

k. Litigation and Dispute Resolution. Litigation support is changing dramatically as a result of computer capabilities. Dispute resolution is now being handled by computer in some situations. Richard Susskind in his book "The End of Lawyers" says that 40,000 claims in New York City (claims by or against the city) have been closed by a computer program. The program analyzes the facts, makes a reasonable determination of the outcome, and makes an offer.

l. Information Sharing (*The American Lawyer*). When Milbank partners found out that other firms were making much more money, it had an enormous impact on the firm. The most important statistic published in *The American Lawyer* became profits per partner. Steven Brill has had an enormous impact on the American practice of law.

m. Technology and Erosion of the "Monopoly" of Lawyers. LegalZoom has prepared 1 million wills on their system, with amazingly high customer satisfaction. That means lawyers in private practice did not get that business. When Fran Musselman told Milbank lawyers in 1987 they must either learn to do word processing or become extinct, many lawyers were outraged. There was tremendous resistance. Now, no one wants to give up Lexis, word processing, Tiger tables, etc. Technology has eliminated many of the rudimentary tasks that we previously did. We used to have to read document drafts word for word.

n. Looking Forward: Smart Computers. Smart computers now begin to mimic human thought. That will become more profound over time.

10. Richard Susskind, *The End of Lawyers*

a. Overview; Evolution of Legal Services. Technology reduces the cost of rendering legal services. More information produces more "informed" clients. Susskind says the result is a different evolution of legal services: beginning with Tailored, to Standardized, to Systemized, to Packaged (the ability to offer and deliver a package of documents; document assembly programs are close to that now), and finally to Commoditized services.

Jonathan says that legal advice is commoditized now to a degree that some lawyers give away their legal advice for free. Go on YouTube and type in "revocable trusts" or "irrevocable life insurance trusts" and you will find dozens of videos available for free.

b. Exaggeration of Uniqueness of Services. Susskind says: "[M]any lawyers exaggerate the extent to which their performance depends on deep expertise. We should subject it to scrutiny and analysis… knowledge is being paraded as expertise and yet analysis shows it to be capable of being reduced to routine tasks in whole or in part…"

"Lawyers often overstate the extent to which the content of their work is creative, strategic and novel. If [Thomas] Edison allowed that [only one percent] of his work was inspiration, I wonder what the possibility of lawyers' claims that most corporate work (to take an example) involves a higher level of creativity."

"[O]n analysis, many tax problems can be reduced, actively, to a large decision tree of a structured body of rules, so that a computer system would be especially well suited to solving what otherwise might seem to be an insoluble challenge for the non-expert."

c. Decomposition and Multi-Sourcing. Susskind says there must be a decomposition of legal services into the separate real elements of the tasks, and then there will be an outsourcing of those tasks. Jonathan calls this the "legal assembly line:" human judgment with outsourcing of tasks to computers.

11. Disruptive Legal Technologies

a. Description. "Applications of technology to challenge the old ways and, in doing so, bring great cost savings and new imaginative ways of managing risk."

b. Examples.

- Automated document assembly.
- Relentless connectivity. (Jonathan's Blackberry works in the Alaska wilderness.)
- Electronic marketplace. Amazon has reviews of anything. EBay has auctions. That is now happening for legal services and will be increasing. (We may see wealthy people

sending e-mails with RFPs to all ACTEC attorneys in NYC. Then the prospect may go back to selected attorneys asking for a capped or fixed price. Companies are already doing this. Companies can be hired to bid out legal work.)

- E-learning; Legal Wikipedia. Encyclopedia Britannica is out of business; it has been replaced by Wikipedia. Jonathan thinks ACTEC should prepare its own proprietary Wikipedia.
- Closed legal communities. The ACTEC listserv is an example of this. Selected law firms may join to form a similar close legal community for information sharing purposes. (Some law firms in Britain have combined to do this in a formal manner.)
- Embedded legal knowledge in assembly systems. Document assembly systems have embedded legal knowledge. For example, the planner cannot go forward in drafting a will until answering whether the spouse is a U.S. citizen, which automatically triggers certain elements.
- Workflow and project management with automated checklists or procedural manuals. Jonathan gave an example of a 29-item workflow and project management template for implementing a sale to grantor trust transaction.

12. Preparing For the Future of Your Practice

a. <u>Willingness to Plan</u>? Many will say, "Forget it; I practice law my way."

b. <u>Determine Goals</u>. Example: Make $500,000 a year, get intellectual satisfaction; associate with best lawyers, etc. Advisors can assist with this process.

c. <u>Can Your Practice Achieve the Goals</u>? Be realistic.

d. <u>How to Change Practice to Achieve Goals; Services and Market</u>. If changes are needed, consider the types of services offered and the marketplace for those services.

e. <u>Marketing</u>. Keep vigilant.

f. <u>Education</u>. Ensure consistent and up-to-date education.

g. <u>Website</u>. Develop an interactive website that drives prospects to your practice. This is beyond just a website listing lawyers.

h. <u>Outsourcing</u>. Microsoft outsources legal work to India. English is a common language in India, and India uses the common law. Companies can have the equivalent of a Harvard lawyer for $25,000 a year in India. CPA Global provides "legal process outsourcing." Microsoft has entered into an agreement with CPA Global for offshore legal work from lawyers in India. There is an ongoing erosion of American lawyers. Outsourcing can also apply on a more local level.

i. <u>Develop Document Assembly and Greater Standardization</u>. Standardize everything, including correspondence.

j. <u>Office Space Needs</u>. Carefully consider realistic needs for future actual office space. There will be an increase in working from home and a decrease of need for office space. The Brobeck law firm was more profitable than any firm west of the Mississippi, but it went out of business because it overcommitted to office space. "A very cheap 50-year lease may put you out of business." That is also true for trust companies. Having to impress wealthy clients with big offices will change.

k. <u>Dealing With Defection</u>. Defection is the main reason law firms fail. If the most lucrative areas of the practice leave, the firm still is stuck with a long-term lease and expenses, etc.

The economics look bad so other sections leave as well. This is the case whether dealing with a three-person firm or a 3,000 person firm. Come up with a plan to discourage defection. That is the scariest thing for any law practice.

l. Develop Data Sharing Deal Flow. A data sharing deal flow system allows all lawyers *and clients* to know the ongoing status of each element of a transaction. That is done routinely in England for banking deals. The clients insist on it.

m. Develop Business Model. Some attorneys like solo or very small practices, and others like big firms and like to leverage. The most lucrative law firm in the United States is Cravath Swain and Moore — and they have the highest leverage. "If you want to make more money, figure out a way to leverage." Leverage can be inside the firm or outside. Many law firms have young mothers working at home on a contract basis.

13. Future of Billing Methods

a. Billable Hour. "The billable hour is dead." Richard Susskind in "The End of Lawyers."

b. Be Flexible. The trend will be using a fixed or capped fee, with no success fee. There are ethical considerations. For example, Circular 230 addresses contingent fees.

14. Blattmachr's Ten Year Predictions

a. Development of Legal Wikipedia. ACTEC should develop this, with word searchability.

b. In-Person Meetings Will Diminish. There will be a trend toward video meetings, eventually replaced by "virtual" meetings. A partner left Milbank several years ago to join a project for the development of technology for projecting people and things in three dimensions with holograms. Twenty-five years from now we will meet with people long-distance and it will appear as though you are with each other. Kids use Skype all the time. That is another reason that the need for office space will diminish. New young consumers will have a bias toward long-distance communication.

c. Need for Office Space Will Diminish. The decrease of in-person meetings and the increase of alternative work arrangements will decrease the need for office space.

d. Supercomputers. Supercomputers this year will have the capacity of the human mind. They will begin to mimic human thought. A computer learns from past mistakes, something we humans don't always do.

Computers will become smaller and increasingly integrated into everyday life, from driving an automobile to preparing meals. More and more computer devices will be used as miniature Web servers, and more will have their resources pooled for computation and data processing including analysis.

e. Increased Retirements. Planning for retirement is increasingly important.

f. Typing Will Disappear. iPhones now allow dictating e-mails. Typing will nearly disappear and be substituted with verbal and eventually with thought input. (Christopher Reeves used a rudimentary thought input system.)

g. Paper Books, Newspapers and Magazines Will Disappear. Paper periodicals (including legal periodicals) will essentially disappear, in part driven by the need for word search capabilities.

h. Internet Broadband. High-quality broadband Internet access will become available almost everywhere for free.

i. Virtual Assistants. For example, free real-time language translation will become available that would appear as subtitles to a user wearing special glasses. Computers will automatically do rudimentary research for free.

j. Increased Government Benefits and Wealth Shift; Increased Life Expectancies. Within 10 to 15 years, life expectancies will be significantly extended. Jonathan indicates that the life expectancies of people living in developed countries, both on average and maximum age (now essentially 100 years for most) will increase (in part by nanotechnology) producing an increase in demand for legal services. The demand for legal services will be met, in an ever-growing measure, by computer software.

k. Expansion of Services Offered to Law Firms. Examples include emotional counseling services, financial services, Monte Carlo simulation analyses, etc. For example, whether to make Roth IRA conversions depend in large part on what happens with the investment assets in the future.

15. Short Term Trends for Estate Planning Strategies

a. Supercharged Credit Shelter Trusts.sm The trust is designed so that the spouse-beneficiary is treated as the owner for income tax purposes.

b. Installment Sales to Grantor Trusts by Grantor or Spouse.

c. Installment Sales from Marital Deduction Trust to Dynasty Trust for Spouse.

d. Installment Sales to Third Party Created Section 678 Trust (PLR 200949012).

e. QPRTs and Split Purchase Trusts.sm QPRTs still make sense, even in a low interest rate environment, if the client thinks the value of real estate will increase significantly.

f. Income Tax Planning With Life Insurance. Income tax rates will be increasing from 35 to 39.6%, with additional increase of the Medicare tax. In some states, income tax rates are much higher. Life insurance is the only place for tax-free compounding other than Roth IRAs.

g. Integrated Estate Planning by Many Advisors.

h. Family Split Dollar Insurance. Jonathan is working on a new version of split dollar insurance.

i. Alaska Community Property Trusts. Jonathan says that he has saved his clients unbelievable amounts of money through using these trusts. Why not do that for most clients who own their property 50-50?

j. Qualified Plan Planning Including Roth IRA Conversions. Roth IRA conversions are a significant development this year.

k. Reverse Freezes and Deathtime Freezes.

l. Backloaded Charitable Lead Trusts (Especially If Funded With Life Insurance). These will be available even if GRATs are outlawed or restricted in the future.

m. Business Succession Planning (Including Buy-Sell Provisions).

n. Dispute Resolution. “The only time you really get to know someone is when you share an inheritance.”

16. Fundamental Disagreement With Susskind: Not the End of Lawyers

Jonathan's fundamental disagreement with Richard Susskind is that there will be a fundamental increase of new laws and regulations. That means there will not be a reducing demand for lawyers, at least until computers can mimic human thought. Jonathan anticipates that there will be greater government regulation of industry, relationships and lawyers.

Items 17-20 are observations from a seminar by Larry Brody and Mary Ann Mancici, "Sophisticated Life Insurance Techniques." The seminar focuses on private premium financing and private split dollar arrangements.

17. Temporary Financing Arrangements

Private premium financing and private split dollar are both arrangements primarily used to reduce the gift tax cost of transferring money to a trust so that it can pay life insurance premiums. Both strategies reduce the gift to something less than the full premium amount. In analyzing these arrangements, planners must address (1) the gift tax cost, and (2) the economic impact of the amount of assets that would be left in the trust. For example, if loans are made to the trust to pay premiums, there will be no gift tax for those transfers, but the ultimate amount in the trust will be reduced by the aggregate amount of the loans that must be repaid.

If the client dies early, life insurance proceeds can repay the financing amounts. However, exit strategies must be planned in case the client lives a long time. Each of these arrangements gets expensive over time (for different reasons, discussed below). The planner must plan the initial transaction, the policy that goes into it, and the exit strategy. If all of those issues are not addressed, clients may find that the death proceeds are not as much as expected and that the amount included back in the estate will be more than expected.

18. Private Premium Financing

a. <u>Description</u>. The client (or the client's spouse) makes an AFR loan to the owner of the policy. Loans may be made each year of the premium amount, or a large loan may be made upfront, which can assist in building a side fund for an exit strategy. The borrower is typically a grantor trust.

b. <u>Do Not Use Below Market Loans</u>. Below market interest loans (having an interest rate below the AFR) would be subject to §7872, which creates unnecessary complexities. For a below market rate demand loan, the deemed interest amount is treated as if it were transferred each year, and the interest rate changes every month. For a below market gift term loan, there is an upfront gift equal to the aggregate discounted interest amount. Neither works as a long-term financing solution.

c. <u>Application of Split Dollar Rules</u>. The split dollar regulations are so broad that they clearly cover private premium financing. That does not make a lot of difference for most purposes. There is no difference in how the interest is calculated or in the amount of the gift, but there are some issues that must be addressed.

   (1) <u>Application of §7872 Rules Under "To Pay" Provision</u>. Even if the loan provides for adequate interest, it will be treated as an interest-free loan, subject to §7872, if the lender is "to pay" the interest, directly or indirectly. The phrase "to pay" is not defined, except by examples. For example, if the trust has no ability to make the interest payments, except by receiving additional contributions or advances from the lender, the trust may be subject to this rule. The effect is unclear. Does this provision double-tax the interest for tax purposes -- once as indirect gift or

compensation and once under §7872, or do we literally ignore the actual payment and receipt of interest for tax purposes?

This is one reason for pre-funding the trust with a large loan upfront. There is a fund out of which interest can be paid, reducing the implication that the lender is "to pay" amounts that can be used to make the interest payments.

(2) Forgiveness of Interest. The split dollar regulations make clear that if the loan requires interest and it is forgiven in any year, that amount is treated as a gift. (That makes sense.) However, the regulations also require a deferral charge (equal to the underpayment rate plus 3%). Having the lender forgive the interest is too expensive.

(3) Annual Statements Required. If the loan is "non-recourse" (undefined in the regulations), the lender and borrower each must attach a statement to their respective income tax returns saying that a "reasonable person" would expect the loan to be repaid. Simply repaying the straight AFR amount is not enough, because unless those statements are filed, the interest would be computed under the contingent interest rules of §7872, which would complicate the calculation of the imputed interest and increase the risk that adequate interest would not be paid or accrued. Those statements should be filed with the income tax returns of the lender and the borrower every year in which a loan is made. Treas. Reg. §1.7872-15(d)(2).

