ACTEC 2010 Fall Meeting Musings

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Introduction

The following are my observations from the seminars presented at the ACTEC 2010 Fall Meeting held in Baltimore, Maryland on October 15-16, 2010. (At the request of ACTEC, information from the Committee Meetings is not summarized.) I am not attempting to summarize all of the excellent information from the seminars, but merely highlight some of the items that were particularly interesting to me. Everyone at the meeting has his or her own personal particular interests, and other attendees would no doubt point to other things that were highlights to them. Some of the information in this summary is based on additional information received after the Fall Meeting.

Hot Topics: This Time a Study in Certainties — Ronald Aucutt, Catherine Hughes, Beth Kaufman

1. Repeal Effort Re-Emerging. The Wall Street Journal on October 14, 2010 reported that the American Family Business Institute is an advocacy group leading a movement to repeal the estate tax. Two hundred fifty five candidates for the Nov. 2 elections signed a pledge to support the repeal of the estate tax, 253 Republicans and two Democrats. The estate tax tends to be a hotter issue in rural areas because of concerns among farmers and landowners. Repealing the estate tax will cost about $410 billion over ten years, as compared to revenue increases under the pre-2001 level of the tax. Senator Bernie Sanders, who is leading a drive by congressional liberals for higher rates on large estates, called the repeal effort "morally obscene" but has indicated that he is worried by its renewed momentum. The report observes that a strong showing for repeal in November could raise pressure to lower rates and increase exemptions, and could lay the groundwork for reconsideration of the repeal issue following the 2012 election.

   A recent study of wealth in America indicates that the top 20% hold 85% of the country's wealth and the bottom 40% own 0.5% of the wealth. Some would suggest that is a compelling argument for an estate tax.

2. Ron Aucutt's Summary. "After the election, Congress will have to address the income tax. Can the estate tax hitchhike on that? It is a possible vehicle. Is it likely? I have no idea. It is something to watch.

   "Decisions will be made by politicians for political reasons, and utterly beyond normal predictive efforts. We've seen enough over the last 12 months to know for a fact that the politicians themselves don't know what they will be able or willing to do. There are distinct coalitions around the various positions. There have been discussions about repeal efforts emerging again. It is a highly politicized issue and each coalition views the positions of others as immoral and obscene.

   "Fiscal constraints and fiscal responsibility are very real when they are in vogue — and all this is happening in a political climate like I have never seen before.

   "Staffs of the legislators appreciate the technical issues, partly because of contacts by ACTEC. If they are given the opportunity, staffs can address the technical issues — but it will happen quickly no matter how long it takes." (How's that for a Yogism?)

3. GST — Two Things We DO Know About 2010. (a) Outright gifts to grandchildren this year are direct skips that are not subject to a GST tax in 2010 or in future years. (b) If an existing non-exempt trust makes a distribution or terminates in 2010 and passes to a skip person, the GST tax does not apply. That's it. That's all we really know for sure about GST transfers in 2010.

4. Transfers in 2010 from Non-Exempt Trusts. This year is a good year to make distributions from or terminate a non-exempt trust to get out of paying a GST tax when the assets pass to skip

persons. However, that may not be advisable if the trust was designed to last for generations. "Don't let the tax tail wag the dog."

5. Contributions to or Creation of New Long-Term Trusts in 2010. The consensus is that there is no 2010 GST exemption to allocate to the trust. If a timely allocation is made, §2642(b)(1)(B) says that GST exemption allocation is made effective as of the date of the gift — but the GST exemption on that date (in 2010) is zero. Late allocations are effective as of the date of the allocation, §2642(b)(3)(B), or as of the time the late allocation is made in 2011. Therefore, only a late allocation will operate to allocate any GST exemption to the trust for a 2010 transfer. A late allocation cannot be filed until April 16, 2011 at the earliest. If the donor's income tax return is extended that automatically extends the gift tax return as well to October 15 (or October 17 in 2011). In 2011, a late return for the October deadline could not be filed until October 18, 2011.

   There is concern in having to wait that long to allocate GST exemption, because GST exemption would have to be allocated to all appreciation in the asset up to October 18 (or October 1 using the "first of the month" approach allowed in Regulation §26.2642-2(a)(2).) One Fellow suggested that the IRS consider adopting a valuation rule, similar to the first of the month approach, that would permit late allocations to transfers made in 2010 based on the values on January 1, 2011, in light of the special situation of having no ability to allocate timely GST exemptions for 2010.

   In 2011, depending on how the "had never been enacted" rule is applied, the GST exemption apparently will equal $1.0 million, indexed for inflation since 1997 (if there is no legislation regarding the amount of the GST exemption). *See* I.R.C. § 2631(c) (prior to amendment by the 2001 Act). (Observe, § 2631(c) stated that the GST exemption amount would be $1.0 million, inflation adjusted from 1997. There was no provision for inflation adjusting the estate tax exemption amount.) For 2011, there are indications that the inflation adjusted amount will be $1,360,000. Therefore, there would likely be at least $1.36 million of GST exemption in 2011 to allocate on late returns.

   If there is a concern that values will appreciate significantly before being able to make a late allocation, consider the following strategy. Make a gift to a trust in 2010. In early January 2011, create a new trust and fund it with enough assets to be able to support a purchase from the prior trust. Later in January, the new trust would purchase the appreciating assets from the old trust in return for a note. When a late allocation is made to the old trust, it would be based on the value of the note at that time. A timely GST exemption allocation would be made in 2012 with respect to the contribution to the new trust in January, 2011. Therefore, both trusts would be exempt, but there would be no need to allocate exemption based on the appreciation between the date of the sale transaction in January until the date of the late allocation later in 2011.

6. Direct Skip Gifts in Trust. There will be no GST tax for direct skips in 2010, but the concern with making a gift to a trust is that distributions from or termination of the trust in a later year may result in a GST tax. (The concern is that chapter 13 does not apply to GST transfers in 2010, therefore the move-down rule does not apply to the trust.) From a practical standpoint however, clients don't want to make outright gifts to young grandchildren. How can we plan? We cannot give any assurances to clients regarding trust transfers. The purpose of the sunset rule was to assure, back in 2001 when EGTRRA was enacted, that there would be no revenue impact after 10 years. If a direct skip is made to a trust in 2010, the revenue loss is in 2010. If distributions are made in later years, there is no revenue loss in those later years — the revenue loss occurred in 2010. Therefore, it would not violate the spirit of the sunset rule to allow direct skip gifts to trust. However, panelists are not advising clients to use direct skips to trusts based on this reasoning.

7. Testamentary Transfers. There is the possibility that trust transfers from decedents in 2010 will never be subject to GST tax. (The "transferor" is the last person subject to a transfer tax, and a decedent in 2010 was not subject to estate tax. A skip person is someone two generations or more below the transferor, and nonskip persons are everyone else. Without a transferor, there could not be skip persons, so everybody in the world would be nonskip persons.) This result was certainly not intended, and seems to violate the spirit of the sunset rule — which was to assure that revenues would not be impacted past 2010. (The IRS's counter-argument is that the "had never been enacted" provision applies to GST transfers after 2010 and that 2010 decedents should be treated as transferors because the estate tax would have been applied to the transfer in 2010 if the 2001 Act had never been enacted.)

8. IRS Guidance. The IRS issued a "Frequently Asked Questions" document about the 2010 estate and gift issues earlier in the year. Among other things, it indicated that estate tax returns are not required for 2010 decedents, and if an estate files an estate tax return for a 2010 decedent, it will be returned.

   Cathy Hughes, with the Treasury Department, indicates that issuing further guidance, particularly about issues for administering estates for 2010 decedents, is a high priority with the IRS and Treasury. Some of the issues that the IRS and Treasury have considered include the following (although there are no assurances that any of these particular issues will be addressed in the upcoming guidance).

   a. Carryover Basis Report Due Date. When will the carryover basis report required under §6018 be due? Section 6075(a) says that the return required by §6018 "shall be filed with the [decedent's final income tax return] or such later date specified in regulations…" Thus, the due date would be April 15, 2011 if the decedent's final income tax return is not extended, or October 17, 2011 if it is extended. However, the IRS may by regulations extend the filing due date. Decedents who die late in the year may be hard pressed to gather all of the information required for filing the report by April 15, 2011, and the Guidance may extend the due date of this report.

   b. Form. The IRS has reportedly been working on the form for the return due under §6018 since about July. There are regular conversations between the IRS National Office and the "forms and publications" staff. There have been some indications (from sources other than Cathy) that the form may be available sometime in November (which probably means December at the earliest). Part of the holdup on the form is that it cannot be released with instructions until some of the other substantive policy decisions have been made regarding the due date and various basis allocation issues.

   c. Appraisals. What kind of appraisal is needed? The basis is the *lesser* of the decedent's carryover basis or the fair market value at the date of death. In addition, the allocation of additional basis cannot be in excess of the fair market value of each asset, so appraisals of the date of death values are relevant. However, if an asset clearly has a value in excess of the carryover basis and of the basis adjustment being allocated to the asset, is a "full-fledged" appraisal necessary, or might a statement suffice that the value far exceeds the possible basis adjustment?

   d. What Property Qualifies for Basis Adjustments? The statute indicates that assets in a QTIP at the surviving spouse's death do not qualify. The statute is not clear about retained life interests. For example, if the grantor dies during the term of a QPRT, can basis adjustments be allocated to assets in the QPRT?

e. Selling Property Before Making Basis Adjustment Allocation. Can basis adjustment be allocated to an asset that is sold before the allocation is made? (We think the answer to this is yes, but Cathy did not hint what position the guidance will take.)

f. Default Rules. What if the estate is $2 million and should have filed a § 6018 return to make the basis adjustment allocations but does not do so. Does the estate lose all basis adjustments, or would a default rule provide basis adjustments even if no filing is made? How can there be a default allocation if the fair market value of the assets is unknown?

g. De Minimis Rules. Is there a need to allocate basis adjustment to the piano, for example, or should there be de minimis rules?

h. Holding Period. Does allocating basis to an asset change the holding period rules with respect to that asset in any way?

i. Who Files Basis Allocation If No Executor? If there is no executor of the probate estate, who files the §6018 return? For purposes of filing an estate tax return where there is no executor, the persons in possession of property file the return. How does that work for this report, for example, if there is a trustee of a revocable trust and a surviving joint tenant of joint tenancy property, who each want to allocate the $1.3 million basis adjustment to assets under his or her control? That issue will likely be included in the Guidance Notice.

j. Section 2511(c) Uncertainties. Section 2511(c) provides that gifts to non-grantor trusts will be treated as completed gifts. A charitable remainder trust cannot be a grantor trust, so §2511(c) literally appears to apply to charitable remainder trusts, so that the full amount contributed to the trust may be treated as a completed gift subject to gift tax (or at least the full value of the non-charitable interests in the trust). Will the guidance provide any relief for this unintended result?

k. Testamentary Charitable Remainder Trusts. The regulations provide that there must be a deduction available with respect to assets transferred to a CRT in order for it to be a qualified exempt CRT. Treas. Reg. § 1.664-1(a)(1)(i). There would be no such deduction this year for a testamentary CRT because there is no estate tax, and therefore no estate tax deduction. Will relief be provided?

l. Pecuniary Bequests From Revocable Trust. If a pecuniary bequest is satisfied with in-kind property from a probate estate, §1040(a) provides that gain is recognized only to the extent of post-death appreciation, and not with respect to pre-death appreciation for which there is no basis step-up. Will that same rule apply to assets in revocable trusts? (Section 1040(b) says that regulations may extend this rule to revocable trusts.)

9. Treasury Guidance Plan. Treasury's highest priority this year, in the estate and gift tax area, has been to provide guidance regarding the special 2010 issues. Cathy Hughes mentioned several other items, in particular, that are on the Treasury's Priority Guidance Plan.

a. Section 67(e). In particular, with respect to the §67(e) regulations, the IRS would like to avoid having to issue another notice, like it has the last several years, saying that trustee fees will not be subject to the unbundling requirements on 2010 returns.

b. Private Trust Companies. The private trust company guidance is "pretty far along" but meshing the income tax rules with the estate and gift tax rules has been complex and difficult.

Can You Keep a Secret? A Look at your Client's Confidentiality Privileges — Kurt Sommer and James Pressly

1. Privilege vs. Ethical Rule to Keep Confidences. The attorney-client privilege is an evidentiary privilege, which is different than the ethical rule to maintain client confidences.

2. Description of Attorney-Client Privilege. The best description of the attorney-client privilege comes from United States v. United Shoes Machine Corp., 89 F. Supp. 357, 358-59 (D. Mass. 1950):

   The privilege applies only if

   (1) the asserted holder of the privilege is or sought to become a client;

   (2) the person to whom the communication was made (a) is a member of the bar of a court, or the member's subordinate and (b) in connection with this communication is acting as an attorney;

   (3) the communication relates to a fact of which the attorney was informed (a) by the attorney's client (b) without the presence of strangers, (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and

   (4) the privilege has been (a) claimed and (b) not waived by the client.

3. Elements of Attorney-Client Privilege. The privilege applies to (a) a communication (b) between privileged persons (c) in confidence (i.e., no third party is present other than a representative of the attorney) (d) for the purpose of obtaining or providing legal assistance to the client (not, for example, such as providing investment advice or business advice). A limitation is that the privilege does not apply if the client will commit a fraud, tort, or crime.

4. Items Not Covered. The following are examples of things not privileged:

   - purpose of the engagement
   - persons present at meeting
   - date and time of meeting
   - participants at the meeting
   - location of the meeting
   - subject matter of the discussion (the substance of the advice is privileged)

   In discovery, the questioner will typically ask who was present at meetings, who heard the discussions, etc. The purpose of those questions is to determine whether privilege applies to the substance of the advice.

5. Privilege Belongs to Client. The attorney-client privilege belongs to the client and not the attorney.

6. Attorney-Work Product Description. The attorney-work product doctrine is distinguishable from testimonial privileges. (An important distinction is that it applies only after there is reasonable anticipation of litigation.) It is codified in rule 26 (b)(3) of the Federal Rules of Civil Procedure. It generally applies to materials that arose in anticipation of litigation or for trial. A party may seek to overcome the qualified protection by showing (1) substantial need for the materials and (2) inability to obtain the substantial equivalent of the information without undue hardship. Even so, an attorney's mental processes are protected from disclosure to the opposing party. The U.S. Supreme Court in Hickman v. Taylor, 329 U.S. 495 (1947) stated that an "attorney's thinking- theories, analysis, mental impressions, beliefs, etc.-- is at the heart of the adversarial system, and privacy is essential for the attorney's thinking; thus, the protection is the greatest, if not absolute, for materials that would reveal that part of the work product." However, documents or other

items that do not reflect the attorney's mental impressions are not protected by the work product doctrine.

Essential elements: (1) the work must be done in anticipation of litigation or for trial, and (2) mental and thought processes are covered and are not discoverable.

7. <u>Confidentiality in Will Contest Context</u>. A confidentiality ethics issue is raised in the following example. After an individual's death, a will contest is brewing but has not yet been filed. The estate planning attorney carefully documented competency and there is a string of wills cutting out the contestant. The attorney would like to disclose that evidence to head off the litigation. However the duty of confidentiality survives the death of the client. Florida Bar Ethics Opinion 10-3 (September 24, 2010) pointed to an exception when the attorney believes the disclosure could serve the client's interest. The personal representative could waive the duty of confidentiality, but what if there is no personal representative appointed yet? The opinion letter concluded that the lawyer could disclose the confidential information.

   Once a lawsuit has been filed, the ethical rules take a backseat to the evidentiary rules. The Evidence Subcommittee of the Fiduciary Litigation Committee has published a detailed paper entitled "Post Death Application of Attorney-Client Privilege Between Decedent and Counsel."

8. <u>Attorney-Client Privilege Where Two Parties Claiming Through Same Decedent</u>. About 30 states have a rule providing that if two parties claim through the same decedent, there is no attorney-client privilege. In states without a clear statutory provision, case law generally reaches the same result. Therefore, the attorney can testify about an event prior to death where two persons are claiming through the same decedent. This exception does not apply if there is an actual dispute against the estate. The privilege survives where there is a suit to recover under a contract against the estate (such as to recover on a prenuptial agreement in a divorce situation).

9. <u>Common Examples of Privilege Issues.</u>

   a. <u>Who Was Present</u>? Asking who was present at the meeting is appropriate, to determine if the privilege applies. It is well-established in all jurisdictions that if the attorney hires an accountant to assist in the case, and the lawyer and accountant both meet with the client, that does not compromise the privilege. (It is important that the purpose of the accountant attending is in connection with rendering legal advice.) In high-profile cases, a public relations person may be present at the meeting; courts have gone both ways as to whether that blows the privilege.

   b. <u>What Documents Did The Witness Review To Prepare for Deposition</u>? It is appropriate to ask what documents or papers were reviewed in preparation for the deposition. However, if the attorney gave the client a set of documents and said "these are important documents that I want you to review," that is privileged work product that does not have to be disclosed. In light of this general rule, it is not a good idea for the client to do too much self-help — interviewing witnesses, assembling documents, etc. If the attorney asks the client to prepare a memo of all the facts of the case, that is privileged. However, if the client just takes random notes, they may not be privileged. Similarly, interview notes by the client of prospective witnesses may not be privileged.

   c. <u>Request to Produce All Documents Relating to the Will in Question</u>. If there was a request to produce all documents relating to the will, the client must produce all documents, even if the lawyer has ferreted out the documents. However, if the question is to produce all documents that the client delivered to the lawyer, that would be privileged.