(4) Payment Ordering Rules. The regulations provide a required ordering rule for repayments of split dollar loans, which will prevent the parties from choosing which loans to pay first (i.e., the ones with the highest interest rates). Payments are applied first to accrued interest, in the order it was accrued, then to loan principal, in the order the loans were made.

d. Financing Variable Policies. If the policy acquired with the loan is a variable policy, the staff of the board of governors of the Federal Reserve system takes the position that the underlying funds in the variable policy are securities (a not surprising result). Therefore, a loan to allow somebody else to buy a variable policy, where the policy is taken back as collateral, is a margin loan. That has two consequences: (1) there are limits on how much can be loaned -- 50% of the underlying collateral, which means, for example, that in the first year the entire premium cannot be loaned; and (2) even more surprising, if the client (the lender) is not a financial institution (which it won't be) and if a sufficient amount is loaned, the client must register with the Federal Reserve as a financial institution. That would be like "the Bank of Larry." Larry Brody has verified that there is someone in Washington with the Federal Reserve that has the job of registering individuals as financial institutions because of this position.

Practical Planning Pointer: Do not use private premium financing to purchase a variable life policy. (Variable policies are not popular now in any event, in light of the performance of the stock market over the last 10 years.) If a variable policy is acquired using loans, do not take back the policy as collateral security. It is not clear that would avoid this problem, but at least it gives an arguing position.

e. Exit Strategies. Premium financing works great in the short run but not in the long run. The problem is that a stack of loans would result over time. Each has a different interest rate, and increasing amounts of the death benefits would be required to be repaid to the client in payment of the loans. This is exacerbated if the loans are accruing interest.

` Consider funding the trust with other assets during the client's lifetime, such as discounted entity gifts. Consider loaning a large amount upfront, with a fixed rate for a very long time. This can build a side fund for varying purposes including paying premiums each year, paying interest to the lender each year, purchasing assets in an installment sale, etc. Start the side fund upfront, not years later. Larry says: “Like in Chicago — do it early and do it often.”

f. <u>Will Related Premium Financing Loans Be Respected (As a Bona Fide Debt Obligation) For Tax Purposes</u>? One case, <u>Sutter v. Comm’r</u>, T.C. Memo 1998-250, did not respect a loan advanced to pay premiums. However the facts were unusual and the court seemed to reach the right result in that case. An agent loaned clients 100% of the premiums. The loans were nonrecourse and interest was accrued. The clients eventually sold policies in the life settlement market and the agent never collected any of the loans. He received 200% of the premium as commissions so he did not care that he never got repaid. The court concluded there was no intent to repay the loans and they were not respected.

The final split dollar regulations provide comfort. They provide that a split dollar loan (including a premium financing arrangement) will be treated as a loan for federal tax purposes if it would be treated as a loan under general tax purposes or if a reasonable person would expect it to be repaid. Treas. Reg. §1.7872-15(a)(2). Filing the annual statements that the lender and borrower have a reasonable expectation that the loan will be repaid helps satisfy this test. The preamble to the regulations say the same result applies even if the policy has no value in the beginning years before cash value has developed. They contemplate that a loan to a “naked trust” will be recognized as a bona fide loan.

In addition, there have been various gift tax cases and rulings that have respected intra-family loans for gift purposes unless the notes were intended not to be enforced or were intended to be forgiven.

g. <u>Large Loan Amount Upfront is Desirable</u>. Financing alternatives are (1) make a loan each year when the premium comes due (but this would be at the mercy of the annual AFR, which may be increasing), or (2) make a large upfront loan. The speakers encouraged a large upfront loan approach. The long-term AFR is still relatively low, and clients will know exactly the amount of interest that will be charged. There would be an excess large amount of cash that can be used to pay future premiums and to create investment vehicles for an exit strategy. The final split dollar regulations give comfort that the loan will be respected even though the policy has no value in the beginning years.

Making a large upfront loan is the closest that we can get to the old “equity split dollar” arrangement. All that the trust has to repay is the loan amount to repay these loans. The trust can have access to the policy’s cash value. (Under the final regulations, a classic equity split dollar approach results in unworkable tax consequences.)

h. <u>Income Tax Consequences</u>. Interest on the loan can either be paid currently (if a large amount is loaned to the trust, the trust will have the ability to pay interest currently; otherwise additional loans or gifts would be needed to make current interest payments), or can be accrued. Accruing the interest causes the loan to compound quickly, but at least there is not a gift issue each year when an interest payment is due. Accruing the interest shortens the time that an exit strategy will be needed to make the transaction economically feasible.

The lender will report income each year whether the interest is paid or accrued. The preferable approach is to use a grantor trust (treated as owned by the lender) as the borrower-owner of the policy. That would avoid having to recognize the interest amounts as taxable income in each year.

Using grantor trusts does have the disadvantage of creating possible income recognition when the grantor dies or the grantor trust status terminates for any other reason if the loan has not been repaid before that time. The relief of liability would be recognized as income, to be offset by the basis of all assets in the trust (not just the policy). Revenue Rulings 2009-13 addresses sales of policies and provides two important rules. First, the seller must reduce the basis in the policy by the cost of insurance (and we are not sure how to calculate that cost). This could result in a low basis in the trust assets, so a significant gain may be recognized. Second, the Ruling addresses the character of the gain. It says that when a policy is sold, even though it is a capital asset, the proceeds are part ordinary income because of the "substitution of ordinary income doctrine." This is the amount that would have been recognized as ordinary income if the policy had been surrendered rather than sold.

Despite this potential drawback of grantor trust status, almost all of these transactions handled by Larry and Mary Ann use grantor trusts. Just realize that it is important to control the loan and repay it before grantor trust status terminates.

i. Preferred Lender.

(1) Insured. Under a straightforward loan arrangement, there should be no incidents of ownership. However, this gets murky if the insured takes a security interest in the policy to secure the loan. Nothing in the final split dollar regulations requires security to make the loan a bona fide loan. If a security interest is used, it will usually be a collateral security arrangement. The speakers do not want to run the incidents of ownership risk, so they typically do not use a security arrangement. If the client insists, use a restricted collateral assignment, similar to those that have been used in the past where the insured is the major shareholder of the company involved with the split dollar arrangement.

(2) Insured's Spouse. The spouse could be the lender, particularly if a security arrangement is desired. Having the spouse retain a security interest in the policy would not create an incident of ownership risk, as long as the policy is not a second to die policy. If the spouse is the lender, the trust that owns the policy should be structured so that it is treated as owned by that spouse under the grantor trust rules. If a below-market loan were used, §7872 would apply and under that provision deemed interest payments between spouses are ignored. However, for interest-bearing notes, the interest payments are not ignored. See Gibbs v. Comm'r, T.C. Memo 1997-196. There can be unintended income tax consequences if the spouse loans to the insured's grantor trust rather than to the spouse's grantor trust.

j. Where Should Note Pass If Lender Dies Before Repayment? The planner should address where the lender's note will pass if the lender dies before the note is repaid. If the note passes to the insurance trust that is the borrower, the note would be canceled. That might create some concern of whether there is really a reasonable expectation of repayment, thus coming within the provision in the split dollar final regulations treating the loan as a bona fide loan.

19. Private Split Dollar

a. Regulations Prospective Unless Modifications to Preexisting Plans. The final split dollar regulations are prospective, applying to arrangements entered into after the regulations became effective. One huge exception is that the regulations apply to arrangements that are materially modified after the date of the final regulations, which would have a dramatic effect on the tax consequences. The regulations have a nonexclusive list of nonmaterial modifications, but they are generally unhelpful.

Practical Planning Pointer: Do not change the economic terms of a life insurance policy under a pre-existing split dollar arrangement without considering whether it constitutes a material modification.

b. Major Issues. The major issues to consider in any split dollar arrangement are the same basic issues that have been addressed since the early rulings in 1964. (1) What are the income/gift tax consequences of using a private split dollar arrangement to get money into the trust to pay premiums? (2) If the economic deal is that the premium payor just gets back the premiums, what is the effect? Under the old rules (before the final regulations), the split dollar arrangement was not just treated as an interest-free loan, but instead was treated as transferring the economic benefit in the policy each year. It did not matter who owned the policy or what the amount of the premium payments were. Under the new rules, §7872 does not apply (and thus interest will not be imputed) in several circumstances, one of which is if there is a private nonequity arrangement, where the trust is never entitled to any cash value, and the lender is entitled to the greater of a return of advanced premiums or cash surrender value. (Equity split dollar arrangements are not used under the new regulations, because we do not know how to calculate the economic benefit in that situation.)

c. Leveraged Gift Amount. Under a private split dollar arrangement, the gift amount each year is the economic benefit during that year. Therefore, the transfer tax cost of moving dollars to the trust to pay premiums is reduced from the full premium amount to the economic benefit (discussed below, but which does not depend upon the amount of the premium).

If the trust pays the insurance company the amount of the economic benefit in a year, there is no deemed gift to the trust by the insured. The problem is how to get money to the trust so that it can make that contribution. Should the client give that additional amount to the trust or should it be loaned to the trust?

In comparison to private premium financing, it is harder to avoid gift consequences under the economic benefit approach of a private split dollar arrangement. Annual gifts can be avoided entirely using the private premium financing approach.

d. Importance of Exit Strategy. An exit strategy is needed for premium financing arrangements, because the amount to be repaid to the lender increases over time. For split dollar arrangements, the risk is that as the client gets older, the economic benefit amount increases each year, thereby increasing the gift amount each year. The economic benefit deemed gift continues each year until the arrangement is terminated or the premium advancer has been repaid the greater of premiums paid or the cash surrender value of the policy. That is a particular problem for a survivorship policy after the first insured dies. While both are alive, the economic benefit is very low, because it is the value of the policy if both insureds were to die in that one year. After one insured dies, the economic benefit is based just on one insured, and it jumps dramatically. Split dollar arrangements with survivorship policies should be designed to exit before the high economic benefit increase at the first spouse's death.

Sometimes clients will start with one arrangement (i.e., financing or split dollar) and later switch to the other. Appendices to the speakers' outline provide examples of the financial impact of different possibilities.

e. Measuring the Economic Benefit; Table Rates; Availability of Alternative Term Rates. The economic benefit is based on the age of the insured. It is premium insensitive. Notice 2001-10 provides a table amount, which is much lower than the PS 58 rates that were used previously. Notice 2002-8 provided that there would be future announcements about the rates, but the IRS has never issued different rates. The IRS probably just does not want another situation where the amounts would remain static for decades (as they did under the PS 58 table).

While the table rates are lower than the old PS 58 rates, it is possible to use even lower rates. The Notices continue the old rules, since the 1960s, of allowing the use of the insurer's alternative term rates. These are the rates that the carrier who issued the policy in the trust uses to sell term insurance to the public generally. The latest additional limitations on these alternative term rates were added in 2004. Carriers are getting very wary about whether their rates qualify. Exhibit B shows a comparison of John Hancock's alternative term rates. The rates are almost half of those in Table 2001-10.

Practical Planning Pointer: The worst possible situation is using the alternative term rate table provided by carrier, and finding out five years later that the insurance company stopped selling term insurance at those rates. When the company stopped selling standard rated term policies at those rates, the table rates should have been used, and so the reporting would have been incorrect for some period of years. Another practical problem is that agents sometime say they cannot get information from the carrier whether particular term policies satisfy the requirements and what their "alternative term rates" are. Some insurance companies say that is a legal issue and will not give any assurance.

20. Valuation of Life Insurance Policies

a. Section 83 and 402 Purposes. Abuses emerged in having qualified plans or companies distribute policies with "springing" cash values, which imposed large surrender charges in early years that disappear sometime after the transfer. Safe harbor rules were adopted in 2005 providing that the fair market value of the policy for those purposes is the greater of the interpolated terminal reserve value (adjusted for unearned premiums) or the PERC amount — Premiums plus Earnings minus Reasonable Charges. As a practical matter, insurers have trouble finding out what the PERC amounts are.

b. Gift Tax Purposes. The gift tax regulations addressing the value of life insurance policies were written when there were only two types of policies, term and whole life. They do not contemplate all the different types of policies now. Regulations under §2512 provide that the gift tax value is the value of a comparable policy. For a single premium policy, the gift value is the replacement cost. For a new policy, the gift value is the amount of the premium paid. For the more typical policy, on which further premiums are due and which has been in force for some time (an undefined term), replacement cost would be hard to determine, and the regulations provide that its gift tax value can be approximated by the policy's interpolated terminal reserve plus any prepaid premiums. That makes sense with traditional whole life, but it does not translate well with universal life or variable life because there are no guaranteed cash surrender values.

Interpolated terminal reserve values must be obtained from the insurance carrier. A problem in practice is that interpolated terminal reserve values have been increasing dramatically. Carriers are getting much more conservative; state regulators are requiring them to preserve larger amounts, thus increasing the interpolated terminal reserve value.

Practical Planning Pointer: Do not transfer a policy and then ask the company for the interpolated terminal reserve value. Ask in advance. If a large policy is being transferred and the planner is concerned about the gift value, call the advanced underwriting group of the carrier and find out how they calculate the reserve. Carriers are getting more conservative and some take the position that the fair market value of the policy is a legal issue to be determined by legal counsel, not by the company. The company may provide all possible values, and burden the planner to choose among them. The last Form 712 that Larry received had six different values, varying by $1.5 million. At least, it helps to know in advance what number or numbers the carrier will put on the Form 712.

c. Value to Avoid §2035. Section 2035 covers transfers of life insurance policies within three years of death, but there is an exception for sales for full value. For that purpose, it is not clear whether the gift tax value or the amount necessary to replace the value in the insured's estate applies. Allen v. U.S., 293 F.2d 916 (10th Cir. 1961) suggests that the full face amount would be the appropriate value for purpose of the §2035 exception. Technical Advice Memorandum 8806004, dealing with a single life policy owned by the insured, held that the full value was its face amount for purposes of the §2035 exception. Private Letter Ruling 9413045, dealing with a survivorship policy while both insureds were alive, held that the gift value of the policy applied, reasoning that on one of the insured's deaths, the policy would still exist on the remaining insured's life.

Unfortunately, there has been silence ever since from the IRS and no further court cases have addressed the issue. Planners aren't comfortable telling clients that they can sell policies at fair market value and avoid the three-year rule.

Items 21-26 are observations from a seminar by Mil Hatcher and David Pratt, "Effective Planning Without Discounts"

21. Section 2704

Very briefly "applicable restrictions" on the liquidation of a corporation or partnership controlled by the transferor and members of the transferor's family before a transfer are disregarded for purposes of valuing a transferred interest in the entity. There are various limitations on the scope of "applicable restrictions:" (1) only transfers to or for a member of the transferor's family are covered; (2) restrictions on liquidation that require the consent of a person other than the transferor or member of the transferor's family to remove the restriction are not "applicable restrictions;" and (3) the restriction must be more onerous than the state law default provision.