In many states, the attorney must list every document for which the attorney-client privilege or work product privilege is claimed, the date of the document, who it was to, a broad statement of the subject, and what privilege is being asserted. This can be burdensome. In some states, if that kind of privilege log is not maintained, the privilege is waived.

d. Where Did the Decedent Go After He Left Your House? Imagine a situation where the client tells the attorney in the initial conference that he did not know where the testator went after signing the will. However, the attorney found out in the discovery process that the decedent went to an attorney's office to discuss the will. The witness now knows where the testator went, even if he did not know on his own. The witness must answer that the client went to the attorney's office. If the witness is then asked HOW he found that out, that would be privileged. If the witness is asked WHEN he found out, that would not be privileged.

e. Attorney's Notes in Estate Planning File. For the most part, the attorney's notes are not privileged. However, many planning lawyers sprinkle their memos with comments like "the client is bright as a penny today," or "I'm concerned about the client, she should be interviewed by a psychologist." That statement is in anticipation of litigation, so the comment would be privileged as work product, and could be redacted. (That is a state by state determination.)

f. Can the Litigating Attorney be a Colleague of the Planning Attorney? There is disagreement on the ACTEC Subcommittee about whether the litigating attorney can be a law partner of the planning attorney if the planning attorney will be the main witness in the case. The rule in Alabama and Florida is that the partner can be the litigating attorney. However, that may lead to an uncomfortable situation when the planning attorney is on the stand. There will be an issue raised as to whether conversations between the witness and the litigating attorney are privileged.

g. Party Attempting to Disqualify Attorneys By Approaching Them About Being Hired. A contestant may call all of the top fiduciary litigating attorneys in the city to approach them about representing the contestant in the case. The contestant would tell them confidential information and then not hire them. The contestant would then try to disqualify them from representing the other side in the lawsuit. Many times that would be successful; an attorney does not have to be hired to be disqualified. Therefore, an attorney should be careful upon receiving a call like that to first make sure that there is no conflict, find out what court the action will be in, discuss with the client the appropriate hourly rates, etc. but not accept confidential information unless the attorney is satisfied that the client will hire the attorney.

10. Fiduciary Exception to Attorney-Client Privilege. The fiduciary exception provides that a fiduciary, such as a trustee of the trust, is unable to assert the attorney-client privilege against the beneficiaries on matters of administration. Some states recognize that exception (such as Delaware and New York) but a majority of courts do not. (California and Texas both have strong case law rejecting the fiduciary exception.)

Even in jurisdictions that applies the exception, it has limits. Advice given prior to any lawsuit is discoverable, but once litigation is threatened and the fiduciary seeks to obtain counsel to protect himself or herself, the attorney-client privilege should apply. Therefore, if there is a threat of litigation, document that at the beginning of the representation so that the privilege will apply.

In the states where the exception does not apply (such as California and Texas) the attorney-client privilege is not waived even if the attorney's fees are paid out of the trust, and whether the matter relates to matters of administration of the trust or the threat of litigation. The same applies for the work product doctrine. The panelist's outline quotes several cases giving the reasons for this position.

> The Supreme Court of California in Wells Fargo Bank v. Superior Court rejected the beneficiaries' argument that the trustee's attorney also represented the beneficiaries, stating: "The attorney for the trustee of the trust is not, by virtue of his relationship, also the attorney for the beneficiaries of the trust. The attorney represents only the trustee." 22 Cal. 4^{th} at 208, 990 P.2d at 598. The Supreme Court of Massachusetts in Spinner v. Nutt noted that an attorney must advise a trustee to make difficult decisions with regard to the latter's fiduciary duties, and declined to impose a duty on the trustee's attorneys running to the trust beneficiaries, reasoning that imposition of such a duty in light of the often divergent and conflicting interests of a trustee and trust beneficiaries would create conflicting loyalties that would "impermissibly interfere with the attorney's task of advising the trustee." 417 Mass. at 552, 631 N.E.2d at 544. The Supreme Court of Texas in Huie v. DeShazo found that, under Texas law, "the trustee who retained an attorney to advise him or her in **administering the trust** is the real client, not the trust beneficiaries." (Emphasis supplied.) 922 S.W.2d at 925… [T]he Supreme Court of Texas found that "[i]t would strain reality to hold that a trust beneficiary, who has no direct professional relationship with the trustee's attorney, is the real client." Huie, 922 S.W.2d at 925.

If a successor trustee is suing the prior trustee, rather than a beneficiary, the privilege may not protect against disclosure.

Anticipating the Audit Letter: Planning and Defending Against IRS Attacks on Entity Planning — Randy Grove, Patrick Green, Stephanie Loomis-Price

1. Consider Future Disclosure in All Oral and Written Communications. "Begin with the end in mind — i.e., the audit." Remember that everything the attorney says and writes may be published in a reported case. In the federal district court, even a jury might be looking at those communications. E-mail may be discoverable. Do not rely on the attorney-client privilege.

   In every §2036 case Stephanie has represented, they waived the attorney-client privilege and put the estate planning attorney on the stand. The primary issue is a subjective one — was there a substantive non-tax reason? The only person who knows why he or she formed the entity is dead. The attorney's files become critical in proving to the IRS that there was a substantive non-tax reason for creating the entity.

   (There is also a tax practitioner privilege that applies to CPAs and tax practitioners. It generally applies the same as the attorney-client privilege, except that it does not apply in tax shelter and criminal cases.)

2. Attorney-Work Product Doctrine. The attorney-work product doctrine is not as broad as the attorney-client privilege. It only attaches if there is a reasonable anticipation of litigation. In the Seventh Circuit, the audit letter is considered the "antechamber" of litigation, so all work after the audit letter is issued is covered by the work product doctrine. Is planning work that is done where an audit is anticipated even at the planning stage also covered by the work product doctrine? Courts are still considering that and we do not know yet.

3. Purpose of Entity. The purpose of the entity is the issue that planners are most often questioned about in audits. There is nothing better than to see contemporaneous evidence in the file of non-

tax reasons for forming the entity. There is nothing wrong with discussing tax effects in the course of discussing non-tax reasons. Non-tax reasons may not have a great deal of documentation — that may be because the client knew all too well the non-tax reasons (for example, that the daughter had been divorced three times already).

One approach of documenting non-tax reasons is to first ask the client what the client wants to accomplish. Then ask whether the client wants to accomplish that in a tax efficient manner or a non-efficient manner. (This approach has been attributed to Stacy Eastland.)

Helpful purposes include the following.

- Creditor protection (clients are often most concerned about this reason, but the courts give the least deference to it). Mirowski recognized various non-tax reasons, but not creditor protection. Black and Murphy did recognize creditor protection last year as a legitimate and significant non-tax reason for purposes of the §2036 bona fide sale exception.
- Divorce protection
- Management efficiency
- Holding legacy assets under a buy and hold philosophy.

Avoid "stock" non-tax purposes in the agreement that do not apply. The more the non-tax purpose provision in the agreement is tailored to the client, the better in upholding the partnership under §2036.

4. Qualification of Client for FLP. FLPs are not for everyone, in light of the potential for attack under §§2036 and 2038. Factors include:

- Client's financial independence from the entity
- Mental capacity of the client (creating the partnership under a power of attorney is not ideal; that has been mentioned critically in several cases, and the client must understand there is some additional risk if the partnership is created under a power of attorney.)
- Client's willingness to abide by terms and conditions of the partnership.

5. Qualification of Assets. Assets that are particularly appropriate include:

- Assets that can only be owned by those satisfying accredited investor or qualified investor rules where some of the partners might not qualify on their own
- Assets requiring active professional management
- Assets that can result in lowering investment costs by pooling
- Exclude the personal residence and other personal use assets (even if fair rental is paid, the IRS still raises objections if personal use assets are in the partnership).

6. Cash Flow Planning. Steps for avoiding §2036(a)(1) include:

- Involve the accountant or financial planner to prepare cash flow financial needs projections
- Retain sufficient assets outside of the entity to maintain the client's lifestyle
- To the extent feasible, retain assets to pay estate taxes outside the partnership (that was not required in Mirowski because the client's death was not anticipated).

7. Control Planning. As much as clients like to retain benefits, they like control even more. The client can retain management control, but cannot retain distribution control, even in a fiduciary capacity under the reasoning of Judge Cohen's decision in Strangi. Alternatives for avoiding §2036(a)(2) include:

- If the client must have any distribution input, the client would keep only limited distribution power under an enforceable standard subject to court review
- Use a special manager (an independent party that has authority over distributions; that was the situation in Byrum with respect to distributions made from the corporation; an example would be the retired CPA; do not use an employee or family member)
- Use a trust with an independent trustee as a limited partner.

8. Creation and Funding. "The reason for time is that everything doesn't happen at once." -Albert Einstein. Helpful steps include:

- Fully execute the partnership agreement
- Establish capital accounts from the inception of the partnership
- Do not delay in transferring assets into the partnership upon its creation
- Maintain a spreadsheet showing the date of establishment of capital accounts (Stephanie fights with the IRS often over capital accounts; the IRS does not consider the partnership income tax returns as the creation of capital accounts, and the tax return is often not filed for many months after the partnership is created; the capital accounts should reflect the proportionate value of assets contributed by each partner)
- Establish a bank account for the entity (many cases talk about not commingling funds)
- Record and list the assets being contributed by each partner on Schedule A to the partnership agreement (Stephanie said that half of the 300 FLP cases she has worked on did not have the schedule of assets attached to the partnership agreement and it had to be created after the fact; it is difficult to defend a "contract to contribute" concept if there is no list of assets attached to the agreement)
- Record deeds and title transfers.

9. Communications With Third Parties. In communications with third parties, be mindful of the attorney-client privilege. Communications regarding the creation of capital accounts would be fine. However, if a financial advisor referred the client to the attorney, and the attorney copies the financial advisor on all correspondence, the attorney-client privilege is probably waived.

10. Timing of Funding. Make sure that the entity is properly formed under state law before doing any funding or transfers. After the entity is formed, one planner advises clients to "let this simmer a little bit." Consider delaying discussions and documentation of gifts for some period of time after the partnership is created. In particular, defer substantive discussions regarding the amounts of gifts or drafting trusts as recipients of gifts of partnership interests.

    For avoiding the indirect gift and step transaction arguments addressed in Holman, a rule of thumb used by many is to delay six days to two months before making transfers of partnership interests.

    Holman and subsequent cases have pointed out three tests, all of which must be avoided to avoid application of the step transaction doctrine: (1) Binding commitment test (Holman reasoned that there was no binding commitment to make gifts); (2) End result test (logically, that should be avoided, because the children do not end up owning partnership assets); and (3) Interdependence test (which would not be avoided if the creation of the partnership and gifts were so intermingled that one would not stand without the other).

11. Respecting the Entity. Having meetings of partners and keeping minutes is not formally required. However, it is best to have meetings and keep minutes on a regular schedule. The more the FLP is treated and operated as a real business entity, the more likely it is to be respected in tax litigation.

12. Distributions — Avoiding §2036(a)(1). One approach is to allow distributions in the agreement under a standard enforceable in court. Do not make disproportionate distributions. Stephanie believes that the partnership is more defensible if there is a regular distribution history. However, another panelist suggested that less discount might be available if there are regular distributions. Furthermore, if distributions are mandated, there is not as much creditor protection. Various appraisers have told Stephanie that even if distributions are made quarterly, there is very little impact on the amount of the discount, and she prefers to see regular distributions.

13. Annual Exclusions. Having regular distributions also helps in establishing that a gift of a partnership interest is a gift to a present interest that qualifies for the gift tax annual exclusion. The Price and Fisher cases reflect that if the donee does not have regular and substantial distributions, or have use or possession of the assets, there will be a substantial attack by the IRS to disqualify a gift for the annual exclusion. (In Price, substantial distributions were made, but only in five of the seven years after the gifts, and the court held that did not constitute regular distributions that satisfied the present interest requirement.)

14. When to Involve Litigator. After the audit begins, involve a litigator as early as possible. However, if the litigating attorney is involved at the planning stage, the litigator will likely be a witness so would be conflicted out of being the litigation attorney.

Current Developments in Asset Protection Planning Strategies — Barry Nelson, Gideon Rothschild, Nancy Roush

1. Creditor Protection Problems With Inherited IRAs.

   a. Overview. In many states, inherited IRAs are NOT protected from claims of the beneficiary's creditors. Planning possibilities may be to have the IRA beneficiary be a spendthrift trust to pick up creditor protection through the trust. An article regarding creditor protection for inherited IRAs will appear in the Fall 2010 issue of the ACTEC Journal.

   b. Differences Between Regular and Inherited IRAs. There are various differences between regular and inherited IRAs. For example, contributions can be made to regular IRAs but not inherited IRAs. For regular IRAs, distributions cannot begin before age 59 and must begin at age 70 ½, but for inherited IRAs in some situations distributions must start within one year of death, and there is no limit on when the amounts may be withdrawn. Both regular and inherited IRAs are exempt from income taxation until assets are distributed.

   c. Cases Finding Inherited IRAs Are NOT Exempt From Beneficiaries' Creditors' Claims. In reviewing creditor protection cases, realize that some states opt out of the federal exemption system, and that only state exemptions are available in those states. Some cases apply federal exemptions and others apply state exemptions. Most states have not allowed a creditor exemption for inherited IRAs; there is not a big sentiment in legislatures to protect a beneficiary who receives, for example, a $1 million windfall in an inherited IRA.

      In re Sims, 241 B.R. 467 (Bankr. N.D. Okla. 1999) — apply Oklahoma exemption, not exempt because inherited IRAs do not qualify for special tax treatment under the Internal Revenue Code (this makes no sense; after all, the IRA is exempt from income tax until assets are withdrawn).

      In re Greenfield, 289 B.R. 146 (Bankr. S.D. Cal. 2003) — apply California exemption, not exempt because inherited IRAs do not have to be held until the retirement of the beneficiary.

In re Navarre, 332 B.R. 24 (Bankr. M.D. Ala. 2004) — apply Alabama exemption, not exempt because the Internal Revenue Code distinguishes regular and inherited IRAs.

In re Taylor, Bank. No. 05-93559, 2006 WL 1275400 (Bankr. C.D. Ill. May 9, 2006) — apply Illinois exemption, not exempt because the Internal Revenue Code distinguishes regular and inherited IRAs.

In re Kirchen, 344 B.R. 908 (Bankr. E.D. Wis. 2006) — apply Wisconsin exemption, not exempt because payments under inherited IRA are not on account of age.

In re Jarboe, 365 B.R. 717 (Bankr. S.D. Tex 2997) — debtor elected to apply Texas exemption, not exempt, based on differences between regular and inherited IRAs, particularly, that distributions could be taken at any time without penalty.

Robertson v. Deeb, 16 So. 3d 936 (Fla. 2d DCA 2009) — apply Florida law, not exempt, Florida statute provided that "money or other assets payable to an owner, a participant or beneficiary" are exempt from "all claims of creditors" if held in a "fund or account" maintained as an IRA exempt from taxation, reasoned that the different tax consequences of inherited IRAs and moving the money to a new account resulted in the creation of a new unprotected account.

In re Chilton, 2010 WL 817331 (Bankr. E.D. Tex March 5, 2010) — debtor elected federal exemption, not exempt, because inherited IRA not intended for retirement purposes.

In re Klipsch, 2010 WL 2293957 (Bkrtcy S.D. Ind. 2010) — apply Indiana exemption, not exempt because inherited IRA cannot be rolled over and is not a retirement plan.

d. Cases Finding Inherited IRAs ARE Exempt From Beneficiaries' Creditors' Claims

In re McClelland, Bank. No. 07-40300, 2008 WL 89901 (Bankr. D. Idaho. Jan. 7, 2008) — apply Idaho exemption, exempt because the exemption was not meant only to "protect retirement money earned and held by the account owner," and the legislature did not limit the exemption to the person who opened and contributed to the account.

In re Nessa, 2010 Bankr. Lexis 931 (B.A.P. 8th Cir. Apr. 9, 2010) — debtor elected federal exemption which includes "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under sections" of the IRC, exempt because the transfer to the inherited IRA was a trustee-to-trustee transfer and so retained its character as retirement funds.

In re Tabor, 2010 WL 2545524 (Bkrtcy M.D. Penn. 2010) — debtor elected both Pennsylvania and federal exemption, exempt, under reasoning that the state and federal exemptions were the same for this purpose and the court followed the rationale of In re Nessa.

Ohio case (not in outline) — Ohio exemption applied, court reasoned that the inherited IRA would not be exempt under the Ohio exemption but it would under the federal exemption, and it allowed the exemption.

e. Which State Law Applies? The law of the state where the inherited IRA beneficiary resides at the time of filing for bankruptcy applies.

f. Spousal IRAs. All of the cases cited above involve children, not spouses. If a spouse elects inherited IRA treatment, it would seem that the rationale of those cases would apply to spouses as well. However, a spouse can choose to treat the IRA as his or her own IRA, and if the spouse does so, the regular IRA rules would apply to provide creditor exemption.

g. Using Spendthrift Trust as IRA Beneficiary. Use a spendthrift trust as the beneficiary to get the creditor protection of a spendthrift trust. A design question is how the trust is structured to avoid the five-year distribution rule. There are two possible alternatives, a conduit trust or an accumulation trust.

(i) Conduit Trust. A conduit trust provides that any withdrawals from the IRA to the trust must be distributed to the beneficiary of the trust. It is simple to write and foolproof. Distributions carry out DNI to the beneficiary, so the beneficiary is taxed rather than the trust. With a conduit trust, it is possible to use powers of appointment to provide flexibility. For a 10-year-old beneficiary, very little comes out each year that creditors could reach. Can the trust provide that distributions could be paid for the benefit of the beneficiary? The trust could then make payments directly for the beneficiary's benefit and creditors could not reach the distribution in the beneficiary's hands. Furthermore, in the bankruptcy context, conduit trusts are advantageous because the beneficiary could receive a discharge in bankruptcy so that future distributions would not be reachable by creditors.

There is uncertainty as to whether the "pay to or for the benefit of the beneficiary" approach risks the trust not being a conduit trust. Regulations do not specifically address this issue (although interestingly, in the marital deduction area, it is clear that the mandatory income distribution requirement can be satisfied by permitting payments for the benefit of the spouse). PRACTICAL POINTER: Draft the trust to rely upon a facility of payment clause rather than a direct "pay to or the benefit of the beneficiary" provision and include a savings clause that the trustee can do whatever is necessary to qualify the trust has a designated beneficiary.