There is little legislative history about §2704(b), which was adopted in 1990. It was a "stealth of night" provision, being added in the Conference Committee after the legislation had already passed both Houses of Congress. The 1990 Conference Report states: These rules do not affect minority discounts or other discounts available under [former] law."

22. Regulations Restricting Discounts

The IRS Priority Business Plan for the last six years has included "Guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership" (first appearing in the 2003-2004 Priority Guidance Plan). This probably relates to the statutory authority to issue regulations regarding the effect of a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." I.R.C. § 2704(b)(4). Cathy Hughes, with the Treasury Department, suggested in the fall of 2008 and in early 2009 that these new regulations might be released soon and that this regulation project is "at the top of the list." At the ABA Tax and Real Property, Trust and Estate Law Sections Joint Meeting in September, 2009, Cathy indicated that these regulations will not be released pending possible action on the "Greenbook" proposal to tighten §2704, discussed below. Some commentators believe that the regulations may be more aggressive than §2704 currently permits, so the IRS is holding back on releasing the regulations until further legislation is passed revising §2704.

23. Proposed Legislation Restricting Discounts

a. Greenbook Proposal. The Treasury on May 11, 2009 released the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. Section 2704 would be revised to add a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Disregarded restrictions would include limitations on a holder's right to liquidate that are more restrictive than a standard to be identified in regulations, and any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in an entity. For purposes of determining if restrictions can be removed, certain interests (to be identified in regulations) held by charities or others who are not family members would be ignored. (Kerr v. Commissioner held that requiring the approval of a small charitable interest before the partnership could liquidate was not an applicable restriction, and could be considered in valuing the limited partnership interests. 202 F.3d 490 (5th Cir. 2002).) Regulations could create "safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met." There would be "conforming clarifications" regarding the interaction of the valuation discount restrictions with transfer tax marital and charitable deductions. (This provision is estimated to raise $19 billion over 10 years.)

The effective date will be date of enactment. The regulations will be issued very quickly in proposed form and there will be a firestorm of comments. There will be final regulations within 18 months, and under §7805(b)(2) such regulations could be retroactive to the date of enactment.

This is a most unusual statutory proposal. The heart of the statute (i.e., to disregard restrictions on liquidation that are more restrictive than standards to be provided in regulations) would be written by regulation. Mil Hatcher gave a terrific pithy summary of all the uncertainties in the proposal: **"Some yet to be defined statutes applied in a yet to**

be defined manner, applying to yet to be defined taxpayers, all subject to a yet to be defined safe harbor."

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 has an excellent general summary of valuation discounts, and addresses the §2704 proposal. It suggests that the regulations allow a broader exception to what is treated as an "applicable restriction" than the statute. The statute says that an "applicable restriction" does not include "any restriction imposed, or required to be imposed by any Federal or State law." However, the regulations define an applicable restriction as a "limitation on the right to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restrictor." The Tax Court viewed the regulation as an "expansion of the exception" in Kerr v. Commissioner, 113 T.C. 449, (1999), aff'd on other grounds, 202 F.3d 490 (5^{th} Cir. 2002). The Joint Committee Staff report speculates that the new standard that would be adopted in regulations "is intended in part to address interpretive concerns that have arisen regarding the present-law exception for restrictions that are imposed or required to be imposed under State or Federal law. The proposal, however, does not provide information from which one could determine what such a regulatory standard might include or whether such a standard might also be intended to address other concerns."

The Joint Committee Report observed various possible objections to the proposal: (1) It does not specify or adequately describe the liquidation restrictions that will be disregarded, and leaves the key aspects to future regulations; (2) the IRS already has broad statutory authority to issue new regulations and further legislation is premature and unnecessary; (3) it only targets marketability discounts arising from liquidation restrictions, and a broader approach would be preferable, because "taxpayers might seek to take advantage of marketability discounts through structures that did not depend on liquidation restrictions;" and (4) it does not directly address minority discounts and other proposals (e.g., the 2005 Joint Committee Staff proposal and H.R. 436) address "excessive minority discounts more directly through aggregation of certain interests."

The President's Fiscal Year 2011 Budget Proposal contains the same proposal.

b. Proposal in H.R. 436. H.R. 436 was filed by Representative Pomeroy (D-ND) on January 9, 2009 and has been referred to the House Ways and Means Committee. It adopts a permanent \$3.5 million estate tax exemption, a 45% rate (with a 5% surcharge for taxable estates between \$10 million and \$41.5 million), and imposes restrictions on valuation discounts for interests in entities that are not "actively traded." The changes would apply to transfers after December 31, 2009.

H.R. 436 has three major provisions restricting valuation discounts. (1) Nonbusiness assets (not used in the active conduct of a trade or business) in any entity that is not actively traded would be valued at a pro rata portion of the full value of those assets, with an exception for real estate in which the transferor "materially participates" and for reasonably required working capital needs. (2) Look-thru rules would ignore "tiered discounts" for nonbusiness assets consisting of a 10-percent (presumably or greater) interest in another entity. (3) Look thru rules would disallow any minority discount for transfers of interests in a family controlled entity (using the very broad attribution rules of §2032A(e)(2), which counts interests held by an [1] ancestor, [2] spouse, [3] lineal descendants of the individual, of the individual's spouse, or of a parent of the individual, and [4] the spouse of any individual described in [3] immediately above). Marketability discounts for the business portion of family entities would still be allowed (except for the portion represented by nonbusiness assets, as discussed above).

c. Joint Committee on Taxation 2005 Suggestion. In January 2005, the Joint Committee on Taxation's report on "Options to Improve Tax Compliance" suggested a proposal that would remove lack of control discounts by applying a transferor aggregation rule (valuing the interest as a pro rata portion of what the transferor owned before a transfer) and a transferee aggregation rule (valuing the transferred interest as a pro rata portion of the transferred interest plus what the transferee owned before the transfer). For example, if a person owned an 80% interest in a family entity and gave a 40% interest, the value would be 40/80 or one-half of the value of the 80% interest (under the transferor aggregation rule). If the person later gave or bequeathed his or her remaining 40% interest to the same donee, that interest would be valued at one-half of the 80% interest owned by the transferee after the transfer (under the transferee aggregation rule). In addition, the proposal included a look-thru rule to value "marketable assets" that comprised at least 1/3 of an entity's assets without a discount. The look-thru rule would eliminate both a marketability and minority discount for transfers with respect to "marketable assets" inside family entities.

d. Clinton Administration Proposals. Proposals to eliminate "family discounts" have been around for years. The Clinton administration made proposals to disallow valuation discounts for "non-business assets" (other than reasonable working capital) in 1999, 2000, and 2001.

e. Proposals Are All Aimed at Entities. Observe that all of the proposals discussed above are aimed at discounts for entities: corporations, partnerships or LLCs.

24. Impacts of Loss of Discounts on Current Planning Techniques

a. GRATs. If discounted assets are transferred to a GRAT, the annuity payment amounts necessary to "zero out" the GRAT are lower than if the assets were not discounted. However, if the annuity payments are satisfied with in-kind distributions of those same discounted assets, the discounting provides little advantage. The best planning scenario is a structure that allows discounting assets contributed to the GRAT, but not discounting asset distributed from the GRAT (i.e., if the annuity payments can be paid in cash). However, that is not always workable, especially for short term GRATs. For a longer term GRAT, that has substantially lower annuity payments, is easier to satisfy the annuity payments with cash flow.

Summary: Discounts just act as a supercharge to the GRAT in the event that annuity payments can be made in cash flow. Even without the discount arbitrage advantage, substantial freezing advantages are available to the extent that the return on assets in the GRAT exceeds the §7520 rate.

b. Installment Sales to Grantor Trusts. Because of the longer-term payouts for installment sales, it is easier to satisfy payments with cash flow, thus achieving the arbitrage advantage. The cost of losing discounts would be much more of a disadvantage for sales to grantor trusts than for GRATs.

25. Planning Without Discounts

a. GRATs and Sales to Grantor Trusts. As discussed above, these structures will continue to be effective even without discounts. (However, sales to grantor trusts and long-term GRATs will not be as advantageous as they are with discounts.)

b. Intra-family Loans. Intra-family loans at the AFR may become more important without discounts. This is a very simple but effective freeze technique because it limits the lender's upside to the AFR. A notable benefit in comparison to FLP planning is that the transaction costs are considerably lower.

c. Fractional Interest Discounts. There will be a lot of "play" with fractional discounts. The various legislative proposals address discounts with respect to entities, but not undivided fractional interest discounts for co-tenancies in real estate. An abundance of case law supports fractional interest discounts for undivided interests in real estate.

   The real estate does not have to be divided 50-50. A 99-1 division in theory should provide discounts as well (but may not pass the "smell test").

   There could be a co-ownership agreement to provide appropriate management for undivided interests. It might even be possible to obtain a greater discount based upon restrictive terms in the co-ownership agreement, but the IRS might attempt to apply §2703 in that event.

d. QTIPs for Married Clients. The Bonner and Mellinger cases held that interests that are included in the gross estate under §2044 and under other Code sections would not be aggregated for valuation purposes. For example, a husband might give a one-half interest in Blackacre to his wife during his lifetime, and leave the remaining one-half in a QTIP trust at his death. At the wife's subsequent death, discounts should be available for both undivided interests.

e. Single Persons. A single client can take advantage of undivided interest discounts by giving gifts during lifetime. The various gifts as well as the interest remaining at death could be discounted.

f. QPRTs. Contributing an undivided interest, rather than the full interest, in the residence into a QPRT takes advantage of a fractional interest discount to reduce the value of the gift when the QPRT is created.

g. QPRTs Split Interest Purchase. A QPRT is structured so that the grantor retains an interest for life and sells the remainder for full and adequate consideration. For example, assume that spouses own Blackacre which is severed to create a tenancy in common with a 30% discount. Each spouse might contribute his or her one half interest to a lifetime QPRT. Each sells the remainder interest in his or her QPRT to a grantor trust for a 9- year balloon note. The grantor trust will be left with the full appreciated value of the real property at their deaths.

h. Gifts/Sales With Real Estate. The client might sell a one half interest in real estate to each of several different grantor trusts for different beneficiaries. Because of the discount, with a sale it is more likely that rent payments could service the note.

i. Undivided Interest Discounts for Tangible Assets? Stone v. U.S., 103 AFTR.2d 2009-1379 (9th Cir. 2009) permitted a discount for an undivided interest in art equal to the potential costs of partitioning the artwork. Although some discount was appropriate, the court held that the estate had not provided sufficient evidence to support anything above a 5%

discount that the government conceded. It will be interesting to see whether future case law, particularly outside the 9th Circuit, will permit fractional interest discounts in tangible personal property, particularly where a better-supported appraisal is offered.

26. Preferred Partnership; Leveraged Preferred Interest

a. General Description. The client forms and funds an LLC and takes back regular preferred interests. There are no objective guidelines for determining appropriate preference returns, but a preference return of 8 to 9% is conservative. (Financial institutions often have to pay a 10% rate and also have to pay warrants.) (Alternatively, if children have assets to contribute to the LLC, the children could receive a preferred interest for their contribution, and the client could receive the common interest. Typically the children do not have sufficient assets for the contribution, so the client receives the preferred interest and sells it to grantor trusts for the children.) After the client sells the preferred interest to the grantor trusts, the client retains a note at the AFR, and the trusts own the preferred interest with a preference return that is substantially above the AFR. That arbitrage factor can generate tremendous returns for the trusts relatively conservatively.

b. Example. Mil Hatcher indicates that the following example is based on an actual case in which the client wanted to shift value to his children to support their lifestyle. Knowing how much the client wishes to shift determines how much is contributed to the LLC.

The client contributes $15 million to LLC and receives:

- $7.5 million in regular preferred interest with 8.5% (or $637,500) annual net cash flow preference and $7.5 million liquidation preference
- $150,000 in non-stapled class A common interests
- $7,350,000 in non-stapled class B common interests

Client then sells the $7.5 million of regular preferred interests to a grantor trust in return for a $7.5 million note, representing the undiscounted value of the regular preferred interests.

- If a 25-year term note at 4.4% long-term AFR is used: potential annual net cash flow of at least $307,500 ($637,500 preference minus $330,000 interest payment) will be generated.
- If a 9-year term note at 2.82% midterm AFR is used: potential annual net cash flow of at least $426,000 ($637,500 preference minus $211,500 interest) will be generated for the first nine years.

This may be accomplished without any transfer tax cost if guarantees are used for seeding of the grantor trusts. Even if the grantor trusts are seeded with 10% gifts, the gift tax would be relatively low compared to the potential amount that will be transferred.

c. Potential Uses of Excess Generated Cash Flow to Grantor Trusts.

(1) Lifestyle Support. Because a grantor trust is used, the trust will not have to bear income taxes, so there can be tax-free cash flow to the children.

(2) Purchase of Life Insurance. The excess cash flow could buy huge life insurance coverage without the complexity of premium financing or split dollar arrangements. The strategy provides the most cash flow for the least transfer tax. Mil has not found a better way to transfer funds to pay life insurance premiums.

(3) Pay Down Debt on Purchase of Preferred Interest. The trust could use the excess cash flow to pay down the debt on the purchased preferred interest. For example, over nine years the trust may be able to pay the note entirely. Have a discussion with the child that if the child will work nine years, taking no distributions, there can be very substantial cash flow generated for the child's lifestyle after the 9-year note is paid and there is no further need to service interest or principal payments.

(4) Long-Term Investment Vehicle; "Pacman" Gobbling of More Discounted Interests. Use the cash flow (which is not discounted) to buy other discounted interests.

d. Amount of Leverage. Mil structures the entity so that the preferred interest represents 50% of the entity value. Some advisors would recommend that the preferred interest not exceed one-third. As the percentage interest represented by the preferred interest gets larger there is a greater possibility that the entity will not be able to satisfy the preference distributions as well as maintain sufficient value to support the liquidation value of the preferred interest. (Mil quips: "Being a history major, I can divide by two a lot easier than I can divide by three.")

e. Structuring to Utilize Higher Preference Returns With a Balloon Preferred. If no payments are made on the preferred interest for 10, 15, or 17 years, and then there is a lump-sum payment, the preference return will have to be significantly higher to support that the preferred return is equal in value to its liquidation value. "This will not be a hot selling item. This is right up there with 'toxic assets.'" The preference return required on the long-term preferred balloon interest might be approximately 12%.

Section 2701 generally requires annual payments in order to avoid applying the subtraction method of §2701. However, if there is a mandatory payment of a specific amount any specific time, that interest is excepted from §2701. The difference between a 12% preference return and the AFR on the note given by the grantor trust in purchase of the interest is a huge arbitrage spread.