(ii) Accumulation Trust. The required minimum distribution can be accumulated in the trust, so there is more protection against creditors' claims. However, drafting is more critical for accumulation trusts to assure that they qualify for designated beneficiary treatment. For special-needs beneficiaries, an accumulation trust is typically used.

h. Investing Inherited IRA in Annuities. Under some state laws, annuities are protected against creditors' claims. What if the inherited IRA is invested in an annuity so there is double potential protection? A possible concern is that if the beneficiary already has creditors when the beneficiary recommends that the IRA invest in the annuity, the investment might possibly be treated as a fraudulent conveyance.

2. Potential for Attorney Liability. In some states, attorneys cannot be held liable for asset protection planning, but in other states they clearly can be liable.

3. SEC v. Solow: Contempt Action to Urge Distribution From Foreign Trust to Enforce Disgorgement Order.

a. Basic Facts. In 2004, the SEC notified Mr. Solow that it would inquire about alleged fraudulent investment schemes. Shortly thereafter, Solow transferred to his wife a corporation that owned his home. In 2005, the SEC issued an intention to sue. In July 2006, Solow transferred valuable real estate in Utah to his wife. During 2006, many claims were filed alleging $15 million of damages. Later, the SEC sued for disgorgement of profits from the fraudulent trades. In January, 2008, on the eve of trial, Solow transferred more securities to his wife.

Later in 2008, the wife hired a lawyer to create a foreign asset protection trust. With her husband's consent, she placed $6 million of mortgage liens on the house and transferred to $6 million of loan proceeds to the foreign trust. (No bank would loan 100% of value of the home, so the loan was obtained from a bank affiliated with the trustee. The loan proceeds passed directly to the Cook Islands trustee.)

Later in 2008, there was a jury verdict for $6 million in a judgment of disgorgement. In June 2009, the SEC filed a motion to hold Solow in contempt for not making payment. His defense was that the transfer was of exempt assets, i.e., tenancy by the entireties property (but tenancy by the entireties could not apply to a house owned by a corporation rather than by the spouses directly).

b. Holding. A disgorgement order is more like an injunction than a money judgment. Disgorgement orders, unlike judgments, can be enforced by contempt and are not limited by state law exemptions. (SEC v. Nicewiler, 580 F.3d 869 (2009) held that the IRA exemption does not apply in a disgorgement case.)

c. Enforcement. Solow was jailed in 2010. He appealed and said that if released he would find a way to make payment. He was released for 30 days on the condition that he makes payment. The panelists have not heard what happened after that.

d. Action Against Wife. The wife has been named in a separate action on a fraudulent transfer charge. That case has not yet been tried.

e. Lessons From the Case. In asset protection planning for clients, make sure there are no clouds on the horizon. (This is the same whether the case is a disgorgement or fraudulent transfer matter.) Do the proper due diligence. If the client is already being sued, analyze whether the client's spouse received assets that he or she wants to transfer to a foreign trust and make sure that it is not simply a continuation of a fraudulent transfer by the client.

There is also a "pigs get fat and hogs get slaughtered" lesson. Solow transferred every single asset he owned to his wife and she transferred every single asset to the foreign trust. That creates tremendous suspicion as to their intentions.

4. Domestic Asset Protection Trust Statutes and New Florida Statute. There are now 12 states that have domestic asset protection trust statutes permitting self-settled asset protection trusts with the settlor as a discretionary beneficiary. The latest is Hawaii. One of the requirements under the Hawaiian statute is that no more than 25% of the settlor's net worth can be contributed to the trust. A very distinctive requirement is that the settlor must pay a 1% transfer tax on all assets being transferred to the trust. No other state requires that, so few people will use the Hawaii statute. (This statute may still be helpful for Hawaiian residents who create a domestic asset protection trust under the laws of another state; if a creditor argues that the exemption protection is not entitled to full faith and credit, the Hawaii resident could argue that the statute of the other state is not contrary to the public policy of Hawaii in light of its own domestic asset protection trust statute.)

5. Letter Ruling 200944002 Approving Transfer to Alaska Trust as Being Excludable From Settlor's Gross Estate Under §2036. If an individual transfers an asset to a trust in which there is no retained interest, but under state law creditors can reach the assets merely because the person is a discretionary beneficiary, the assets are includable in the individual's estate under §2036. Is the

reverse true? If a trust for which the settlor is a discretionary beneficiary is settled in a state in which the settlor's creditors cannot reach the assets, and the settlor keeps no other rights to retain use and enjoyment or to dictate who can use the assets (such as a power of appointment) is there no inclusion under §2036?

a. Prior Rulings.

- Revenue Ruling 76-103 held that a transfer is incomplete if the grantor's creditors can reach the trust assets.
- PLR 9332006 addressed a foreign trust, where there was a representation that the grantor's creditors could not reach the trust assets. The IRS ruled that it was a completed gift and was excluded from the gross estate.
- PLR 98307007 addressed similar facts regarding an Alaska trust. The IRS ruled it was a completed gift but would not rule on the §2036 issue, reasoning that it depended on the facts and circumstances at the time of death.
- Revenue Ruling 2004-64 addresses a tax reimbursement clause for the grantor of the grantor trust to be reimbursed for income taxes attributable to the trust. A mandatory reimbursement clause causes §2036 inclusion, but if the trustee merely has discretion to reimburse the grantor AND if under local laws such discretionary right does not result in creditor attachment rights, then the trust would not be includable under §2036.

b. PLR 200944002. The IRS relied on Rev. Rul. 2004-64. PLR 200944002 concluded:

> [B]ecause the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, the Grantor has not retained a reimbursement right that would cause Trust corpus to be includable in Grantor's Gross estate under § 2036. See Rev. Rul. 2004-64. In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause Trust corpus to be includible in Grantor's gross estate under § 2036."

The ruling added a caveat:

> We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.

c. Applicability in Other States. Alaska and Nevada are distinctive among the domestic asset protection trust states of having no "exception creditors" that can reach the trust assets in particular circumstances. Will the same results apply in a state where certain creditors could reach the trust assets in particular circumstances?

d. Giving Strategy For 2010. A risk with making a gift in 2010, to take advantage of the 35% rate, is that the client may die before the end of the year and pay gift tax unnecessarily. An alternative is to transfer assets to a domestic asset protection trust, retaining a testamentary power of appointment until just before December 31. On or near December 31, the grantor could release a testamentary power of appointment to complete the gift. This keeps the ability to delay the decision of whether to make a completed gift and also allows the flexibility to receive discretionary distributions.

6. Creditor Protection for Florida Single-Member LLCs, Olmstead. Olmstead v. FTC, 2010 Fla. LEXIS 990, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010) concluded that the charging order is not the exclusive remedy for an LLC under Florida law, reasoning that the Florida limited partnership statute specifically provides that the charging order is the exclusive remedy of creditors for limited partnerships, and there is no similar provision in the LLC statute.

Under the facts of the case, the debtor had transferred substantial assets to a single-member LLC. A dissenting opinion pointed out that the court's reasoning could be applied to all LLCs, not just single-member LLCs. A Florida Bar task force is urging passage of a measure that would provide that the charging order is the exclusive remedy for LLCs as well as limited partnerships, except for single-member LLCs. If that passes, Florida will be the only state that explicitly distinguishes single-member and multi-member LLCs for creditor protection purposes.

If the laws of a particular state do not provide that the charging order is the exclusive remedy for LLCs, clients with multi-member LLCs in that state might consider converting the LLC to a Delaware LLC. Delaware law specifically provides that the charging order is the exclusive remedy of creditors of members of the LLC.

Wyoming is the only state that specifically provides that the charging order is the exclusive remedy for both single-member and multi-member LLCs. If a client insists on using a single-member LLC for protection purposes, consider moving the LLC to Wyoming.

Interesting aside: Tax Court cases give short shrift to asset protection as a legitimate and significant nontax reason for purposes of §2036. If partnerships or LLCs are created in Wyoming or somewhere where the charging order is the sole remedy, perhaps that creates a stronger argument that asset protection is a key purpose of the entity.

7. Inter Vivos QTIP Trusts. If one spouse (say, the husband) creates an inter vivos QTIP trust for the other spouse (say, the wife), the trust could provide that if the wife dies first, the remaining assets would pass into a trust of which the husband was a discretionary beneficiary. For estate tax purposes, the wife is treated as the transferor of the trust (since the trust assets are included in the wife's estate under §2044 so she is treated as the transferor of the continuing trust, not the husband-original donor spouse). Therefore, §2036 would not cause inclusion in the husband's estate at his subsequent death. Even though the original donor-spouse is not treated as the transferor for federal estate tax purposes, would that same result necessarily apply under state law for creditor purposes? Arizona, Delaware, Florida, and Michigan have all passed laws providing that the original donee-spouse will be treated as the settlor of the continuing trust for creditor purposes. (The Florida statute is FL. STAT. § 736.0505(3).

What if each of the spouses creates reciprocal inter vivos QTIP trusts for each other? There may be a possibility of avoiding the reciprocal trust doctrine by using different terms. Would that apply for state law purposes also?

Practical Issues Arising During Trust Administration — Trent Kiziah, Donna Barwick, Tami Conetta, James Bertles and Mary Ann Mancini (Moderator)

All of the panelists other than Mary Ann Mancini are now trust officers. They address difficult practical issues that arise during the administration of trusts.

1. Outrageous Requests. It is not unusual for trustees to receive rather outrageous distribution requests. For example, a beneficiary requests a distribution of $85,000 to purchase a Porsche. What are the standards that the trustee uses to make that decision? There is always the one beneficiary that quits his job, shops for a new house, buys a new car, and comes to the trustee

requesting a standard of living more appropriate for his station in life now that he is a beneficiary of this trust.

Actual case: A beneficiary requested a Turbocharged Porsche and had a letter from a doctor saying that he needed it for health reasons — for back support. (Another panelist quipped — maybe it was a middle-aged man who needed it for mental-health.)

Actual case: A trust officer questioned whether the trust should make distributions for private jets for the beneficiary. The estate tax return reflected the assets in the estate when the trust was created, but it did not indicate how often the family flew in private jets. The beneficiary responded: "My husband would roll over in his grave if he knew how difficult you were making my life." The children say the same thing — because the trustee is too liberal in making luxury distributions. The officer responds: "My conclusion — I will never visit that graveyard. There's too much rolling around."

2. <u>Removal Powers</u>. Does the trust officer consider removal powers in making these decisions? One officer relayed an actual situation. Upon beginning at the trust company, the trust officer received an e-mail from a colleague in a satellite office: "I want you to understand that this is the single largest trust in our office. If you don't grant her request, she will remove us and we will lose $150,000 of annual pressure on the young trust officer. Did that have any impact on the objective analysis of the decision? (The officer asked the other panelists: "Have you had similar pressure or will sit it up here and lie today?")

Despite the practical implications, trust officers cannot consider removal powers in making these kinds of decisions. (The counterargument is that the grantor gave the beneficiary a removal power to convince the trustee to be liberal in making distributions.)

Practical drafting questions for removal powers:

- Who should hold the power? Not the sole or primary beneficiary — that is the beneficiary who wants a distribution for a Porsche who will forum shop until the distribution is made. However, primary beneficiaries typically are named as the removers.
- Better choices: trust protector, independent party, lesser beneficiary, group of beneficiaries, joint decision of discretionary beneficiary and remainder beneficiary.
- An alternative: Put limits on the number of times that the removal power can be exercised.

3. <u>Health, Education, Support and Maintenance Standard</u>. Section 50 of the Restatement (Third) of Trusts says that "health" is consumed in "support." Furthermore, "support" and "maintenance" are synonymous. Therefore, these words are really just two words, "support" and "education."

The Treasury regulations referring to support and maintenance say that they are not limited to the bare necessities of life. However, none of the beneficiaries of trusts that the officers work with are ever worried about the bare necessities of life. Those types of requests are routinely granted. Only requests for luxuries bring a detailed review by a review committee.

a. <u>Additional Information Needed</u>. If the trust for the beneficiary who is requesting the $85,000 distribution for a Porsche has a HEMS standard, how does the trust officer know whether an $85,000 distribution for a Porsche is within the support definition? The trust officer would consider other information such as the wealth of the family, the grantor's underlying intent, the age of the beneficiary, when the trust terminates, whether the trust terminates in favor of the beneficiary, the size of the trust, etc. Did the beneficiary's father give the beneficiary a Porsche when he graduated from college or has he been driving a modest car? If the latter, the beneficiary probably will not get a distribution for a Porsche even if it is a very large trust.

b. Health. The Restatement cites no cases defining the term "health." The grantor's frame of reference regarding health related distributions is often not provided. (For example, is elective cosmetic surgery included?) The Restatement says that payment of health insurance premiums is generally included within a "support" standard.

Drafting Example:

> The Trustee shall distribute principal to or for the benefit of any Beneficiary for such Beneficiary's health needs, as provided below:
>
> (a). The health of any Beneficiary shall be met in full, regardless of financial need, provided that when requesting such principal the Beneficiary can show that he or she (i) obtained what the Trustee considers to be adequate health insurance and such distribution covers only the cost of uncovered health expenses, or (ii) attempted to obtain health insurance and was determined to be uninsurable.
>
> (b). Health needs shall not include elective cosmetic surgery unless such surgery is recommended as a result of an injury, accident, illness, disease or other medical reason (such as, reconstructive surgery after cancer treatment).
>
> (c). Health needs shall include costs incurred as the result of infertility and the costs of adoption, but only to the extent of fifty thousand dollars ($50,000) per Beneficiary during his or her lifetime. Such dollar amount shall be adjusted, upward or downward, for changes in the cost of living indices, as announced by the applicable governmental agencies, beginning in the year after the year in which this Trust Agreement was executed.

c. Education. The term "education" by itself provides limited insight into the nature and degree of education intended by the grantor. Does the term include kindergarten private school tuition? Grammar, secondary, and high school tuition, fees, activities fees? Post-graduate school? Medical school, law school, and other professional school expenses? Support of beneficiary during the school year? Support of the beneficiary between semesters and between school years? Extended post-graduate studies for the student who makes a career out of learning? Technical school training? Career training such as a cooking school? A year of college in Europe as part of a university program? Traveling the world as part of studying world culture?

Assume grandparent creates a trust for grandchildren for the primary purpose of providing for education. After a grandchild reaches age five, his or her parent asks the trustee for private school tuition. Is the intent to relieve the parent of his or her legal obligation to provide support? Private school may not be in the legal obligation to support. However, the grandparent probably was considering college first and foremost in providing for education. (There is a very popular private school in Atlanta. The school says that half of the tuition payments come from grandparents.)

Drafting Example. The outline has several detailed drafting examples. The shortest of the drafting examples follows.

> The term "education" shall include, but not be limited to, attendance at elementary, junior high, secondary, vocational, college, graduate and/or professional schools, whether public or private. The Trustees should do all things

necessary to ensure such beneficiary receives a reasonable education. Educational expenditures shall include, but not be limited to, expenditures for tuition, books, lodging, food and a reasonable allowance. The failure of any such beneficiary to apply himself or herself to his or her studies, as evidenced by failure to attain passing grades, shall constitute sufficient cause for the refusal on the part of the Trustees to authorize further advancements from income or corpus on account of education. It is my intention that this trust pay for the expenses associated with study abroad for one year provided it is part of an established curriculum of the college and university or graduate school the beneficiary is attending. This trust is not established to provide support for a beneficiary to attend school for his/her entire life. Eventually, the beneficiary should choose a career and begin employment.

d. Support and Maintenance. The Restatement (Third) of Trusts §50 takes the position that the following distributions are generally encompassed in a support and maintenance standard: (1) regular mortgage payments; (2) property taxes, (3) suitable health insurance or care, (4) existing programs of life and property insurance, (5) continuation of accustomed patterns of vacation, (6) continuation of family gifting, and (7) continuation of charitable giving.

Borderline cases are: (1) reasonable additional comforts or luxuries, and (2) special vacations of a type the beneficiary had never taken before.

Not included in the standard, according to the Restatement, are: (1) payments unrelated to support that merely contribute to the beneficiary's contentment or happiness, (2) distributions to enlarge the beneficiary's personal estate, and (3) distributions to enable the beneficiary to make extraordinary gifts.

Drafting Example.

I'm establishing this trust to provide for my son, whom I dearly love. At the time I sign this will, my son is gainfully employed. I believe it is important that my son continued his employment for both fiscal reasons and the psychological benefits a job provides. It is my intention that this trust supplement the income he receives from his employment. It is not my intention for my son to rely upon this trust as his sole source of financial support until his retirement at an age individuals generally receive Social Security, currently age 65. It is my desire that this trust be primarily invested for growth rather than the production of income. It is not my intention for the assets of this trust to be conserved for the benefit of remaindermen. On the contrary, my primary purpose in creating this trust is to provide for my son. The rights and interests of remaindermen are subordinate and incidental to the interests of my son in this trust.

4. Additional Guidance Needed. The essential message of the panelists is to encourage attorneys to spend more time addressing what the grantor would intend under various circumstances.

Actual case: A $3 million trust provided discretionary invasion provisions for a 56-year-old beneficiary who had provided his own support his entire life without support from his mother. When the trust officer discussed limitations on support distributions, the beneficiary replied that "what you're asking me to do is quit work so I will need support distributions." The officer concluded that at least the income should be distributed to the beneficiary, and that the mother would have wanted to make some distribution to him rather than to encourage him to quit working. (Observe that the trust was only $3 million. How much time does the grantor want the attorney to spend on drafting the distribution guidelines for a $3 million trust?)

One panelist observed: "When I was in private practice I spent 99% of my time on saving the 45% estate tax and little time on the remaining 55% that would remain."

5. Unlimited Discretion. Some trusts use a "sole and absolute discretion" provision with no further standard. That allows maximum flexibility to deal with changing circumstances. Some clients are concerned with that approach; the client may be happy with the current trust officer but does not know who will be making decisions in the future. Clients often want to provide significant guidance rather than just giving the trustee unlimited discretion. (Many clients are so controlling they would never give anyone unlimited discretion.) Giving trustees wide discretion but with guidance seems to be a workable approach.