If a balloon preferred interest is sold to a grantor trust, Mil also "staples" a small common interest to the preferred interest to reduce an income tax risk.

Observation: With such a large preference return over a long term there would seem to be a significant risk that the entity would not be able to produce sufficient value to fully satisfy the preference return at the end of the specified term.

Items 27 includes observations from a symposium by Duncan Osborne and Henry Christensen, "FATF and the Good Practices Guidance"

27. 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 member 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. (The Treasury Department has responsibility for implementing the recommendations in the U.S.)

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 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. There have been three guidance documents: Guidance published by ACTEC in 2005 (which was prescient in using a risk-based approach); the FATF Guidance mentioned above that was issued in 2008, and a report finalized in November 2009 entitled "Voluntary Good Practices Guidance for Transactional Lawyers to Detect and Combat Money Laundering and Terrorist Financing" prepared by ABA organizations, ACTEC, and various other professional colleges and groups. The "ABA Guidance" 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. If the attorney "touched the money," there is a much higher standard that is applied.

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.

The ABA Guidance takes the position that some level of due diligence is ALWAYS required. (That annoys Duncan. For example, why should the attorney have any due diligence responsibility at all for the "little old lady" church member who the attorney has known for 50 years?)

g. Legislative Proposals; Uniform Act. 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.

Another bill would be 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.

The Treasury asked the Uniform Law Commissioners to draft a Uniform Act that would address who owns and control entities. The Act was approved by the Commissioners in July 2009 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. However, some individuals from the Financial Crimes Network thought it is not strong enough and the Uniform Act project has been put on hold until the bureaucrats in Washington can be satisfied.

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. The risk-based 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.

It is very important that attorneys not be subject to federal regulation. At this point, cooperating with the Treasury to educate attorneys (and ourselves) about these guidelines is important.

From our personal standpoints, it is certainly important for us to be aware of what is going on in the money-laundering arena. If one of us were to represent a money-launderer, we would be highly embarrassed.

Items 28-33 are observations from a symposium by Henry Gissel, Elaine Bucher, and Shirley Kovar, "Marital Planning: A New Look in a New Environment" (Including Discussions of Portability, Tax and Expense Apportionment, Carryover Basis, Roth Conversions, Estate Planning for Divorced Spouses, and Marital Agreements)

28. Portability

a. General Principles. Portability refers to the statutory transfer of a deceased spouse's unused "exemptions" to a surviving spouse. Legislative proposals (including S. 722 [introduced by Senators Baucus, Schumer and Rockefeller] and S. 2784) have included portability of the gift and estate tax "exemptions," but not the GST exemption.

(1) Favors Only Surviving Spouse ("I don't know the key to success, but the key to failure is to try to please everybody" – Bill Cosby). The unused exemption can be used only by the decedent's surviving spouse, not his or her children or other estate beneficiaries.

(2) Multiple Exemptions ("The More the Merrier"). A spouse may apply unused exemptions from multiple spouses — subject to a cap equal to the surviving spouse's exemption when he or she dies.

(3) Privity ("Two's Company, Three's a Crowd"). A surviving spouse can only use the unused exemption of his or her deceased spouse, not exemptions the deceased spouse received from his or her predeceased spouse (or spouses).

(4) Election on Deceased Spouse's Estate Tax Return ("If It Looks Too Good to be True, It Probably Is"). A timely estate tax return must be filed for the deceased spouse's estate, making an appropriate election, in order for the surviving spouse to be able to use the decedent's unused exemption. The return would be subject to audit notwithstanding any statute of limitations, solely for the purpose of determining the correct amount of the unused exemption. (Following Shirley Kovar's presentation to the Senate Finance Committee in April 2008, a group of ACTEC participants urged the staff not to require an election because it would be a trap for the unwary. So far, that advice has not been followed.)

(5) Portability of Estate and Gift Exemptions, Not GST Exemption ("Don't Look a Gift Horse in the Mouth"). Portability will likely apply only for the estate and gift exemptions, not the GST exemption. Not having portability of the GST exemption will complicate planning.

b. Consider Client Objectives. Relevant objectives would include four possible priorities: (1) simplicity (which would favor outright transfers without trusts); (2) financial benefits (lower-cost Wills without bypass trust planning); (3) control (desire of the deceased spouse to control the disposition of his or her estate); and (4) interest in generation-skipping planning (which would suggest using a bypass trust and/or an "exempt" QTIP trust at the first spouse's death in order to take advantage of the deceased spouse's GST exemption).

c. Example. Assume husband dies in 2010 and estate tax does apply, with unused estate tax exemption of $3.5 million, portability applies, and husband's Will does not create a bypass trust for wife. Assume wife dies in 2020 with an estate of $8.5 million at a time when the estate tax exemption is $5 million. Wife's estate tax exemption is $5 million (her own) + $3.5 million (from her husband), which is sufficient to shelter all of her estate from estate taxes. In this example, the couple has the advantages of simplicity and avoiding estate tax, but the trade-off is that husband's GST exemption is lost.

Alter that example by assuming that husband dies in 2010 when the estate tax does not apply, leaving all of his estate outright to wife. Wife has only the benefit of her $5 million exemption at her death, which does not fully shelter her estate from estate taxes. In this situation, having a bypass trust in husband's estate would be helpful.

The outline includes a number of examples covering a variety of situations.

d. Concerns With Portability. Portability may exacerbate underlying conflicts between spouses and conflict issues for joint engagements. Portability may increase malpractice exposure, because damages may not be known for a very long time which may turn on whether the planner has fully explained the ramifications of relying on portability and on whether an estate tax return is filed at the first spouse's death for what may be a modest estate. Portability may put financial pressure on estate planning attorneys' practices. Henry Gissel observed: "At my firm, clients never came into the office wanting a complicated will — but unfortunately, that's what most of them got."

e. Planning Suggestions In Light of Concerns. (1) Inform clients of portability. Consider having a general mail-out about portability. Most important: keep copies of all of the communications in case there is a later malpractice claim. (2) Include a simple trust in which assets could be disclaimed and that would be QTIPable. That demonstrates that bypass trust planning was considered.

f. Post-Mortem Decision Points. (1) Consider whether to probate the will or use a family settlement agreement. (2) Consider options under the will. (3) Consider whether to disclaim. (4) Consider whether to file an estate tax return, making the portability election. (5) Consider whether to make a QTIP election, if applicable. (6) Prepare memoranda to document all of the above.

29. Tax and Expense Apportionment

Appendix I of Henry Gissel's outline includes a helpful checklist for tax apportionment problems. One example of a problem situation is if the decedent leaves a discounted asset to one set of beneficiaries and the residuary estate to another. Even if taxes on the discounted asset are charged against that bequest, the administration expenses may come out of the residue, potentially costing hundreds of thousands of dollars.

30. Carryover Basis

a. Carryover Basis Report. The carryover basis report under §6018 is required for an estate with over $1.3 million of non-cash assets (not $1.3 million of appreciation but $1.3 million of value). That will catch a lot of estates. One speaker asked the head of the IRS estate and gift tax agents in a particular city when the form might be available. The agent responded: "What form?" IRS agents are as confused as we are.

b. Executor Allocation of Basis Adjustments. Under local law, can the executor make the basis adjustment allocation to property that is not in the probate estate? For example, is the executor authorized to allocate the adjustment to the surviving spouse's one half of community property, which is not in the probate estate? In addition, how will the executor deal with conflicts if he or she is also a beneficiary? The will should address those issues regarding the executor's allocation authority.

31. Roth Conversions

a. Factors Regarding Whether to Convert. Factors impacting the decision of whether to make a Roth IRA conversion include: (1) whether there are assets outside the IRA to pay income taxes; (2) whether there are outside assets to provide lifetime support expenses; (3) the desire to avoid estate taxes on income tax that would be embedded in a regular IRA, because payment of the income tax would remove those dollars from the gross estate; (4) the desire to benefit individuals other than charities; (5) whether younger generation beneficiaries will likely utilize the stretch payout in a Roth IRA for their lifetimes (this is a real worry; when the child is faced with selling an asset to buy a car or taking money tax-free out of an IRA, many will use the IRA); (6) interest in asset protection (unprotected assets are used to pay the income taxes on conversion, leaving a protected fund that is free of income taxes and therefore worth more); (7) willingness to pay current income taxes to avoid taxes in the future; (8) whether beneficiaries will be in the top income tax brackets; (9) whether the Roth IRA assets will increase over time; (10) whether the top income tax rates are likely to rise; (11) age and health of the owner (the longer the period of tax-free growth, the more valuable the conversion will be; conversely, the conversion may make sense for very old clients, for whom minimum distributions are very large requiring large income tax payments in the near future in any event); (12) whether the Roth conversion may be available for all taxpayers only in 2010 with the possible reinstitution of the maximum compensation limit; and (13) whether the owner or beneficiaries live in a state with high state income taxes.

b. Deathbed Opportunities. Deathbed Roth conversions may make sense, because the gross estate is reduced by the amount of income taxes payable at death, and there is no "gross up" of the income taxes paid on the conversion. The income exclusion will not apply to distributions made within the first five years following conversion, but that may be a minimal impact if the beneficiary is a grandchild for whom the distributions in the first five years may be negligible and for whom tax-free compounding may be available over many years.

c. Deferral Decision. For conversions in 2010, the individual generally recognizes one-half of the conversion income in each of 2011 and 2012, respectively, but may elect to recognize all of the income in 2010. (The election to be taxed all in 2010 might make sense if Congress significantly raises income tax rates beginning in 2011.)

32. Representing Divorced Spouses

a. Obtain Copy of Divorce Decree and Property Settlement Agreement. Elaine Bucher had a case where a divorce attorney was her client, and the divorce attorney-client was wrong as to the provisions in her own divorce decree. It is imperative to obtain a copy of the divorce decree or marital property agreement and review it closely.

An example of the dangers of consequences of ignoring prior martial agreements is a recent New York case, Leff v. Fulbright & Jaworski, LLP, 2009 NY Slip Op. 31445(U) (Sup. Ct. New York County June 30, 2009). A decedent's third wife brought suit against the attorneys who drafted her husband's Will, arguing that she had received less than her intended share of probate assets due to their failure to take into account the decedent's testamentary obligations under his separation agreement with his first wife.

The separation agreement, drafted in 1974, provided that the decedent's Will would set aside no less than half of his probate estate for his son from his first marriage. The decedent married for the third time in 1998, and in 2001 he presented to his wife (as an anniversary present) a copy of a Will in which he bequeathed to her half of his adjusted gross estate. This 2001 Will made no reference to the obligation decedent owed to his son under the 1974 settlement agreement.

The decedent died in 2002, leaving an estate of approximately $90 million. Shortly thereafter, the client's son made a claim pursuant to the separation agreement for half of the probate estate. Only upon receipt of the claim did the drafting attorneys become aware of the existence of the separation agreement, even though a copy of the agreement was found in their files, and despite the fact that the firm that drafted the separation agreement had long before merged into the firm that drafted the 2001 Will.

The Estate settled with the son and ultimately paid him approximately $20 million. The third wife received a total inheritance of approximately $62 million. Nevertheless, she brought suit against the drafting attorneys for an additional $9 million she claimed she would have received had the attorneys informed the decedent of the terms of the separation agreement, so that he could have employed other estate planning devices (such as inter vivos gifts) to pass additional assets to her despite his obligation to his son.

Luckily for the drafting attorneys, the Court concluded that the third wife did not have standing to pursue a malpractice claim for two reasons: (1) she was not in privity with the drafting attorneys (since the attorneys had only entered into an attorney-client relationship with the decedent, and not with the decedent's wife) and (2) she did not present any evidence that the decedent would have set aside additional money for her "but for" the attorneys' failure to inform the decedent of the separation agreement.

b. <u>General Issues in Representing Divorced Spouses</u>. General issues to consider in representing divorced spouses include obligations under the prior divorce decree, elective share considerations, dealing with blended families, dealing with significant wealth disparity between the spouses, and dealing with significant age disparity between spouses (children of the first marriage will not want to wait to receive assets until the surviving spouse's death).

c. <u>Age Disparity; Yeager Case</u>. The Howard Marshall case is an example of issues that can arise where there is significant age disparity between spouses (Marshall was 89 and Anna Nicole Smith was 26). Another example of problems that arise in cases of extreme age disparity is the family of the famed test pilot, Chuck Yeager. (The case is discussed in Richard Barnes, <u>Till Death Do Us Part (Again): Estate Planning for Second Marriages</u>, 21 PROB. & PROP. 34 (2007).) Mr. Yeager's daughter handled his finances after his wife died — until he remarried (he was 80 and his new wife, D'Angelo, was 44). Chuck said he wanted to regain control of his assets. He revoked his daughter's power of attorney and changed his will to leave his estate to D'Angelo. Yeager's relationship with his children, in his own words, had gone "to hell." Various lawsuits erupted between Yeager, his children, and D'Angelo. The court ultimately ordered his daughter to repay his trust the amount of sale proceeds she had hidden from Yeager.

d. <u>General Planning Steps For Divorced Client</u>.

(1) <u>Joint Representation</u>. Be closely aware of who the attorney is representing. The Model Rules provide that there can be no joint representation if the goals of one client would be adverse to the other or if the representation of one client would be materially limited by the responsibilities to the other. Practical Planning Pointer:

The more lopsided the situation in terms of wealth and age, the more important it is to represent just one party.

(2) Engagement Letter. Make sure the engagement letter sets forth very clearly who is being represented. Doing so not only clarifies the duties of loyalty, but it also may help with a possible privity defense against a malpractice claim by the other spouse.

(3) Obtain Prior Divorce Documents.

(4) Beneficiary Designations and Titling of Assets. Make sure that assets are titled in the proper way, especially if there is a pre-or post-nuptial agreement. For example, the agreement may require titling the home jointly with the spouse. Under Treasury regulations, in order to leave qualified retirement plan benefits to someone other than the spouse, the spouse's waiver must be obtained after the marriage.

(5) Tangible Personal Property. The children may have different recollections of which spouse owned the property prior to their marriage. This is especially important if the client leaves a residence in a life estate to the spouse but tangibles are not addressed. Children of the first marriage may want to take all of the household furnishings. It is more important to address specific tangible personal property items in split family situations. As an example, household furnishings might remain with the surviving spouse if the surviving spouse is bequeathed the house, whereas family jewelry might not.

(6) Listing Each Spouse's Assets. Encourage clients to make a detailed list of who brought what assets to the marriage.

e. Elective Share Planning.

(1) Get Waiver. In order to avoid a claim for an elective share, it is best to get a waiver from a spouse in a written agreement.

(2) Will Planning to Frustrate Elective Share Claims. If it is not possible to get a written agreement, and if the client wishes to minimize elective share claims, leave less desirable assets to the spouse in satisfaction of the elective share if the spouse makes such election. However, discounts might have to be taken into account in funding the elective share. In a recent case in Florida, Zoldan v. Zohlman, 11 So. 3d 982 (Fla. 3rd DCA 2009), husband had the obligation under a prior agreement to treat his stepdaughter equally with children of his prior marriage. He did not do so. The court awarded the stepdaughter monetary damages equal to 25% of the estate. The question was whether they should be satisfied on the basis of assets valued with or without discounts. The court concluded that the funding should reflect discounts.

(3) Gifts. Make gifts to remove assets from the elective estate. However, in some states (such as New York and Florida), gifts made within one year of death are brought back into the elective estate.

(4) Insurance. The augmented estate subject to the elective share may or may not contain the proceeds of life insurance policies held on the decedent's life. In Florida, insurance proceeds are included only to the extent of the decedent's beneficial interest in the net cash surrender value immediately before death.

(5) Transfers to Trusts. States differ as to how the bequests in trust can be used to satisfy the elective share. Some varying examples are described below. In New York, the elective share can be satisfied only with assets passing outright to the spouse. In some states, such as Tennessee, only the value of the income right in a trust is treated as passing to the spouse. In Florida, a certain percentage of the trust qualifies, depending upon a variety of factors. If the trust allows the spouse or trustee to invade principal for the health, support, and maintenance of the spouse, 80% of the property in the trust is counted toward satisfaction of the elective share. In South Carolina, all property passing in trust counts toward the elective share even if the spouse only has an income interest.

f. Using Less Wealthy Spouse's Exemption.

(1) Inter Vivos QTIP Trust. The wealthy spouse could transfer assets to a QTIP trust, making the QTIP election under §2523(f)(4). The election must be made on a timely filed gift tax return. The wealthy spouse may retain an interest after the other spouse dies, and her exemption will be applied to assets in the trust. An advantage of this arrangement is that the wealthy spouse retains control of how the assets will pass. A disadvantage is that the trust is irrevocable, and in the event of divorce, the trust remains. However, the trust could provide that in the event of divorce, the donee spouse would have only an income interest and no discretionary rights to principal distributions.

(2) Joint Revocable Trust. Two private letter rulings (PLRs 200101020 and 200210051) approved using a joint revocable trust in order to be able to use the estate tax exemption of the first spouse to die, because each spouse has the unilateral right to revoke the trust so the first spouse to die has a general power of appointment. The disadvantage is that the deceased spouse has a general power of appointment, and the wealthy spouse may be uncomfortable granting that power. In addition, despite the favorable rulings, there is a significant question as to whether the gift tax marital deduction applies to the deemed transfer at the first spouse's death.

(3) Spousal Power of Appointment Trust. A similar arrangement involves the creation of a trust by the wealthier spouse to take advantage of the poorer spouse's exemption amount. If the poorer spouse predeceases the wealthier spouse, the poorer spouse is granted a testamentary general power of appointment in the amount necessary to utilize whatever remaining estate tax exemption amount is available at his or her death. PLRs 200403094 and 200604028 have approved this approach. However, the same question remains regarding whether a gift tax marital deduction is available for assets passing at the spouse's death. To avoid that uncertainty, Jeffrey Pennell, Stephen Davis and Len Casen have suggested (see LISI Newsletter #1292) granting the poorer spouse a lifetime general power of appointment, exercisable upon written notice by the poorer spouse, delivered to the trustees. The poorer spouse can then either (1) immediately exercise the power by written notice, effective immediately upon the poorer spouse's death (and then, only if the settlor is still alive) or (2) immediately release the power of appointment in accordance with §2010(a)(2) of the Code. In either case, the trust assets would be includable in the gross estate of the poorer spouse if he or she predeceased the

settlor, without calling into question whether the gift tax marital deduction arises technically the moment before death.

g. Unitrust. Creating a trust with unitrust distribution provisions for the spouse can be very helpful for second marriages. The unitrust provisions minimize the conflict between the surviving spouse and the decedent's children by prior marriage.

33. Marital Agreements

Henry Gissel's outline has a 14-page detailed list of issues to consider in planning marital agreements. This contains many distilled ideas that Henry has developed in working over the years with the family law section of his prior law firm. For example, one idea is that if the prospective spouse is more than 37 1/2 years younger than the client there may be GST concerns with expensive gifts. The premarital agreement may make the gifts contingent upon a subsequent marriage.

Henry quips: "Some of the most interesting clients are those who engage in serial polygamy."

Items 34-39 are observations from a seminar by Ed Beckwith, Turney Berry, and Michele McKinnon, "Selecting the Best Charitable Donees: Public Charity, Donor Advised Fund, or Private Foundation"

34. Overview of Types of Charities

"When you read, you begin with ABC. When you sing, you begin with "Do Re Me." When you do charitable planning, you begin with 501(c)(3)." – Turney Berry. Section 501(c)(3) organizations are tax-exempt entities. There are two basic types, public charities and private foundations. A charitable organization is presumed to be a private foundation unless it can establish that it meets the requirements of one of the categories of public charities. §509(a).

35. Public Charities Overview

a. Classification. There are several ways to meet the test to be a public charity, rather than presumptively being a private foundation.

- Inherently public charities. These are "we know it when we see it" charities such as churches, educational institutions, hospitals, etc.
- Broad based public support, §509(a)(1). There are two alternative tests: a 33 1/3% public support test or a more subjective facts and circumstances test. There are intricate rules for determining the fraction. If an entity is a startup organization with a few large donors, it would not be able to meet the 33 1/3% support test but it may meet the subjective facts and circumstances test if it has at least 10% public support but is making good-faith efforts to attract broad public support. Reg. §1.170A-9(e)(3).
- Other publicly supported charities, §509(a)(2). For this type of entity, over one-third of the organization's total support must be received from grants from nondisqualified persons, admission fees, fees for the performance of exempt function services, or sales of goods related to the organization's activities. Investment income cannot exceed one third of the organization's total support. An organization that receives the majority of its support from activities related to its exempt functions (such as a museum charging admission fees) rather than from contributions from the general public will generally try to qualify under §509(a)(2).
- Supporting organizations, §509(a)(3). The organization must meet three tests (the organizational, operational, and relationship tests): (a) it must be operated to carry out

the purposes of one of more public charities; (b) it must be operated, supervised, or controlled by or in connection with one or more public charities; and (c) it must not be controlled directly or indirectly by one or more disqualified persons. The relationship test requires one of three types of relationships: (i) operated, supervised or controlled by test (Type I); (ii) supervised or controlled in connection with test (Type II); or (iii) operated in connection with test [which is the least restrictive of the three types] (Type III).

b. Advantages. There are fewer operational rules and the income tax deductions are potentially more generous. The income tax deduction rules and limits are generally not addressed in this summary.

c. Intermediate Sanctions Rules. Historically, there have been no restrictions in the income tax code on the operation of public charities. Now, however, there are intermediate sanction rules on "excess benefit transactions" under §4958. For example, before §4958, if the person running a public charity paid herself huge unreasonable compensation, the only recourse of the IRS was to "yank the exemption." That punished the entity when the wrongdoer was the one in control. Under the intermediate sanction rules, it is now possible to punish the wrongdoers in an amount equal to the excess benefit received.

d. Donor Advised Funds. A donor advised fund is not a separate charitable entity, but is a program or fund offered by a public charity to facilitate gifts by individual donors. The 2006 Pension Protection Act provided a specific statutory definition of a donor advised fund for the first time, and provides significant operational limitations.

The definition was created because "advice" is necessarily amorphous. Anyone can give advice on any issue. The definition of donor advised funds is limited to situations where there is a reasonable expectation that the donor will have advisory privileges. If funds can be paid only to one institution, that is not a donor advised fund. If the sponsor rather than the donor is in control of who is designated on the advisory committee, that is also not a donor advised fund.

Various operational restrictions apply to donor advised funds that do not apply to other public charities:

(1) "Taxable distributions" (generally distributions to individuals or any other person for other than an exempt purpose, or if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility);

(2) Prohibited benefit (the donor receives directly or indirectly more than an "incidental benefit;" 125% excise tax to the entity and 10% excise tax on fund manager who knowingly confers an excess benefit);

(3) Excess benefit transactions (any grant, loan, compensation or other similar payment, such as an expense reimbursement, distributed to a donor, donor advisor, or a person related to a donor or donor advisor; the wrongdoer must give back not only the excess benefit but 100% of the amount received; the only exception is for sales or leases at arm's length); and

(4) Excess business holdings (excess business holdings rules of §4943 apply; this removes one of the principal benefits of donor advised funds).

36. Private Foundations Overview

a. Section 501(c)(3) Rules. Private foundations are §501(c)(3) organizations. They are subject to the same private inurement and prohibition on private benefits that apply to charities generally. They are also subject to special rules for private foundations.

b. Entity Tax. Private foundations are exempt from the federal income tax but pay a 2% tax on net investment income. The 2% tax may be reduced to 1% for certain years in which the foundation's payout rate is increased from prior years.

c. Impact of Pension Protection Act of 2006. The 2006 Act does not impact private foundations very much, other than to double the various excise taxes (discussed below).

d. Self-Dealing Rules, §4941.

(1) General Description. A tax is imposed on a disqualified person who engages in a direct or indirect act of self-dealing. The amount of the consideration received is irrelevant. The key is who constitutes a disqualified person. This includes ancestors of the donor (but not collateral relatives), directors, officers, or trustees, as well as entities owned more than 35% by any of those persons.

The definition of self-dealing in the statute is very broad. The regulations describe what does *not* constitute an indirect act of self-dealing, and the implication is that other suspect transactions are self-dealing. Prohibited self-dealing transactions between a foundation and a disqualified person include (a) the sale or exchange or leasing of property, (b) loans, (c) furnishing goods, services, or facilities from the foundation to a disqualified person, (d) paying compensation or reimbursement of expenses to a disqualified person, and (e) any transfer to or for the use of a disqualified person of the private foundation's income or assets.

(2) General Exceptions. There are a few exceptions from this list of prohibited self-dealing transactions, which include: (1) the foundation can receive an interest-free loan from a disqualified person; (2) the foundation can receive a lease from a disqualified person if it is without charge; and (3) reasonable compensation for personal services necessary to carry out the exempt purposes can be paid to a disqualified person.

(3) Estate Administration Exception. An estate administration exception recognized in regulations permits (i) a sale by an executor (ii) that is approved by the probate court (iii) before the estate is terminated (iv) for which the estate receives consideration that exceeds the fair market value of the asset (v) and that is at least as liquid as the asset transferred (vi) if the transaction results in the foundation receiving an asset related to its exempt purpose or is required under the terms of a binding option on the estate, Reg. §53.4941(d)-1(b)(3). This exception is very helpful if the transfer is made to a private foundation of an asset that the family wants to get back. This often happens where the residuary estate passes to a private foundation. A very critical requirement is that the transaction must occur while the asset is still in the estate and before it is passed to the private foundation. The IRS has interpreted this exception broadly under many rulings. The purchaser can give a note in payment of the asset in most situations, as long as the note is more liquid than the asset being purchased. For example, in one ruling involving a charitable lead trust, the ruling specifically pointed out that the asset was purchased for a note, and reasoned that the note was secured by real estate and

secured by the family so it was more liquid than the real estate itself, because the note had more security than just the real estate.

(4) Corporate Redemption Exception. There is also a corporate redemption exception, allowing the corporation to redeem a disqualified person's stock if all securities of the same class as that held by the foundation are subject to the same terms and those terms provide that the foundation shall receive no less than fair market value for its stock. The exception is satisfied if only the foundation accepts the redemption offer, but there is always a concern that another minority owner will want to exercise the redemption option as well, so the corporation must have the ability to redeem others also. A note cannot be used to purchase the stock under the redemption exception. A concern with this exception is that if the value paid is even slightly less than the full fair market value, the exception does not apply, and there is no way to get an advance ruling on the valuation issue.

(5) Notes Owned by Donor. None of the exceptions cover a transfer of a note owned by a disqualified person.

Practical Planning Pointer: There is no exception for transferring a note from a family member to a private foundation, or for making payments on the note to the private foundation. That must be taken into consideration in planning for philanthropic clients who have significant family notes in their estates.

(6) Penalty. The penalty is a two-tier excise tax that can be imposed on a foundation manager as well as a disqualified person. There is no tax imposed on the private foundation. The first-tier tax is a tax on the disqualified person who participates in an act of self-dealing equal to 10% of the amount involved in the self-dealing, and any foundation manager who participated in the act of self-dealing is liable for a tax of 5% of the amount involved (up to $20,000 per act for all managers) unless the participation was not willful and was due to reasonable cause. Also, the disqualified person must correct the self-dealing by undoing the transaction. If the act of self-dealing is not corrected, the second-tier tax imposed on the disqualified person is 200% of the amount involved, and an additional tax of 50% of the amount involved is imposed on foundation managers who refused to agree to part or all of the correction within an aggregate cap of $20,000.

e. Minimum Distribution Requirements, §4942. The foundation must distribute 5% of the average fair market value of its assets each year in qualifying distributions. In effect, there are two years to make the distributions — the calculation is made in year one, and a distribution must be made by the end of year two. There is a five-year carryforward for excess distributions. Qualifying distributions include any amount paid to accomplish charitable purposes, including necessary and reasonable expenses. Usually these are made by distributions to public charities, but certain distributions to supporting organizations do not count (and no distributions to other private foundations count).

Practical Planning Pointer: The minimum distribution may be made to a donor advised fund. That is very helpful if the family is not sure how it wants the charitable funds to be used. However, if a private foundation makes all distributions as contributions to a donor advised fund, that may at some point become problematic.

The excise tax is 30% of the amount of the underdistribution, with an additional 100% of the amount remaining undistributed at the close of the correction period.

f. Excess Business Holdings, §4943. A private foundation is permitted to hold 20% of the voting stock of a corporation or 20% of the profits interest in a partnership or joint venture, reduced by the percentage of stock or profits interest owned by all disqualified persons. There is a de minimis rule allowing a foundation to hold stock that is not more than two percent of the voting stock and of the value of all outstanding shares of the corporation. The excess must be disposed of within five years. That period can be extended up to another five years with permission of the IRS upon showing of a valid reason (i.e., the inability to sell the asset).

Planning Pointer: An interest in an LLC or FLP that owned only marketable securities is not an excess business holding. There is an exception for entities for which 95% of the income comes from passive sources.