6. Incentive Trusts. Incentive trusts are an alternative regarding distribution guidance, but they may be inflexible.

7. Letter of Wishes. A detailed Letter of Wishes, prepared by Jonathan Blattmachr, is attached as an appendix to the seminar outline. The purpose of the Letter of Wishes is stated early in the form:

> Without in any way limiting the sole and absolute discretion of the Distribution Trustee, the Grantor offers the following thoughts about eligibility for benefits from the trust created hereunder. Although these thoughts are only precatory expressions of the Grantor's general intent, it is the Grantor's hope that the Distribution Trustee and the beneficiaries will find them useful and will take them into serious account in administering the trusts created hereunder."

(This document is also available on the ACTEC website: CLE Materials/National Meeting CLEs/2008 Annual Meeting/Item 5 Symposium I (page 5). This seven page form includes the following divisions: Family Statement, Disqualifications, Alternative Financial Resources, Tax Effects of Distributions and Benefits, Excessive Lifestyle, Education, Health, Support, Special Activities and Events, Matching Funds, Business Ventures, Distributions to Beneficiaries, and Maximum Distribution.

a. Part of Trust Agreement? The moderator (and I assume most attorneys who draft trusts) prefer that this be an informal side document for guidance and not a part of the trust agreement. Most of the panelists expressed a preference that the Letter of Wishes be a part of or incorporated into the trust agreement. The key issue is whether the letter of wishes can be used to support the trustee's decision if a beneficiary disagrees with that decision. (The Uniform Trust Code §103(18) says that the trust is not just the trust agreement but includes other evidence reflecting the settlor's intent. The classic black letter rule is to look only at the four corners of the trust instrument unless there is an ambiguity. Has the Uniform Trust Code changed that?) Even if the Letter of Wishes is not in the trust document, trust officers prefer as much guidance as possible. Another alternative is a letter directly from a parent to the child saying what the parent wants for the child.

   If the Letter of Wishes is not explicitly incorporated into the trust agreement, does that happen anyway as a matter of law? The issue is addressed in Alexander A. Bove, Jr., *The Letter of Wishes: Can We Influence Discretion in Discretionary Trusts?* 35 ACTEC J. 38, 39 (Summer 2009).

b. Who Prepares? Some attorneys have the client prepare the initial draft of the letter of wishes, but other attorneys prepare an initial draft for the client.

c. Disclosure. May (or must) the trustee disclose the Letter of Wishes to the beneficiaries? A reporter's comment to the Restatement (Third) of Trusts §82 (comment a) maintains that the beneficiaries should have a right to see not only the trust agreement but also the letter or memorandum of wishes "(subject to exclusion of any material considered confidential, e.g., relating to the mental or physical health or marital problems of another person interested under the trust)." However, Alexander Bove's article disagrees with those comments and believes that if the letter is not binding on trustees it would not be discoverable by beneficiaries.

8. Consideration of Outside Resources. If there is no direction in the trust agreement, should the trustee consider outside resources? Sometimes documents do address this issue, but often they are that the trustee "may but need not" consider outside resources (which gives little guidance as to the settlor's intent). The Restatement (Second) of Trusts said that the trustee did not have to consider outside resources, but the Restatement (Third) of Trusts says that the trustee should consider outside resources if the document is silent on the issue. Florida case law says to consider income but not other resources. There is no clear uniform law.

An article by Prof. Ed Halbach in 1961 said that no trust should be drafted without answering the basic question of whether outside resources should be considered in making discretionary distribution decisions. However, many trust agreements do not address this at all.

Actual case: When one of the panelists asked a beneficiary for financial information, the beneficiary responded "I have never been so offended in my whole life. My dad would never have wanted me to release this confidential information. Your four prior trust officers never asked for that." The trust officer told her "the policy changed."

The Restatement says that the trustee can rely on what the beneficiary gives the trustee without performing outside investigation. (However, one officer had a case where a spendthrift beneficiary said he needed money to lease property. The trust officer looked at the public records and found that his wife already owned the property.)

For a minor beneficiary, are the parent's resources considered?

9. Accustomed Manner of Living. The "accustomed manner of living" standard is not static but changes over time. This ultimately depends on the settlor's intent, as to whether the standard at the time the document became irrevocable or at the time of the settlor's death is the appropriate standard, or whether it is an evolving standard. The Restatement (Third) of Trusts says that the standard can change over time.

Actual case: A trust was distributing $1.2 million annually to the beneficiary. The distribution amount had remained static over a number of years. While the trust had grown substantially, the yield on trust investments had declined and the amount of trust income had remained about constant. The beneficiary told the trust officer that she was turning down dinner invitations because $1.2 million was not sufficient to maintain her standard of living. She wanted the trust to reimburse her for her $350,000 Rolls Royce that she had bought the day before. How does the trustee determine the standard of living at the time of her husband's prior death? (In that case, the bank knew that the beneficiary had other resources, because she had another $20 million individual account at that bank. She withdrew the $20 million individual account when she found out the trustee was reluctant to make the distribution for the Rolls Royce.)

10. Pot Trust With Multiple Beneficiaries. Grandparent creates a trust for grandchildren when there is originally only one grandchild, but later there are various additional grandchildren. There are no separate shares and no requirement that distributions be equalized. Perhaps the trust has

$500,000 and the first beneficiary to reach college age wants to go to an Ivy League school that will cost $400,000. What does the trustee do?

One trust officer-panelist does not like pot trusts. Unless there is language about priority or preferences in the agreement, the trustee has a duty of impartiality to all beneficiaries. The Bogert on Trusts treatise says that the trustee would have to make equal distributions to all beneficiaries.

Another panelist tells clients who want pot trusts that they will likely lead to family disharmony. If one child is successful and another "marries someone for love rather than money" and has no money to educate his or her children, a pot trust will often result in hard feelings among family members.

The advantage of pot trusts is that they reflect how the family manages money while the parents are alive. If one child has greater needs than the others, those needs get taken care of. A classic structure is to use a pot trust until the youngest child reaches age 25. No child has a right to pro rata distributions during that timeframe, but at the termination (the typical age that all of the children would be through college) the remaining assets are then divided equally.

First come first served? No, the trustee gives consideration to the anticipated needs of all discretionary beneficiaries. Otherwise, the youngest beneficiary may not have any funds for education. This is a constantly moving target.

11. Drug Provisions. Some trusts provide that no distributions may be made if the beneficiary uses illegal drugs. (One panelist quipped "how does that work in California?") These provisions are difficult to administer. They are well intended, but if the trustee is making weekly distributions, the beneficiary may spend a lot of time in the clinic giving urine samples.

    With urine tests, drugs generally stay in the system only about four days. Hair tests show the existence of drug use over a longer period of time.

    Actual case: One officer had a situation where a suspicious beneficiary repeatedly passed urine tests. Upon inquiry, the clinic told the officer that it always told the beneficiary when the test would be performed. The officer told the beneficiary that a hair test would be needed. The beneficiary showed up at the clinic on his next testing date with absolutely no hair on his entire body. The beneficiary said he was a swimmer and the hair slowed him down.

Mediation and Alternative Dispute Resolution from the Inside Out: What Every Estate Lawyer Needs to Know — Gerard Brew, Steve Hearn, Bob Sachs

1. Flexible Alternatives. Dispute resolution can be very flexible. It includes more than just mediation and arbitration. For example, a private family wanted to avoid the front page of newspapers. When a complex dispute arose, the parties selected a private trial judge and private appellate panel. The parties knew they would have an outcome with an appellate review. The trial judge served about one year in that situation.

2. Common for Entities. The governing documents for entities very often will have mediation or arbitration provisions. In the estate context, in many situations much of the estate assets have moved to entities and that's where the action is in any event.

3. Mediation Description and General Overview. Mediation is an assisted settlement process. The parties are generally present and there is a neutral third-party moderating the discussion. Litigation is expensive, time-consuming, and the outcome is very unclear. Mediation allows the parties to tell their stories, certainly to the mediator and often to the other side. It does not just involve the lawyers talking settlement. Mediation is also helpful if the opposing counsel is not

familiar with trust and estate cases. It can be helpful to have a neutral third party to give guidance as to what will happen in trust and estate litigation.

Mediation allows the parties to be creative. Things can be accomplished that cannot be accomplished in litigation even if your side wins the lawsuit. For example, there can be creativity with tax issues.

One side effect of mediation is that it has had a chilling effect on the old-fashioned way of settling cases. Parties are now geared to the more formal settlement process.

In 1998, Los Angeles started a mandatory mediation program. The effect was that people started talking settlement at a very early stage in the case. Over 80% of the cases settled — and at a very early stage. The parties can settle before they have invested so much in their cases, which makes it harder to settle.

Confidentiality. The entire mediation process is confidential. Nothing that is said in the mediation can be used in any further judicial proceeding, except that the settlement document itself is admissible in a court proceeding to enforce it.