The excise tax is 10% of the value of the excess business holdings. An additional 200% tax is imposed if the foundation does not dispose of the excess business holdings within the statutorily prescribed correction period.

g. Jeopardy Investments, §4944. If a private foundation invests its assets in a manner that jeopardizes the accomplishment of the foundation's exempt purposes, the foundation is subject to a tax of 10% of the amount invested. In addition, any foundation manager who participated is subject to an excise tax of 10% of the amount invested unless the participation was not willful and was due to reasonable cause.

h. Taxable Expenditures, §4945. Private foundations are prohibited from making "taxable expenditures." These are generally any expenditures other than for a §501(c)(3) purpose. These include expenditures to influence an election and grants to any organization other than one that is a public charity (but including a Type III supporting organization) or an exempt operating foundation. In addition, grants to individuals for study are taxable expenditures unless the IRS grants advance approval of the grantmaking procedure. A grant to another private foundation is not a taxable distribution, but is subject to "expenditure responsibility" oversight rules.

The private foundation is subject to a 20% initial excise tax, and foundation managers who knowingly agreed to a taxable expenditure are subject to an initial 5% tax (capped at $10,000 in the aggregate) unless the agreement is not willful and is due to reasonable cause. An additional 100% tax is imposed on the foundation if a taxable expenditure is not corrected, and a 50% tax (capped at $20,000) is imposed on foundation managers who refused to agree to the correction.

i. Income Tax Deduction Limitations. Gifts of cash or unappreciated property to a private foundation are subject to a deduction limitation of 30% of the donor's contribution base (as opposed to the 50% limit that generally applies for such gifts to public charities). Gifts of long-term capital gain property to a private foundation are subject to a 20% limit (rather than the 30% limit that generally applies for such gifts to public charities). Furthermore, the deduction for gifts of long term capital gain property to a private foundation are limited to the lesser of the property's basis or its fair market value. However, a deduction of full fair market value is allowed for the contribution of "qualified appreciated stock," which is stock for which market quotations are readily available on an established the securities market. (Observe that some states do not allow a deduction for state income tax purposes of the full fair market value in that situation.) If there are restrictions on the stock, such as for Rule 144 stock, there are additional special rules; the charity must be able to sell the stock on receipt.

Planning Pointer: An interest in an LLC or FLP that owned only marketable securities does not qualify for the "qualified appreciated stock" exception. The LLC or FLP interest is not sold on a nationally recognized securities exchange, so a contribution of that interest would be limited to the donor's basis.

Observe that the substantiation rules that apply to all charitable gifts apply to gifts to private foundations as well as the public charities. Even if a manager gives cash to a private foundation, the manager needs to give a receipt to him or herself. If there is no receipt, there is no deduction.

j. Disadvantages.

(1) Maintenance Costs. There are significant costs for operating a private foundation including tax filing expenses, state filing fees, legal advice, etc.

(2) Anonymity. The Form 990-PF must list all donors and directors of a private foundation; anonymity is difficult with a private foundation. One alternative is to create a foundation in another state with an innocuous name, but there are now national databases. A public charity can "hide" donors by having contributions made to a donor advised fund.

(3) Tax on Investment Income. There is a 2% (1% in some situations) tax on investment income.

(4) Five Percent Distribution Requirement. While there is a 5% distribution requirement, the family can defer the decision of which charities will receive benefits by making distributions to a donor advised fund.

k. Start With Private Foundation For Trial Run. If a donor is not sure what form of charitable entity it should use, consider beginning with a private foundation. The foundation can make distributions to a donor advised fund. If the donor later decides not keep the foundation, the assets can be distributed to a public charity or donor advised fund. The reverse is not possible; a public charity cannot later be converted to a private foundation.

l. Splitting Foundations. This is done frequently. For example, one child may want a private foundation and another may want a donor advised fund. Transfers can be made from a private foundation to other foundations or donor advised funds or public charities.

37. Donor Control and Involvement

a. Private Foundation.

(1) Family Control. A substantial advantage of a private foundation is that the donor's name can be on the foundation, and the donor's family controls grants, investments, who is on the board, and every aspect of operations of the foundation. There is usually a time limit on family involvement with a public charity, but not for a private foundation.

(2) Hiring Family Members. The foundation can hire family members and pay reasonable compensation for services necessary to carry out the charitable purposes of the foundation; that is not possible with a donor advised fund.

(3) Training Ground. Some families use private foundations as a way of involving the family and training family members in stewardship and how to serve on charitable boards.

(4) Coordination of Family Charitable Efforts. Foundations may be used to accomplish the family's goals in an organized fashion. Wealthy family members often receive separate requests by the same charitable organizations. Charities can be instructed to make contribution requests to the foundation so the family can coordinate how money is spread out among charities.

b. Public Charity.

(1) Family Interest Often Decreases With Younger Generations. "Shirt sleeves to shirt sleeves in three generations" is the mantra given for family businesses. Often that is only two generations for private foundations. Younger generations are often not as excited about the foundation as the donor-generation. A family may keep a significant amount of control with gifts to a public charity and not have the additional complexities of operating and maintaining a private foundation.

(2) Donor Advised Fund. One way to keep significant control over distributions is using a donor advised fund. The donor or others can be specified to give advice regarding distributions. If a community foundation wants to impose a standard approach, the donor can "shop" the proposed donation to find someone who will use a tailored agreement. In the past, there has been discussion among planners whether there may be a problem if the sponsor of a fund *always* approves the family's advice, even though it is legitimate. That concern seems to have diminished.

(3) Prior Notice. If the donor is concerned that the sponsoring organization of a donor advised fund may take undesired actions, require a notice before the fund is able to be specified things. The donor can then try to persuade the fund otherwise.

(4) Restricted Gifts. A carefully crafted restriction agreement can be used. For example, a "field of interest" fund could be created within a public charity, or direct restrictions can be placed on a gift. The key is that the donor must give up dominion and control over the transferred assets.

Restrictions typically appear in the deed of gift. In addition, the charity itself can back itself into a restriction if it solicits funds for a particular purpose. The board members may impose a restriction by setting aside funds for a particular purpose. Operation of law might impose restrictions in some cases.

Who can enforce restrictions is getting less clear. At common law only the state attorney general could enforce restrictions in many states. In some states, however, donors and persons benefiting from charitable activities have standing to enforce restrictions. Uniform laws are being developed regarding this matter. If standing to enforce restrictions is important, build that into the gift agreement.

The donor may agree later to modify restrictions. If the board imposes restrictions, they may change when there is a change in board members. A charity can go to court and argue that a restriction no longer serves charitable purposes (for example, malaria no longer exists in the U.S.) or the limitations are no longer workable (for example, a restriction to invest only in Russian Railroad bonds).

38. Real Estate Issues

a. Deduction Limitation. Real estate can be contributed to public or private foundations, but there are income tax deduction limitations. For gifts to private foundations, the income tax deduction for contributions of long term capital gain property is limited to the donor's basis. For public charities, an income tax deduction is available for the full fair market value of long-term capital gain property, but only up to 30% of the contribution base. (The donor may take a deduction for long-term capital gain property of the full 50% of the contribution base if the deduction is limited to basis of such property.)

b. Self-Dealing Rules. If the family ultimately wants to own the property, self-dealing rules might prohibit a sale from a private foundation to disqualified persons. If the real estate is owned by a public charity or donor advised fund, there is not a self-dealing prohibition, but there is a fiduciary duty to sell for full fair market value. The charity will require an appraisal process to assure that it is receiving full value, and will negotiate hard even if it is selling real estate back to the donor's family. For donor advised funds, there is not a self-dealing prohibition, but the excess benefits transaction rule applies for transactions with the donor's family and advisers.

c. Minimum Distribution Requirements. Having illiquid assets, such as real estate, in a private foundation can lead to problems in being able to satisfy minimum distribution requirements. As a practical matter, the foundation would want to sell the real estate quickly to avoid these problems.

d. Charity May Not Accept. Many public charities will not accept real estate. Most well-run charities have detailed intake procedures, which will, for example, consider whether the real estate is encumbered by debt, or has toxic waste or other environmental problems. Furthermore, there would be maintenance costs, carrying costs, etc., so the charity will carefully consider whether the real estate furthers the charity's exempt purpose.

e. Usually in an Entity. Real estate donated to a charity will typically be in an entity, either an LLC or partnership.

39. Business Interest Issues

a. Deduction Limitations. The income tax deduction limitations described above for real estate also apply to business interests that are long term capital gain assets.

b. Minimum Distribution Requirements. If there is not sufficient cash flow from the entity to satisfy the 5% distribution requirement, having business interests in a private foundation or donor advised fund will be a drain on other assets.

c. Excess Business Holdings and Self-Dealing Issues. If the foundation and disqualified persons own 20% of the business, it must dispose of enough of the business to get under the 20% limit. There must be an exit strategy for how to sell the business interest.

If the business itself is not a disqualified person (i.e., family members and foundation managers own less than 35% of the business), the business could purchase the foundation’s interest in the business, including a purchase for a note.

If a corporation is a disqualified person, the corporation could redeem the stock from a private foundation, if the special requirements of the redemption exception from the self-dealing rules are followed (as discussed in Item 36.b above). The foundation may plan to sell the business interest to a third party. Contributions of business interests are sometimes made in connection with a plan to sell the interest. However, a problem arises if it cannot be sold within five years. The foundation cannot get an extension if it has not been doing anything to try to sell the business interest.

d. Incidental Benefit Concerns. As an example, assume that 10% of a $10 million company is transferred to a private foundation. An appraiser applies a 40% discount, so the 10% interest is worth $600,000. If the company redeems the foundation's 10% interest for $600,000, the family members who own the rest of the company are benefited. This can be pushed to "nonsensical" limits. For example, assume that 99% of the company is transferred to a private foundation, with the children owning 1% voting stock. If the foundation's 99% interest is redeemed at a discount (because of its lack of control) the children may end up with a very substantial benefit. That may be so glaring that the IRS would react (arguing step transaction, private benefit, etc.).

Items 40-43 are observations from a symposium by Skip Fox and Thomas Abendroth, "Tales From the Crypt: Lessons To Be Learned From Past Mistakes"

40. Marital Deduction Problems

a. No Marital Deduction If Income Interest Terminates on Incompetency or Remarriage. Estate of Walsh v. Comm'r, 110 T.C. No. 29 (1998) (income ceased on remarriage; marital deduction savings clause that said to interpret trust based on intent to qualify for marital deduction did not save the marital deduction); Roels v. United States , 928 F. Supp. 812 (E.D. Wis. 1996) (income right ceased on remarriage, in which event assets passed to charity; no marital deduction or charitable deduction).

b. No Marital Deduction If Income Payable to Spouse Only Under Broad Discretion Standard Rather Than Clear Mandatory Income Interest. In Davis v. Comm'r, 394 F.3d 1294 (9th Cir. 2005), income was distributed to the spouse for health, education, or support, maintenance, comfort and welfare." The case held that was not a mandatory income right so no marital deduction was allowed. The court distinguished Ellingson v. Comm'r, 964 F.2d 959 (9th Cir. 1992), which concluded that the spouse had the equivalent of a mandatory income interest where the standard for distribution was "needs, best interests and welfare." The court noted in Davis that there was no expression of intent to qualify for the marital deduction, so the estate could not rely on a state deemed reformation statute to qualify for the marital deduction. Also, the fact that the surviving spouse was the trustee did not save the marital deduction.

c. Indirect Benefits for Others (Bargain Sale Provisions) Disqualifies Marital Deduction. Estate of Rinaldi v. U.S., 38 Fed. Cl. 341, 80 AFTR.2d 97-5324 (1997) (marital trust that was bequeathed stock subject to potential bargain sale to third party under buy-sell agreement not entitled to QTIP treatment); PLR 8843004.

d. Duty of Consistency Not Applied. In Estate of Posner v. Comm'r, T.C. Memo. 2004-112 (2004), the marital deduction was mistakenly allowed in the husband's estate even though his will did not give his wife a general power of appointment. At the wife's death, the court held that the trust assets were not included in wife's estate. The duty of consistency did not require inclusion in wife's estate. The crucial facts were known to both parties, and the erroneous deduction was due to a mutual mistake of law. Practical Planning Pointer: How did the attorney who prepared the wife's will exercising the supposed general power of appointment not read the document to realize there was no general power of appointment?

e. Tax Clause Causes Dramatic Reduction in Marital Deduction. Estate of Lurie v. Comm'r, T.C. Memo. 2004-19, aff'd 425 F.3d 1021 (7th Cir. 2005) (tax clause did not allow allocating taxes to the irrevocable trusts that were included in husband's estate; marital deduction was dramatically reduced). Practical Planning Pointer: Look carefully at reimbursement provisions in tax clauses. If assets held for or passing to individuals other than the spouse are included in the estate, provide that those assets bear a proportionate share of estate taxes.

f. QTIP Election Void Where QTIP Election Unnecessary. Various rulings have followed Rev. Proc. 2001-38, 2001 C.B. 1335, stating that the QTIP election for specific transfers would be treated as null and void when the election was unnecessary to reduce the estate tax liability to zero. PLRs 200702081 and 2000729028.

The IRS's position is that Rev. Proc. 2001-38, which treats a QTIP election as null and void where it is unnecessary, only applies where the QTIP election is unnecessary in its entirety for a particular trust. In Letter Rulings 200219003 and 200422050, the IRS ruled that a taxpayer cannot partially revoke a QTIP election under the procedure described in Rev. Proc. 2001-38.

g. QTIP Election of Insufficient Amount; IRS Approved Supplemental Return Increasing Election. In PLR 200832011, the attorney thought the estate tax exemption amount was \$2.0 million, and the QTIP election was made for all of the estate exceeding \$2.0 million. However, the exemption amount for the year of death was actually only \$1.5 million. After realizing the mistake, the attorney prepared a supplemental return. The IRS approved the estate's request that the marital deduction be allowable for the amount to reduce the estate tax to zero.

Practical Planning Pointer: In making QTIP elections, include a formula election to elect as much as necessary to reduce the estate tax to zero.

h. Spouse Must Actually Survive to Qualify For Marital Deduction. In Estate of Lee v. Comm'r, T.C. Memo. 2007-371, the will provided that the wife was deemed to survive the husband if the spouses died within 6 months of each other. The wills were prepared when the planner knew that both spouses were terminally ill. The husband owned most of the assets. The wife died about 6 weeks before the husband, but under the deemed survivorship clause in the will, the estates were administered as if the wife had survived. This meant that assets purportedly passed from the husband's estate into a credit shelter trust with the balance passing to the wife as if she had survived. This permitted the use of her exemption amount (because she owned negligible assets of her own.) The court held that no marital deduction was allowed in the husband's estate because the surviving spouse must actually survive in order to qualify for the marital deduction. (The parties were just confused as to how simultaneous death clauses work.)

Practical Planning Pointer: Survivorship presumptions in a will cannot be used to take the place of titling sufficient assets in each spouse's name to be able to fully utilize each spouse's exemption amount.

41. Gift Issues

a. Lapse of Withdrawal Power. In PLR 9804047, an ILIT provided that the grantor's spouse had a noncumulative power to withdraw 10% of the principal each year. Despite the fact the spouse was a discretionary beneficiary of the trust, there was a full gift each year to the extent each year's lapsed right of withdrawal exceeded 5%.

b. Indirect Gifts Not Recognized as a Way to Creatively Expand Annual Exclusions. In Heven v. U.S., 945 F.2d 359 (9th Cir. 1991) mother made gifts of bank stock to 27 different persons who immediately signed the stock over to her daughter. The IRS argued that using the 27 donees as "strawmen" was a step transaction and the multiple annual exclusions were not allowed. The IRS also imposed a civil fraud penalty against the daughter.

Practical Planning Pointer: Clients who suggest this type of planning must realize that potential civil penalties or even jail time is the possible result.

Similar cases: Estate of Cidulka v. Comm'r, T.C. Memo. 1996-149; Bies v. Comm'r, T.C. Memo. 2000-338; Sather v. Comm'r, T.C. Memo 1999-309 (reciprocal gifts).

c. Advice to Make Annual Gifts to Trust That Did Not Have Crummey Clause. In Hatleberg v. Norwest Bank Wisconsin, 700 N.W.2d 15 (Wis. 2005) an attorney drafted a trust that did not have a Crummey clause. The trust officer realized it and discussed the matter with the attorney, but they thought no more gifts would be made to the trust. Neither informed the donor of the problem. The donor continued to make gifts to the trust. Indeed a different trust officer in a later year told the donor to be sure to make annual exclusion gifts to the trust. The attorney and the trust officer were held liable.

d. Gift Must Be Complete Before Death. In Estate of Newman v. Comm'r, 111 T.C. 81 (1998) the son under a power of attorney drew 6 checks on decedent's checking account but the bank neither accepted nor paid the checks until after the decedent's death. The Tax Court rejected the estate's arguments that the checks constituted non-taxable completed gifts that should be excluded from the gross estate. The court distinguished Metzger v. Comm'r, 38 F.3d 118 (4th Cir. 1994), which held that checks delivered in one year but cashed in the following year related back and were treated as having been given in the prior year. But in Metzger, unlike Newman, the person who wrote the checks was living when they were cashed.

Practical Planning Pointer: On an estate tax audit, the IRS agent often asks to see the bank account, and will look for a series of $13,000 checks written soon before death. (Also, be sure that an agent has the power to make gifts under the power of attorney. (Estate of Goldman v. Commissioner,, T.C. Memo. 1996-29; Estate of Swanson, 46 Fed. Ct. Cl. 38 (2000); Pruitt v. Commissioner, T.C. Memo 2000-287.)

e. Gifts Cannot Be Disguised as Fees. In PLR 200014004, the payment of excessive fees to the trustees of a QTIP trust constituted taxable gifts to the spouse's children who were acting as trustees.

42. Charitable Planning Issues

a. Charitable Amounts Must be Ascertainable As of the Date of Death; Deduction Lost Where Discretionary Distributions Allowed for Non-Charitable Beneficiaries. Marine Estate v. Comm'r, 990 F.2d 136 (4th Cir. 1993) ($24 million charitable deduction lost because of provision in decedent's will giving personal representatives discretion to make bequests to "persons who had contributed to his well-being during his lifetime").

b. Donation Before Sale. In Ferguson v. Comm'r, 83 AFTR.2d ¶99-648 (9th Cir. 1999), the donor wished to transfer stock early enough during sale discussions so that the donor avoiding being treated as the real seller of the stock (in which event the donor must report the gain on the sale). The case involved a tender offer to sell stock and the court held that the transaction ripened into a right to receive cash when third party offers had been received for 51% of the stock, and that the sale would be required to proceed after that date. The transfers to the charity occurred after that date, so the donor had to recognize the capital gain on the sale. The brokerage firm may not have acted as soon as requested. A suit was brought against the brokerage company for failure to follow instructions to transfer the stock as soon as possible. Practical Planning Pointer: When giving instructions to a brokerage company, follow up to make sure it implements the instructions.

c. Split Interest Requirements. No charitable deduction is allowed for trusts created with both charities and individuals as beneficiaries unless they meet the formal requirements of a CRT or CLT. Zabel v. United States, 995 F. Supp. 1036 (D. Neb. 1998); Galloway v. United States, No. 05-50 (W.D. Pa. May 9, 2006).

d. Failure to Administer Charitable Remainder Trust Properly. Atkinson v. Comm'r, 309 F.3d 1290 (11th Cir. 2002) (failure to make annuity payments, deduction denied); CCA 200628028 (grantor, as trustee, wrote checks from trust to himself, his wife and third parties on a random basis; held that the trust was not a CRT but trust was a grantor trust with income taxable to the grantor). The flip side is that proper administration will not save a trust that does not have the required terms of a CRT. Tamulis v. Comm'r, 509 F.3d 343 (7th Cir. 2007)(parties administered the trust as a CRT, but it was not written that way, deduction denied).

43. Estate Inclusion

a. Is Standard an Ascertainable Standard? Forsee v. United States, 76 F. Supp. 2d 1135 (D. Kan. 1999) indicates that state law determines whether a standard is ascertainable for purposes of §2041. The beneficiary-trustee was entitled to principal for health, support, maintenance, and happiness. The estate argued that happiness is an ascertainable standard, but the court held that it was not.

b. Retained Interest. In Estate of Disbrow v. Comm'r, T.C. Memo 2006-34, a house contributed by the decedent to a general partnership (the "Funny Hats" partnership) with her children was included in the gross estate under §2036(a)(1) because the decedent continued to reside in it and failed to pay fair market value rent.

Practical Planning Pointer: Make the names of FLPS as boring and innocuous as possible. One wonders if the IRS agent who scanned returns to select returns for audit was intrigued by the "Funny Hat" partnership and reviewed the return in more detail.

Items 44-48 include discussions of miscellaneous current developments, separate from topics that were addressed in seminars at the ACTEC Annual Meeting

44. Letter Ruling Approving Grantor Trusts Structured With Beneficiary as Owner of Trust

a. Letter Ruling 200949012. This letter ruling involved a Crummey trust that gave the beneficiary the right to withdraw any property transferred to the trust as a gift, which withdrawal power lapsed with respect to the greater of $z or y% each year (this was a "5 or 5" power.) The ruling held that the trust would not be treated as a grantor trust as to the original grantor, but the beneficiary was treated as the owner of the trust under §678.

(1) Roadmap for Avoiding Grantor Trust Status. The ruling facts provide an excellent roadmap if a planner wishes to avoid grantor trust status:

> "Grantor is not a beneficiary under the Trust, and has no interest under the Trust. Trust provides that no income or principal of Trust may be paid or appointed for the benefit of Grantor or Grantor's spouse, or to pay premiums

on insurance policies on the life of Grantor and/or Grantor's spouse. Trust further provides that neither Grantor nor Grantor's spouse may act as a Trustee of Trust and that no more than one-half of Trustees of Trust may be related or subordinate parties to Grantor, within the meaning of § 672(c).

Trust further provides that Grantor does not intend to be treated under subpart E of Part I of subchapter J as the owner of Trust. Trust further provides that neither Grantor nor any other "nonadverse party" as that term is defined in § 672(b) shall have the power to (1) purchase, exchange or otherwise deal with or dispose of Trust's principal or income for less than adequate consideration or (2) borrow any of Trust's principal or income without adequate interest or security. Trust further provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of § 7701(a)(30)(E) of any trust created under an [sic] held under Trust. No court, other than a court within the United States, shall exercise primary supervision over the administration of any trust created and held under Trust. Grantor and Beneficiary represent that Trust will be a domestic trust within the meaning of §301.7701-7 of the Procedure and Administration Regulations."

The ruling concludes that grantor is not treated as the owner of the trust under §§671, 673, 674, 677, or 679. The ruling also finds that an examination of the trust reveals none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of Grantor or any other person under §675, but that whether the circumstances under §675 apply is a question of fact to be determined each year after the income tax returns of the parties have been filed.

(2) Beneficiary Treated as Owner Under §678. The key significance of the ruling is its one sentence conclusion regarding the application of §678:

"We further conclude that Beneficiary would be treated as the owner of Trust for federal income tax purposes under §§ 671 and 678, before and after the lapse of Beneficiary's power of withdrawal with regard to any transfer to Trust."

Observe that the ruling did not contain any reservation about the extent of the Beneficiary's deemed treated as owner of "Trust." The clear inference is that the Beneficiary is treated as the owner of the *entire trust* both before and after the lapse of the withdrawal powers.

(3) Beneficiary's Powers and Interests. The trust left the beneficiary with a great deal of control. The positions, interests and powers of the beneficiary include: (1) Investment Trustee; (2) non-lapsing power to direct Distribution Trust to make distributions to the beneficiary for the beneficiary's health, education, maintenance or support; (3) broad testamentary power of appointment to appoint the assets to any person or charity other than the beneficiary, the grantor, their estates, their creditors and the creditors of their estates.

b. Analysis of §678 Issues. If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under §678. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. E.g., Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.

The IRS's position under Section 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. (Sections 2041b)(2) and 2514(e) provide that "the lapse of a power … shall be considered a release of a power.") However, the statute refers to a "partial release;" is a lapse a partial release? The IRS position has been clear since the early 1980s. A number of private letter rulings view the lapse as a release, and since there is no "five or five" exception in the income tax statute, the beneficiary whose Crummey withdrawal rights have lapsed is treated as the partial owner of the trust.

A further complication is that under §678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in Treas. Reg. §1.671-2(e)(6), Example 4. In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under §678. However, the term "portion" might refer to as the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. (Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey powerholder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs or the recent PLR 200949102 has even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust that is attributable to the powerholder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.)

For an excellent discussion of the §678 issues, see Blattmachr, Gans & Lo, A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC J. 106 (Fall 2009).

c. Example Illustrating Advantages of "Beneficiary Controlled Trust." A client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). (The ruling suggests that the initial contribution need not be so limited, but that there could be a larger initial contribution, the withdrawal power over which would lapse under a "5 or 5" power. However, of course, this is just a private letter ruling, but it does reflect the IRS's current position.)

The beneficiary would be treated as the owner of the entire trust for income tax purposes under §678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary's estate, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause (especially if the state has passed a law providing that lapses of withdrawal powers within the 5 or 5 amount will not be treated as a transfer from the beneficiary to the trust for creditor purposes). Furthermore, the trust could give the client a broad limited testamentary power of appointment. In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) and over which the client has a great deal of control but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power.

In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.)

Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise results from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. (The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.)

The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees to support a large sale to the trust for a note and to have the trust pay fair value for the guarantees.

For an excellent discussion of planning considerations, see Oshins, The Beneficiary Defective Inheritor's Trust ("BDIT") (2008); Hesch & Handler, Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth, 68th NYU INST. ON FEDL. TAXN (2009) (Part D, The Beneficiary Defective Inheritor's Trust (the "BDIT")).

45. Annual Exclusion for Gifts of FLP/LLC Interests, Hackl, Price and Fisher Cases

a. Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003). The court ruled that gifts of LLC interests to 41 donees over a number of years did not constitute present interests that qualified for the annual exclusion, reasoning that the donees had neither the right to income from the property nor substantial present enjoyment of the property itself.

b. Price v. Commissioner, T.C. Memo. 2010-2. Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts that will qualify for the gift tax annual exclusion. There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term reasonable rate of return. Perhaps most interesting is that the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the Hackl, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002. Clearly, the annual exclusion issue is "in play" and the availability of the annual exclusion for limited partnership interest transfers cannot be assumed.

Several drafting suggestions will assist in countering the court's objections. Alternatives include:

(1) Do not include a prohibition on transfers but provide that any transferee will be subject to a right of first refusal, with reasonable time limits;

(2) Do not explicitly favor reinvestments over distributions in the partnership agreement;

(3) Make distributions every year and "regularize" distributions (although this may make §2036(a)(1) inclusion more likely if the parent retains interests in the partnership or LLC);

(4) Mandate distributions of "net cash flow" (although the IRS may also argue that this is an indication of an implied agreement of retained enjoyment under §2036(a)(1));

(5) Specify that the general partner/manager owes fiduciary duties to the other partners/members;

(6) Give donees a Crummey withdrawal power with respect to gifts of limited partnership interests that would enable the donees to withdraw the fair market

value of their limited partnership interests for a limited period of time after each gift (this is obviously an unusual provision to be in a partnership agreement); and

(7) Give donee-partners a limited period of time to sell the interest to the partnership for its fair market value, determined without regard to the existence of the put right; this provision could be included in a conditional assignment that is subject to the transferee being allowed to require the donor or the partnership to substitute income producing property equal in value to the value of the donated partnership interest. If the put option is used, some panelists prefer giving the partnership the obligation to purchase the interest, but that would require that the partnership be a party to the assignment agreement if the put option is placed in the assignment. (The provision could also say that the partnership would have the first option to purchase the partnership interest but if it did not exercise the option, the donor would have to buy the interest.) Following the Price and Fisher cases, there will likely be a greater tendency to utilize put provisions where qualification for the annual exclusion is important. Be careful how put rights might impact valuation issues and creditor protection issues.

An alternative planning approach is to give cash to the trust and have the trust purchase an interest in the FLP or LLC at some point. If the sale occurs immediately, the IRS may conceivably raise a step transaction analysis. However, that approach provides an additional argument, and Holman and Gross suggest (in a different context) that delays of just a week or two may block a step transaction analysis.

Jeff Pennell says that he once asked an IRS field agent why agents go after annual exclusions when truck loads of value pass out of estates through discounts. The response: "These are the cases we can win."

c. Fisher v. U.S., 105 AFTR 2d 2010-XXXX (S.D. Ind. March 11, 2010). Parents gave membership interests in an LLC to each of their seven children over three years (resulting in 42 annual exclusion gifts). The principal asset of the LLC was undeveloped beachfront property. The IRS contested the availability of annual exclusions, and the court rejected the donors' three arguments.

First, the donors argued that the children had the unrestricted right to receive distributions. The court rejected this argument because distributions "were subject to a number of contingencies, all within the exclusive discretion of the General Manager."