4. Arbitration Description and General Overview. In arbitration, a neutral third person considers the facts and renders a decision that may be binding or nonbinding. In contrast, in mediation, decision-making authority rests with the parties, and the mediator merely assist the parties in identifying issues and exploring settlement alternatives.

   a. Discovery. The arbitrator(s) will control the discovery process, rather than allowing an "all out war" discovery that so often happens in litigation.

   b. ACTEC Arbitration Task Force Report. A detailed study of the use of arbitration in trusts and estate disputes was prepared by an Arbitration Task Force of ACTEC. It is an excellent comprehensive report. An excerpt from the report is attached to the seminar outline. An article about using arbitration in trust and estate matters was published in the ACTEC Journal. Logstram, *Arbitration in Estate and Trust Disputes: Friend or Foe?* 30 ACTEC J. 266 (Spring 2005).

   c. Selection of Arbitrator. The parties have the ability to choose the arbitrator, and often that does not happen with court mandated mediation. The parties can select someone who they know is well-qualified. For example, a panelist said that he would rather have an experienced probate attorney interpret a complex trust document than a judge who just got rotated from the criminal court to the probate court.

   d. Payment for Arbitrator's Services. Clients sometimes ask why they should pay for an arbitrator when the state will provide a judge for free. The answer: you get what you pay for. Arbitrators on the panel do not all have to be attorneys. For example, there could be an appraiser on the panel of arbitrators.

   e. Limited Appeal. There are limited rights of appeal from the arbitrator's decision. There is a "harmless error" standard of review—no remand or reversal occurs if any error is merely harmless error and would not impact the outcome of the case. The primary issue on appeal is whether evidentiary and procedural rules were followed properly.

   f. Combined Mediation and Arbitration. It is possible, though unusual, to have a combined mediation and arbitration proceeding. Mediation would occur first, and if not successful, the parties would move into arbitration. That is somewhat strange because information given to the mediator in confidence would then be used by the same individual in the arbitration proceeding.

g. Binding vs. Non-Binding Arbitration. Why would anyone consider nonbinding arbitration? (1) It forces the lawyers and parties to look at their cases earlier. (2) It gives the lawyers a neutral evaluation of their cases, and in that regard can help settlement. (3) It points out problems early in the case that one or more parties might have to face. All of that can happen before the parties spend a lot of money.

h. Drafting Arbitration Clause in Documents. The document should say more than "disputes shall be arbitrated." For example, there has been a big difference in using a standard three-person arbitration panel rather than a private arbitrator system.

The Task Force Report has sample arbitration clauses. An example that it includes of a short provision (for a jurisdiction that has enacted the Model Arbitration Act or an appropriate variant of it) is as follows:

> It is my hope and expectation that there will be no dispute in relation to this Trust [my estate]. Nevertheless, if there is any dispute among any of the Trust the [personal representative] and the beneficiaries involving this Trust [my estate] or its administration, the disputing parties may agree on the manner of resolution. If there is no such agreement, the disputing parties shall submit the matter to mediation, and, if the matter is not resolved by mediation, shall submit to binding arbitration pursuant to [Model Act]. In any arbitration, the disputing parties shall follow the procedures set forth in [Model Act], including a provision allowing for variance from the procedures in [Model Act] by agreement of all parties to the dispute. The Trustee [my Executor] shall have no liability to any beneficiary or other interested person for participating in or agree to any such procedure.

i. Requirements of Arbitrators. The document may list the requirements of arbitrators. For example, it might provide that the chief on the panel must be an attorney with at least five years of experience.

5. Selection of Mediators.

a. Evaluative vs. Facilitative Style. Consider the style of the mediator. The two major styles are evaluative or facilitative. An "evaluative" mediator hears out everyone, examines the briefs, and then helps the parties understand what will happen if the case goes to trial. "This is what will happen at trial and you are an idiot if you don't settle." A "facilitative" mediator helps the parties come together by sharing their concerns, but does not address what is likely to happen in litigation. As a practical matter, there will be some balance between these two approaches. Realize that just having the parties be able to tell their stories to someone other than their own attorneys (and the ability in the open session to talk to the other parties) is facilitative in its own right.

One of the panelists generally prefers facilitative mediations, and when serving as mediator, prefers the facilitative process. When he serves as mediator, he will tell the parties what he thinks of their case only if they want, but advises them to be careful what they ask for. However, when he is involved in a suit he will sometimes select an evaluative mediator if he thinks that he has a strong case. He likes using *retired judges* if he wants an evaluative mediator. If someone needs to hear bad news, hearing it from a former judge can do the trick.

Another panelist prefers the evaluative mediation approach. He finds that by raising questions about the substantive issues he can get cases started settling sooner. He thinks that he is not good at "getting people to sing and hold hands and then resolve complicated issues." That panelist does *not* like using *retired judges* as mediators. He feels they are too "black and white" and assert themselves as judges rather than mediators.

b. Retired Judges. Different perspectives on using retired judges are discussed in the preceding paragraphs. If a retired judge will be used, find someone that has experience *as a mediator* and has a good reputation *as a mediator*. You do not want to judge who will just quickly decide the case.

c. How Does Mediator Structure the Mediation? Ask the mediator how he or she handles the mediation process. As a practical matter, mediation takes a full day. If the mediator wants to begin at 2:00 PM and finish at 5:00 PM, do not use that person. (It can be helpful for parties to sit through a long day — and into the night — mediation to get a taste of what a five-day trial would be like.)

Some mediators will not schedule mediation for more than one day at time. They say that there is no reason that the matter cannot be settled in one day if the parties are prepared. If the mediation is not successful after a day, the parties can then decide whether they want to schedule another day. If two days are scheduled at the outset, after going through an entire day and possibly getting close to proposals under serious consideration, someone will say "it's 7:00 pm, let's break until tomorrow morning" and all of the momentum pointing toward settlement is delayed.

d. Consider Letting Opposing Side Select. If the attorney thinks that the case is very strong and that the other side has not heard the weaknesses of its case, consider letting the other side select the mediator so that the opposing attorney is more invested in the mediation.

6. Selection of Arbitrator. The primary ground for appeal from an arbitration is if the arbitrator fails to follow the rules of evidence or procedure. Make sure that at least one arbitrator on the panel is very knowledgeable of the rules of evidence and arbitration procedure. Otherwise, the arbitration result may be flawed because of procedural problems.

Select someone who is not afraid to make a decision. Some attorneys who are very good substantively are uncomfortable saying "party A is right and party B is wrong." Also, it is important to select an arbitrator who will make hard decisions and does not tend to just "split the baby."

7. Preparation and Types of Submissions. Mediators typically ask the parties to prepare brief (10 pages or less) summaries of the issues. Also, the brief should discuss the dynamics of the parties that may impact what the mediator needs to know to assist the parties in reaching a settlement. Overblown long summaries are not helpful. If there are key documents, submit those but only the key ones. These tend to be written in a more informal style than a legal brief.

Clients sometimes prefer to see a longer and more detailed mediation submission. This is their opportunity to vent and they want their attorneys to vent in as detailed a manner as possible

One panelist wants to see the Form 706 or at least a pro forma Form 706 when serving as a mediator in order to get some idea of the assets in the estate.

The parties should address up front whether the submissions will be confidential or not. The panelists generally prefer having confidential submissions when serving as mediators. They want straightforward submissions rather than submissions in which the parties are posturing with each other.

8. What Attorneys Attend the Mediation? In order to save costs, sometimes just the substantive attorney or the "chest pounding litigation attorney," but not both, attend the mediation. That can

present problems. If just a litigating attorney attends, he or she may not be able to discuss tax implications of the settlement or other substantive issues that may arise. If just the substantive attorney attends, he or she may be more reluctant to settle, for fear that the litigating attorney perceives that the other side took advantage of the substantive attorney.

9. Enforcement. Due to the confidentiality requirement, the mediator may be unable to testify if there are problems in enforcing the settlement reached at mediation. (One panelist laughed that the attorneys may be able to make more money fighting over what the settlement agreement says than trying the underlying case.) Once the mediation is concluded, "the mediator may not reenter the stage to participate in Act 3." However, the parties could agree that if there are any disputes regarding enforcement they are to be resolved by the mediator. (Both parties may have respect for the mediator and would want him or her to resolve any disputes.)

   If issues arise regarding the capacity of the party to enter into the agreement, the mediator would not be able to help resolve that dispute.

   The panelists recommended that attorneys bring draft settlement agreements with them. They can make changes as appropriate, but it is helpful to think through terms of the settlement agreement ahead of time rather than at 2:30 AM in the morning under pressure.

Interesting Quotations

1. Texting. A recent article says that the average teenager has 3300 texts per month. That is astounding — 100 per day.
2. Wealth Dispersion. A recent study of wealth in America indicates that the top 20% of the population hold 85% of the country's wealth and the bottom 40% own 0.5% of the wealth. –Beth Kaufman
3. Cures. "I used to be a schizophrenic, but after treatment, we're okay."
4. Grandparents and Private Schools. There is a very popular private school in Atlanta. The school says that half of the tuition payments come from grandparents.
5. Timing. "The reason for time is that everything doesn't happen at once." –Albert Einstein.
6. Rolling Over. Beneficiary to trust officer: "My husband would roll over in his grave if he knew how difficult you were making my life." The children say the same thing to the trust officer — because the trustee is too liberal in making luxury distributions. The trust officer responds: "My conclusion — I will never visit that graveyard. There's too much rolling around." –Trent Kiziah