Second, the donors argued that the children possessed the unrestricted right to use the beachfront property. The court responded that the Operating Agreement did not convey this right to members. Somewhat confusingly, the court added that "the right to possess, use, and enjoy property, without more, is not a right to a 'substantial present economic benefit.' *Hackl*, 335 F.3d at 667. It is a right to a non-pecuniary benefit."

Finally, the donors argued that the children had the unrestricted right unilaterally to transfer their interests. Under the Operating Agreement, the children could transfer their "Interests" in the LLCs if certain conditions are satisfied. One of those conditions was that the LLC would have a right of first refusal over any such transfer. If the LLC exercises the right of first refusal it will pay "with non-negotiable promissory notes that are payable over a period of time not to exceed fifteen years" providing equal annual installments of principal and interest. The right of first refusal would not exist for transfers to the donors or to their descendants (but as noted below, the court said that other restrictions would apply, without explaining what those restrictions were). The Agreement defines "Interest" as a member's share of profits and losses and the right to receive distributions. The children could only transfer "Interests" rights as opposed to the rights of "Members" admitted by the LLC, which also include the right to inspect the Company's books and records and to "participate in the management of and vote on matters coming before the Company." (The rights that could be assigned seem analogous to "assignee" rights in the context of a partnership.) The court did not comment negatively on the fact that the children could merely transfer the right to share in profits, losses and distributions rather than a full membership right. However, the court reasoned that the right of first refusal "effectively prevents the Fisher Children from transferring their interests in exchange for immediate value." Even transfers to family members are "not without restrictions." "Therefore, due to the conditions restricting the Fisher Children's right to transfer their interests in Good Harbor, it is impossible for the Fisher Children to presently realize a substantial economic benefit."

The third argument is the one that most donors will use to support the availability of the annual exclusion for gifts of interests in partnerships or LLCs. If the donees had the immediate right to sell their interests for cash or other assets they could immediately enjoy, it would seem that the gifts would constitute present interests. The court did not explain its reasons that the right of first refusal kept the children from being able to transfer their interests for "immediate value." However, the court was probably correct in reaching this result because the LLC could pay with *non-negotiable* notes. This means that if the LLC exercised its right of first refusal, the children had no ability to sell the LLC's note for cash or other "immediate value." While the court did not explain its specific reasons, limiting the right to transfer the interest for only a non-negotiable note does seem to be a substantial impediment to being able to receive "immediate value."

Practical Planning Pointer: As discussed above in the discussion of <u>Price</u>, partnership or LLC agreements should not prohibit transfers. <u>Fisher</u> casts some doubt on whether subjecting transfers to a right of first refusal precludes annual exclusion treatment, but it would seem that the practical planning pointer from <u>Fisher</u> is that the partnership or LLC should not be able to exercise the right of first refusal by giving *non-negotiable* long-term promissory notes.

46. Defined Value Clauses, Petter

a. <u>Appeal Period</u>. The decision document was filed in the <u>Petter</u> case in early March, so the 90-day period for the IRS to appeal the case is running from that time. The case is appealable to the 9^{th} Circuit Court of Appeals.

b. <u>Reference to Installment Sales</u>. Footnote 8 of the <u>Petter</u> opinion notes that the estate tax attorney involved in structuring the transaction "said he believed there was a rule of thumb that a trust capitalized with a gift of at least 10 percent of its assets would be viewed by the IRS as a legitimate, arm's length purchaser in the later sale." There is very little authority for the 10% rule of thumb. At least this is a reference to the rule of thumb in a reported case.

47. Formula Clauses For Hedging Legislative Risks

a. <u>Article</u>. A very thoughtful article by Mil Hatcher and Ed Koren about using formula clauses as a way of hedging against the possibility of retroactive reenactment of the estate and GST tax, as well as for other purposes has recently been published. Hatcher & Koren, Formula Clauses: Hedging Value and Legislative Risks, TAX NOTES (March 15, 2010). Some of the ideas from that article are highlighted below, but the full article is worthy of study.

b. Example Clause. As an example, a distribution from a non-GST exempt trust might be allocated to a grandchild to the extent that the distribution would not be subject to any GST tax, but would be allocated to another person if any GST tax liability would otherwise be incurred. By its nature, such a clause would take into account any retroactive legislation (even if it did not specifically reference retroactive legislation.) Another example use of such a clause would be for an individual who wants to make a large gift to grandchildren, but wants to hedge against the possibility of retroactive legislation that would subject the transfer to the GST tax.

c. Incomplete Gift Argument. Revenue Rulings 69-346 and 79-384 both ruled that a taxable gift resulted under the facts of those rulings only on the happening of a future event, but those rulings did not involve an immediate delivery of property. The concept of an incomplete transfer does not seem to apply to a transfer with a formula allocation.

d. Procter. Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944) refused to recognize a tax savings clause to prevent a gift from being taxable. In Procter, the taxpayer transferred his remainder interests in specific trusts, which he believed to be worthless, to another trust for his children, but provided that to the extent the transfer was subject to gift tax, the otherwise taxable portion "shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the taxpayer]." Three issues are raised by the Procter case, one of which has been attributed as the key to the Procter result in Petter and two of which were discussed directly in Procter. The three issues are:

(1) there was a reversion to the donor (Petter said the key to distinguishing invalid Procter clauses from valid formula clauses is "a donor who tries to take property back — that's Procter);

(2) the savings clause was triggered by a condition subsequent (this is closely tied to the first issue — upon the happening of the condition subsequent, the transfer is deemed not to have occurred but the asset remains with the donor); and

(3) the clause was contrary to public policy because (i) the provision would discourage collection of tax, (ii) it would render the court's own decision moot by undoing the gift being analyzed, and (iii) it would upset the final judgment.

As to the public policy issue, a clause that turns on what Congress does and not what the IRS does in an audit does not seem to raise the issue of "trifling with the judicial process" that was criticized in Procter. Furthermore, some of the reasons given to counter the public policy argument in both Christiansen and Petter would apply (such as the fact that the Code sanctions formula clauses in many other contexts so they are not inherently contrary to public policy).

e. Use Formula Allocation Rather Than Formula Transfer Approach. Structure the clause by making a complete distribution of particular assets and use the formula clause to allocate who receives the property; none of the property remains with the original transferor. Avoiding a reversion helps avoid the incomplete transfer theory as well as the condition subsequent argument under Procter. Planners often focus on the public policy analysis in

Procter, which was effectively rebutted by the analysis in Christiansen and Petter, without addressing the first two issues raised by Procter. The formula allocation approach best addresses all of the various issues in Procter.

This is different from the approach suggested by some planners of making a distribution of so much of the trust as would not be subject to GST tax. (That would be a formula transfer approach.) Using a formula allocation approach seems to provide the strongest argument to thwart a Procter attack.

f. Where Should The "Excess" Portion Be Allocated?

(1) Charity. A charity is not a good choice to provide a hedge against the downside risk of retroactive GST legislation. Various regulatory provisions could negate the allowance of the gift tax charitable deduction, because the charity's interest would be contingent on the enactment of retroactive legislation. Treas. Reg. §§25.2522(a)-2(a) (charitable interest must be presently ascertainable and severable from the non-charitable interest); 25.2522(a)-2(b) (no deduction is allowed if charitable transfer is dependent upon performance of some act or happening of a precedent event).

(2) Spouse. The spouse is not a good choice either. The condition subsequent might make the spouse's interest a terminable interest that would not qualify for the gift tax marital deduction.

(3) Non-skip Person. This is a safe choice. The excess amount, which would otherwise be subject to GST tax if there is retroactive legislation, could pass to a trust in which the child is a beneficiary (assuming a transfer to another trust is permitted under the trust agreement or state law) or directly to a child. That avoids the GST tax currently (but that would not avoid estate tax at the child's subsequent death).

(4) GRAT. There are several potential problems with using a GRAT to receive the excess distribution from a non-exempt trust. First, under state law principles, is the trustee of the trust authorized to make a distribution to another trust? Second, the GRAT rules may be limited to transfers by individuals. See §2702(e), 2704(c)(2); Treas. Reg. §25.2702-1(a). Finally, there is a valuation question. Is the initial fair market value of property contributed to the GRAT the full market value of the initial transfer (in the event that there should be retroactive legislation)? If so, the annuity payments could be designed to "zero out" the GRAT. However, if a risk adjustment is applied to determine the initial fair market value of the transfer to the GRAT there would be a potential large gift if the transfer eventually is allocated to the GRAT because of retroactive legislation. It would seem that the value would not be risk-adjusted because if there is retroactive legislation, it would be effective as of the day that the transfer was made.

48. Proposed Legislation Requiring Ten-Year Minimum Term for GRATs

a. Legislative Proposal. H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010" is another economic stimulus bill. The bill passed the House on March 24, 2010 by a vote of 246-178 (generally along party lines, with only 4 Republicans voting Aye and only seven Democrats voting No). The last section of the bill adopts the proposal in the President's Budget Proposal to impose a ten-year minimum term on GRATs. The bill also stipulates that frontloading is not permitted (the annuity payments cannot decrease during the first ten years), and the remainder value must have a value greater than zero. The effective date is for transfers made after the date of enactment.

The additional requirements for GRATs are detailed as follows:

> "ADDITIONAL REQUIREMENTS WITH RESPECT TO GRANTOR RETAINED ANNUITIES. –For purposes of subsection (a), in the case of an interest described in paragraph (1)(A) (determined without regard to this paragraph) which is retained by the transferor, such interest shall be treated as described in such paragraph only if —
>
> > (A) the right to receive the fixed amounts referred to in such paragraph is for a term of not less than 10 years,
> >
> > (B) such fixed amounts, when determined on an annual basis, do not decrease relative to any prior year during the first 10 years of the term referred to in subparagraph (A), and
> >
> > (C) the remainder interest has a value greater than zero determined as of the time of the transfer."

Some planners have suggested that the purpose of requiring that the remainder interest has a value greater than zero is to force the disclosure of all GRAT transfers on gift tax returns. Footnote 173 of the House Report gives this explanation for the "greater than zero" provision and the prohibition on frontloading the annuity payments: "The proposal also requires that the remainder interest of a GRAT have a term greater than zero and prohibits a reduction in the annuity during the GRAT term. These requirements are designed to prohibit circumvention of the ten-year minimum term requirement of the proposal."

b. <u>Planning Implications</u>. There may be less of a reason for holding separate assets in separate GRATs if 10-year term GRATS are used. Long term GRATs are not as likely to capture volatile upswings as short term GRATs. However, clients who are willing to put up with administering separate GRATs over a long time frame may still find putting different assets classes in separate GRATs to be advantageous. Separate GRATs will continue to be better for some classes of assets, such as the pre-IPO asset, new venture, or similar asset that may have huge appreciation or may go bust. Having that type of asset in a separate trust (perhaps with enough cash to fund any ongoing cash flow needs in the early start-up years) makes sense even for longer term GRATs.

Whether to use a 20% increasing annuity will take some analysis in each separate case. Over ten years, there would be a huge discrepancy in the annuity payments in the early years and in the late years of the GRAT. That may be very helpful in allowing very small in-kind distributions in the early years. For rolling two-year GRATs, it really did not matter whether the annuity increased by 20% in the second year, because the initial principal amount was always in a GRAT. But it will not be so easy to roll-over all of the annuity payments from 10-year GRATs (eventually there would be 10 separate GRATs). However, using the increasing annuity would increase the estate inclusion risk. If there are level annuity payments, there is a chance that in the later years, the assets will have appreciated enough that a death within the term would not require full estate inclusion. The huge annuity payments that would be due in the later years of an increasing annuity approach would all but assure full estate inclusion if the grantor dies during the term of the GRAT.

Planners preparing GRATs currently, knowing that the 10-year minimum term requirement is a serious possibility, may want to consider intermediate term GRATs currently rather than using the more typical 2 or 3-year GRATs. Using an intermediate term could take advantage of the very low §7520 rates for a longer period of time and could leave the asset in a still relatively short term GRAT for a longer time before having to roll over to a 10-year GRAT.

49. Quotations

a. Our Place in the Cosmos. — The issues surrounding the sunset rule "are existential, cosmic and extremely difficult." – Ron Aucutt

b. More on the Sunset Rule. We don't know what the "had never been enacted" rule means. We don't even know what the meaning of "is" is, depending on who you ask. – Carol Harrington

c. A Daunting Task. After looking at a number of specific client situations in 2010, Carol Harrington concludes: "We are facing a daunting task to respond to all our clients to explain it to them. You can't just send a letter and say if you want it fixed, sign this document. I'm finding it does not work like that. It's much more time intensive than that. One size clearly does not fit all."

d. News You Can Use. After hearing a description of the history behind the Madison Plan, New Jersey Plan and the Connecticut Compromise regarding proportional and equal votes in the U.S. legislature, Carol Harrington sarcastically observed "Well that's going to come in handy. That's news you can use."

e. Our Benevolent IRS. Some planners have suggested making direct skip gifts in 2010 to a partnership that would block distributions until a partner reaches a certain age. Carol Harrington worries that looks a little like a trust. "But that means the IRS would be going after these things in a way that looks vindictive and I don't think that's going to happen. I think they will be concerned with trying to administer the tax law in a consistent manner given the chaos." But Carol sarcastically notes: "That would be crazy. What am I saying?"

f. Congressional Efficiency. "We think Congressmen are not doing anything. But the fact of the matter is they're spending lots of time working on the things they are not doing." – Ron Aucutt

g. Secret to Making More Money. "If you want to make more money, figure out a way to leverage." – Jonathan Blattmachr

h. Helpful Lawyerly Advice. A client asked how to give real property to charity. As a helpful young associate, Turney Berry told the client "You should do a deed."

i. Chicago-Style. In discussing the desirable goal of creating a side fund to exit out of financing plans to acquire life insurance, Larry Brody urges clients to start early with the side fund. "Start the side fund upfront, not years later. Like in Chicago — Do it early and do it often."

j. Lessons in Legislative Clarity. The proposal to revise §2704 is to have "some yet to be defined statutes applied in a yet to be defined manner, applying to yet to be defined taxpayers, all subject to a yet to be defined safe harbor." – Mil Hatcher

k. Back to Basics. "When you read, you begin with ABC. When you sing, you begin with "Do Re Mi." When you do charitable planning, you begin with "501(c)(3)." – Turney Berry.

l. Looking Out For Our Health. In discussing that some people at the meeting were feeling ill: "That's what happens when you get too much blood in your alcohol system." – Danny Markstein

m. Higher Mathematics. In structuring preferred partnership interests, Mil Hatcher structures no more than 50% of the value in the preferred interest. He used to use 80-20 before the first market meltdown. Some financial institutions suggest having no more than 33-35% in the preferred interest. Mil likes 50-50. "Being a history major, I can divide by two a lot easier than I can divide by three."